Overview: Lending Operations and Portfolio Risk Management

Lending is the principal business activity for most savings associations. The loan portfolio is typically the largest asset and the most predominant source of income. As such, it is one of the greatest sources of risk to an association. Lax credit standards, poor portfolio risk management, or poor internal controls can expose an association to excessive loss. Effective management of the loan portfolio and the credit function is fundamental to an association's safety and soundness.

The risks associated with any specific lending program or activity will depend in large part on:

LINKS

Program

Questionnaire: Lending Overview

Questionnaire: Portfolio Diversification

- The extent to which the activity is in keeping with the strategic direction and risk capacity of the association
- How it fits in with the other activities of the association
- The adequacy of lending policies and procedures, underwriting and documentation practices, and pricing decisions
- Monitoring and reporting systems, and internal controls
- The experience and knowledge of staff
- Current and prospective market conditions
- Interest rates
- Financial condition of the association

Credit risk should be assessed across the entire loan portfolio and within the context of other noncredit related risks. A risk management system that provides the board of directors and management the ability to identify, measure, monitor, and control risks associated with an association's lending activities as a whole is essential and must be appropriate to the size, complexity, and risk profile of the association.

While this and other sections of this handbook focus largely on **credit risks** and risk mitigation factors for various types of lending programs, there are obviously a number of other risks associated with lending activities, such as interest rate risk, market risk, operational risk and compliance risk.

Management and the board of directors must ensure that lending activities are managed and evaluated in the context of the broad array of risks and their potential impact on the association's earnings and capital. For example, a loan portfolio that, although performing well financially, is riddled with operational or compliance problems (e.g. inaccurate truth in lending disclosures, deceptive marketing practices, RESPA problems) exposes the association to substantial legal, restitution, and ultimately reputation consequences.

This overview section presents guidance fundamental to all lending programs and overall loan portfolio and credit risk management. The subsequent sections and appendices provide comprehensive detail on prudent lending and risk management practices for specific lending programs. The sections completed during an examination will depend on the types of lending activity conducted at the association and the adequacy of portfolio risk management practices. This overview section might be the only one you use for the asset quality phase of the examination for some small or low-risk associations, or for completing the lending review during a risk-focused or targeted examination. However, you should consult with the examiner-in-charge (EIC) when making this determination.

In this overview section, we will focus primarily on the responsibilities of the board of directors and management in overseeing and managing the lending function of an association including:

- Strategic planning
- Portfolio diversification
- Lending policies:
  - Underwriting standards
  - Documentation standards
  - Credit administration
- Portfolio Risk Management:
  - Internal loan review
  - Management Information Systems
  - Internal controls

RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

Strategic Planning

The board of directors has the fiduciary responsibility for all of the activities of the association. The board is responsible for establishing the strategic direction and investment objectives of the association. An association's lending activities should be in keeping with the strategic direction of the association. When developing the lending strategies, the board and management should consider:

- The association's strategic plan and risk tolerances.
- The desired composition of the portfolio: loan product mix, portfolio diversification, loan quality goals, loan growth rates, etc.
- The association's defined and targeted market areas and market conditions within those areas.
- The size, financial condition and financial goals of the association.
- The expertise of its lending and credit administration as well as compliance personnel.
- Legitimate credit needs and nature of its community.

The board of directors is also responsible for establishing a lending framework and portfolio risk-management program consistent with the size, complexity, and risk profile of the association. Elements of a sound risk-management system include:

- Adequate board and management oversight.
- Adequate policies, procedures, and strategic lending goals including lending limits.
- Adequate portfolio monitoring, risk assessment, and management information systems.
- Comprehensive internal controls.

The board of directors relies on management to operate the association on a day-to-day basis. Thus, it must select a management team that is experienced and competent, and that will follow its guidance and directives.

Management is responsible for the day-to-day operation of the association and for implementing the policies established by the board in a manner consistent with safe and sound banking practices and in accordance with laws, regulations, and supervisory policies. Management is also responsible for providing timely and accurate reports to the board of directors, to OTS, and to any other applicable regulatory agencies, such as the SEC.

Portfolio Diversification

The board of directors should address diversification strategies as part of the strategic planning process, and its decision should be reflected in the board of directors' minutes, the association's lending and risk management policies, the annual budget, and the strategic business plan. A diversification policy should contain quantified goals and objectives that establish the composition of the loan portfolio mix and limits in dollar amount or percentage of assets for each loan type, category, or geographic area.

Loan portfolio diversification is a means of controlling and limiting overall credit risk. By prudently diversifying loans among different loan types, industries, borrower groups, and locations, the association can spread credit risk and limit losses that may arise from a regional economic recession, failure of a critical industry, or any factor affecting a group of loans having similar risk characteristics.

Limits and Guidelines for Concentrations of Credit

The board of directors should establish limits on and monitor the association's concentrations of credit. A credit concentration will typically relate to 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).

> It is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.

To evaluate both the need for diversification and collectibility of an association's loan portfolio, management should be alert to indicators of weakness in the markets served. Management should also be alert for indicators of actual or potential problems in the individual projects or transactions financed.

Indicators of potential or actual difficulties in local markets and projects may include:

- Increase in unemployment.
- High or increasing vacancy rates in the area.
- Numerous 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 local market, business, or project become more pronounced, problems with related credits may also surface.

In general, you should include in the Report of Examination concentrations that present a supervisory concern, for example, those that exceed 25 percent of core capital plus the allowance for loan and lease losses (ALLL) or two percent of total assets for undercapitalized associations. When loans have an especially high risk of loss, you should report lower levels of concentrations, such as ten percent of capital plus ALLL or one percent of assets. Moreover, it is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.

Loans-to-One Borrower

Multiple loans, or a very large loan, to one borrower, related entities, or a common enterprise, are a form of credit concentration. OTS regulation 12 CFR § 560.93 establishes a general 15 percent of an association's unimpaired capital and unimpaired surplus limit on loans-to-one borrower or a related group of borrows. The loans-to-one borrower (LTOB) regulatory limitations are an important safety and soundness standard intended to prevent financial institutions from concentrating too great a portion of their assets in any one borrower. (For further information on the LTOB limits, exceptions, and additional requirements, consult 12 CFR § 560.93 of the OTS regulations.)

Aggregate Limits on Loans Outstanding

In addition to establishing controls for credit concentration risks, savings associations should establish procedures and guidelines to monitor and limit the total volume of loans outstanding (usually expressed relative to deposits, capital, or total assets), primarily to ensure adequate liquidity. In setting such guidelines, the association should consider various factors such as credit demand, the volatility of the deposit structure, and availability of alternative funding sources.

Limits and Guidelines for Purchasing Loans

Associations that purchase whole and/or participation loans must thoroughly review such loans prior to purchase or commitment. The association's loan policies should address the acquisition of purchased or participation loans, establish standards for review, and require that such loans meet the underwriting, documentation, and compliance standards applied to loans originated by the association. When purchasing loans, the association may rely on the stated written underwriting standards of the originating lender, provided it performs a due diligence review of the purchased portfolio that includes a review of the loan portfolio's performance as well as a review of a statistically valid and representative sample of individual loans within the portfolio.

Major loan purchases should have board of directors or designated loan committee authorization. In addition, the association should determine the financial health and capability of the selling institution, and if the selling party retains the servicing of the loan, the association should ensure that all contracts require the selling party to administer the loan in accordance with prudent industry standards, and enable the association to change servicers if performance is inadequate. Finally, the policy should consider establishing aggregate limits on the amount of loans purchased from any single outside source.

Loan Policies

An association's loan policies, and underwriting guidelines and procedures should communicate and support the strategic objectives for the portfolio. The loan policy is the primary means by which senior management and the board guide lending activities. Although the policy primarily imposes standards, it is also is a statement of the bank's basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the lending activities in a manner consistent with the bank's strategic direction. Loan policy sets forth standards for portfolio composition, individual credit decisions, fair lending and compliance management.

The board of directors and management should formulate lending policies that are appropriate for the size and complexity of the association's existing and planned lending operations, and ensure that the association has sufficient staff with the expertise to originate, service, and monitor the lending programs and loan portfolio. Lending policies must be specific and detailed enough to foster prudent and compliant credit practices.

If properly formulated, communicated to all lending personnel, and monitored, a well-structured and prudent lending policy will serve to guide, direct, and control the decisions of lending officers consistent with safe and sound and compliant lending practices. Because each association is unique, no single policy can best serve all associations; rather, each association should tailor its policy and procedures to its own needs and characteristics.

It is an unsafe and unsound banking practice for a savings association not to have written well-defined policies and procedures in place for the type and complexity of its lending activity. The lending policy should include a statement of the general credit philosophy of the association (referencing the importance of compliance with consumer credit protection laws and regulations), portfolio diversification objectives, underwriting standards, loan structure and documentation standards, loan administration policies, risk mitigation strategies, and requirements for an internal monitoring and reporting system. OTS requires general lending standards for all loans under 12 CFR § 560.1(b). In addition, 12 CFR § 560.100-101 requires associations to have written real estate lending standards. (Examination Handbook Section 212 covers the latter standards in detail.)

The association's lending standards should:

- Clearly state the board of directors' objectives for the composition and risk of the loan portfolio, including the types of investments to avoid or exclude.
- Apply to loan purchases and loan participations as well as to loans originated by the association for portfolio and/or sale. ***The association may not transfer the responsibility for risk analysis to another lender. The association assumes the risk of noncompliance with consumer protection laws and regulations by another lender when acquiring loans.***
- Establish a system of internal controls, monitoring, and reporting.
- State the types of management and board reports for monitoring the association's lending activities, including delinquency and asset classification reports.
- Undergo review by the board of directors at least annually to ensure that policy remains appropriate as loan performance, market conditions, and regulatory obligations change.
- Set forth the composition of the loan committee(s), the frequency of meetings, and loan approval responsibilities.
- Require the board to ratify all significant loans either prospectively or through a series of subsequent reporting events.
- Require that loan review or other monitoring personnel systematically review all credit portfolios for consistency with established lending policies, and regularly review problem credits, identify problem relationships in a timely manner, and initiate remedial action.
- Establish loan authorities and prudent officer lending limits. Moderate limits are generally established for individuals, based on the officer's position, experience, and tenure with the association. Higher lending limits are typically allowed for groups of officers or loan committees.
- Set forth underwriting requirements including the extent of financial information necessary for the type and risk of the loan, acceptable collateral limits and the means for securing a lien against the collateral, and credit file content requirements, such as loan offering sheets, records of officer, committee, and board approvals, business and guarantor credit reports, financial statements and analysis, and memoranda supporting and/or criticizing the credit.

- Establish loan administration procedures for the servicing, collection, charge-off, and foreclosure of loans and establish guidelines to ensure that charge-offs are taken in accordance with interagency standards. Establish effective collection policies and procedures to reduce lending risk and prevent loan losses.

- Establish policies and procedures for the use of automated underwriting and credit scoring systems.

- Address standards for loans made as exceptions to standard underwriting requirements, paying particular attention to fairness in underwriting exception practices.

- Establish effective loan product pricing strategies consistent with sound financial planning.

Underwriting Standards

An association's first defense against excessive credit risk is the initial credit-granting process. Sound underwriting standards are key. The association's lending policies and procedures should include prudent underwriting standards to mitigate and manage credit risk. The application of sound underwriting principles to the lending process is essential to a high-quality loan portfolio.

Underwriting standards should be in keeping with the types of loans being originated. The extent of the credit evaluation needed to support the lending decision should be commensurate with the size and complexity of the loans. In today's environment, the underwriting process for certain types of credit (e.g., single-family mortgage loans, automobile financing and credit cards) is often highly standardized, automated and largely driven by secondary market requirements. For single-family mortgages, credit evaluation is often based on the borrower's credit score, debt to income ratios and the loan to value ratio. More complex lending (e.g., commercial and income property, agricultural and large consumer loans) is often not standardized and requires careful evaluation and consideration of the borrower's ability and willingness to repay the loan. Prudently underwritten loans should reflect consideration of all credit evaluation factors relevant to the type of loan, including:

- The borrower's *capacity*, or income from the underlying property or business, to adequately service the debt. (Note that in certain lending programs, including small balance consumer loans, or well-secured, low-documentation residential loans, the lender may assess the ability and willingness to repay from the borrower's credit history, collateral, and other factors.) The capacity to successfully repay debt is a critical consideration. It is important that the lender have a clear understanding of the purpose of the loan and the source of repayment so that it can be structured in a way that is consistent with realistic prospects of repayment. For business loans, the lender may determine capacity from income statements, debt coverage ratios, or cash flow analyses. For consumer loans, the lender may assess capacity from debt-to-income ratios, where the borrower's total monthly obligations are compared with gross income. The lender may use other methods. For example, if a borrower has difficulty documenting income, but has performed well on other loans of similar size with the association or with other lenders, the lender may determine that the borrower has demonstrated capacity.

- *Capital* or the money a borrower has personally invested in the property or business. How much does the borrower have at risk? Savings associations should consider the amount of equity in the property, capital invested in the business, and/or subordinated financing invested in the property or business by the borrower, guarantors or other interested parties, such as government agencies and partnerships in many CRA related investments. The association should ensure that borrowers have sufficient capital and cash flow to repay the loan even during economic downturns. Small businesses are often thinly capitalized and illiquid and may not have access to external sources of capital. Very often, the small business must rely on 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. Associations are encouraged to find ways to accommodate the small business credit needs in their communities without exposing themselves to excessive credit risk.

- *Collateral* or guarantees as an additional form of security against the loan. Collateral is a secondary source of repayment for a loan should the borrower become unable to repay. Generally, lenders require collateral when the purpose of the loan is to purchase or refinance real estate, automobiles, recreational vehicles, or long-lived business assets. In general, the longer the term or the greater the size of the loan, the more likely and appropriate it is for the lender to require collateral. Often lenders will also require collateral for smaller, short-term loans when the borrower has not established or has only marginal credit. The association should appropriately consider any secondary sources of repayment, including any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or take-out commitments.

  The association's lending policy should include an explanation of when collateral is required as well as loan-to-value or margin requirements, what constitutes acceptable collateral, and the means for perfecting liens against various collateral types. The association should generally not rely on collateral liquidation as the primary source of repayment. The association should base loan term and amortization on the economic life of the asset being financed, and take into account market price variances, depreciation, condition, usefulness, and any technological and functional obsolescence.

  When collateral is necessary or prudent to support the loan decision, sound banking practices require that the association obtain an accurate valuation of the security property. An appraisal or evaluation of the primary collateral for real estate loans should be in accordance with 12 CFR § 564. The association should also document its perfected security interest and the insurance policies protecting the collateral (such as hazard insurance, hurricane, flood, business interruption, etc.).

- *Character* or the overall creditworthiness of the borrower. A positive assessment of the borrower's character or willingness to repay is essential in the underwriting process. The borrower's payment record on existing and previous loans with the association, his or her credit history in general and reputation in his or her business or industry or community all provide evidence of the borrower's character and willingness to repay the loan and should be documented in the loan file. For most consumer loans, character is generally documented by the borrower's credit report and credit score.

- The *conditions* surrounding the loan. What is the purpose of the loan? How will the proceeds be used? What are the key economic factors that could contribute to the success or failure of a loan's repayment? The credit analysis should reflect consideration of such external factors as: area income-level; employment trends; vacancy rates; the market for the products or services of a business; the customer base; competition; any competitive advantage or disadvantage the business may have; the likely effect of national and local economic conditions on continued employment or the success of the business; and other factors that affect the borrower's ability to repay the loan.

- Conformance with consumer protection and fair lending laws.

You should closely scrutinize from both a safety and soundness and compliance perspective any underwriting standard that gives consideration to credit factors that are not directly relevant to the borrower's ability or willingness to repay the debt. The lending policies should provide clear and measurable standards that enable the lending staff to determine whether the loans comply with the association's underwriting standards.

Underwriting standards should address the following items:

Loan Types

Specific departmental lending policies should outline borrower qualifications and documentation standards for each type of loan offered and should take into consideration the economic composition of its entire market area.

Maximum Maturities

The association should establish realistic repayment plans for loans, including maturities that relate to the anticipated source of repayment, the purpose of the loan, and the useful life of any collateral. For each type of loan, the lending policy should state the maximum number of months for amortization or the maximum length of time to maturity. The association may also develop specific procedures for unique situations. For example, when making a home improvement loan to a borrower on fixed income, the association could offer extended terms or a loan with a balloon payment and option to renew.

Loan Pricing

The association's loan pricing should reflect the association's cost of funds, overhead, credit risk premium, and a reasonable profit, yet must be at a level that is competitive in the market. It is not uncommon to see some lenders adequately estimate their cost of funds and losses, yet fail to estimate the true servicing costs of the loans. Pricing models should also take into account the high degree of variance in loan losses and servicing costs associated with higher-risk lending programs, including subprime. In making such an assessment, management must ensure that risk-based pricing is applied equitably and does not result in pricing based on a prohibitive basis under the fair lending laws and regulations.

Guarantees

The lending policy should include guidance for guarantees and endorsements. Support from financially responsible endorser/guarantors can be an important factor in assessing the credit risk of a loan.

Loan-to-Value Ratios

An association should establish internal loan-to-value (LTV) ratio limits for all types of secured loans, and apply those standards consistently. Loan performance data has shown that borrowers are more likely to repay their loans when they have equity in the property securing them. OTS has not established LTV ratio limit guidelines for non-real estate lending activities. The absence of such guidance, however, does not reduce the need for an association to follow safe and sound business practices by establishing prudent internal LTV ratio limits.

For real estate lending activities, LTV limits should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (Appendix to 12 CFR § 560.101). Section 212 of the Examination Handbook provides additional guidance on real estate related LTV ratio limits.

Exceptions to Lending Standards

Some approved loans do not comply with an association's written loan standards. 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. Also, the board of directors is responsible for establishing standards for handling requests that do not meet articulated policy statements but are deemed worthy of consideration. 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 established policy. You should scrutinize policy exceptions to ensure management is not exercising them in a manner inconsistent with sound lending practices, including fair lending laws and regulations. Policy exceptions that thwart or diminish legislative or regulatory mandated consumer protections are never appropriate.

Loan Documentation Standards

An effective loan approval process establishes minimum requirements for the information and analysis upon which a credit decision is based. It provides standards for the documents needed to approve new credit, renew credit, increase credit to existing borrowers, and change terms in previously approved credits. It is important that an association's loan policies include loan documentation standards to help ensure that underwriters and approving officials have the necessary information to make prudent credit decisions. Furthermore, a properly documented loan file is needed to enable internal loan review staff, external auditors, and examiners to readily ascertain the quality of the loan and whether it was underwritten in compliance with board-approved policies. The inability of an independent third party to ascertain the loan officer's reasoning for approving a loan often indicates poor credit management and may be an unsafe and unsound banking practice.

Section 560.170 requires that the association establish and maintain loan documentation practices that:

- Ensure that the association can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

> Lenders should establish procedures to ensure that adequate documentation, consistent with the size and complexity of each loan transaction, is obtained and maintained.

Lenders should establish procedures to ensure that it obtains and maintains adequate documentation, consistent with the size and complexity of each loan transaction. The association should tailor the documentation for the various types of loans they originate. Below is a partial list of documents that associations should include in the credit files for various loans. Although the documents listed are generally appropriate for prudent lending, a rigid requirement that all these documents be present for each loan is too restrictive and does not take into account other mitigating factors.

- **Loan application** – should include the purpose of the loan and the identity of any security property. The borrower should sign the loan application. If not, there should be some form of acceptable verification that the borrower requested the loan (e-signature, phone verification etc.). Certain mortgage-related loan applications require the collection of government monitoring information.
- **Promissory note** – evidence of the borrower's obligation to repay the loan, executed by the borrower or agent.
- **Deed of trust or mortgage for real estate loans** – evidence of the creation of a security interest in the real property for the benefit of the lender, signed by the borrower (or agent).
- **Valuation Report** – a report prepared by a qualified individual or firm independent of the borrower (which may include a bank employee or agent) that discloses an estimate of the market value of the security offered by the borrower as collateral for the loan as of a specific

date. For valuations on real estate loans, refer to Examination Handbook Section 208, Appraisals.

- Financial Statement and Credit Report – should include a written credit report prepared by one of the credit reporting agencies and the borrower should sign the financial statement. The documents should be current at the time of application. Up-to-date and accurate financial information on each borrower is essential:

  — For individual borrowers seeking personal credit, a credit report and a statement of gross income may be all that is necessary. Financial statements are often requested for larger consumer loans and mortgages. In such cases, the financial information should reflect the borrower's financial condition as of the day of application.

  — For individuals or businesses seeking financing for a commercial or business venture:

    - Audited annual financial statements should be the most current available.

    - Unaudited financial statements should be signed and dated by the principals as close to the date of commitment as possible, but in all cases, within six months of the application or commitment date.

    - Tax return statements must be for the most recent tax year.

  The board of directors should establish the amount or type of loan that requires audited financial statements. For large loans, the association should require audited financial statements or ensure that staff verifies pertinent information in unaudited financial statements. For example, if a business reports real estate as one of its primary assets, the lender should verify ownership, determine that the value stated on the financial report is reasonable and that there are no undisclosed liens on the property. Likewise, if inventory is a significant business asset reported on the borrower's unaudited financial statement, the lender should perform an inspection of the business premises and ask to see the most recent inventory and monthly inventory reports. The lender should also perform a Uniform Commercial Code (UCC) search to determine whether those assets have already been pledged. Of course, such steps are only necessary where the presence of such assets is an important consideration in the loan decision.

  — Associations should review several years of financial statements and compare income and assets between periods. Loan personnel should carefully scrutinize borrowers whose income fluctuates considerably and insist on up-to-date financial information.

- Approval – approval sheet or committee minutes showing the officer(s) or committee responsible for reviewing and approving the loan request, and establishing the terms and conditions of the approval.

- **Disbursement** – use of a "proceeds schedule" disclosing date, amount, purpose, and recipient of the loan proceeds.

- **Title Policy/Opinion of Title/Uniform Commercial Code filings/or other filings that are appropriate in the local jurisdictions in order to perfect the security interest** – affirming the description, validity, and priority of the lender's lien on the collateral taken as security for the loan, and any continuing filings required to maintain the association's lien position.

- **Settlement Statement/Disclosure Statement** – evidence proving that the lender provided the borrower, upon closing, an application, a loan settlement statement and disclosure statement(s) (as appropriate) setting forth in detail the charges or fees payable by the borrower to the lender and any legal rights the borrower may have with respect to those charges or fees and the transaction in general.

- **Record of Payment** – showing the status and current payment of taxes, assessments, insurance premiums, other charges on the security of the loan, and documentation for any loss (and subsequent recoveries) on the loan security by an insurance settlement.

- **Evidence of hazard, flood, and other insurance policies** – maintenance of appropriate insurance policies that will protect the association from loss in the event of damage to or destruction of the collateral securing the loan. All applicable policies should list the savings association as a loss payee.

- **Modifications** – evidence of any changes to the loan or original security interest with the appropriate approval of each party.

- **Collateral Release** – evidence of any portion of the collateral pledged to secure the loan, showing the portion released, consideration (if any), documentation that the required pay down has been collected and cleared, and appropriate officer approvals.

With any type of lending, experienced and competent legal assistance is particularly important in developing a lending operation. Likewise, engaging the services of a professional compliance officer at the outset of development of a lending operation will significantly reduce any risk of noncompliance and will enhance the association's ability to adjust loan programs in the future without running afoul of consumer protection laws and regulations.

> Loan administration is perhaps one of the more complex areas of the association that requires strong management, experienced staff, and diligent oversight.

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.

Credit Administration

It is important that an association have a strong loan administration function, particularly when it is engaged in construction, nonresidential, or commercial lending. Loan administration includes loan closing and disbursement, payment processing, collateral administration and control, servicing and participation reports, and the timely receipt, review (both initially and ongoing, as needed), and follow-up of all borrower financial information.

Loan administration duties are much more involved for business, construction, and multifamily lending, so associations may have a separate loan administration department for these loans. Loan administration includes monitoring the borrower's periodic financial statements, determining ongoing collateral adequacy, and maintaining contact with the borrower to evaluate his condition and determine additional funding needs.

Loan administration is perhaps one of the more complex areas of the association that requires strong management, experienced staff, and diligent oversight. It is important that the association establish operating procedures and internal controls for the loan administration function in the following areas:

- Loan closing and disbursement; payment processing; escrow administration; and loan payoffs.
- Collateral administration and control, including type and frequency of collateral evaluations.
- Claims processing.
- Servicing and participation agreements.
- Type and frequency of financials statements reviews, including verification of information where appropriate.
- Segregation of duties (where appropriate).
- Collateral release; site inspections.
- Loan refinancing and modification procedures; collections and foreclosure procedures; and charge off and recovery policies.

Portfolio Risk Management: Internal Loan Review, Management Information Systems, and Internal Controls

Effective portfolio risk management requires managing credit risk across the loan portfolios, not just on a loan-by-loan basis. Effective risk identification starts with the evaluation of individual credits. Rating the risk of individual loans in timely credit evaluations is fundamental to loan portfolio management. The association should implement an internal loan review system to monitor the credit quality of the portfolio and compliance with or conformity to loan policies. The internal asset review (IAR) process should be separate and independent of the lending function. We discuss in detail the objectives and elements of effective internal loan review systems in Examination Handbook Section 260, Asset Classification, and Appendix A in Handbook Section 261, Allowance for Loan and Lease Losses.

To manage their portfolios, associations must understand not only the risks posed by individual credits but how the risks of individual loans, loan portfolio segments and the entire portfolio interrelate—and manage those risks accordingly. Effective loan portfolio risk management depends in large part on the quality of management information systems (MIS). Credit related MIS helps management and the board to fulfill their respective oversight roles. Considerations in effective management information systems are whether the right people are receiving the right information at the right time, and whether that information is up-to-date and accurate. Such information might include:

- Total loans and commitments by type, including new extensions, credit renewals and restructured credits.
- Loans in excess of existing credit limits.
- Aggregate exception tracking and reporting.
- Concentration or credit exposure monitoring reports (by type, geographic area, collateral, large employers, etc.).
- Delinquent and nonaccrual loans, and credits adversely graded.
- Stress testing results reports.
- Risk pricing models.
- Internal audit and loan review reports.

You should consider:

- Whether the association's risk monitoring practices and reports address all of its material risks.
- The appropriateness of key assumptions, data sources and procedures used.
- Accuracy and timeliness of reports to management and the board.

Another element of an effective portfolio risk management system is internal controls appropriate to the size and complexity of the association and the level of risk it accepts. The association should ensure that its lending operations are subject to strong internal controls (see discussion of Internal Controls in Examination Handbook Section 340).

Finally, an effective self-assessment compliance review program should verify that the association is complying with all applicable consumer protection laws and regulations.

SUPERVISORY REVIEW

You should assess to the extent to which the board of directors and management have in place the policies, processes and systems necessary to identify, measure, monitor, and control risk exposures within the loan portfolio. You should assess the extent to which management and the board of directors are able to evaluate and manage risk of individual credits, individual portfolios by loan type, and across the portfolio as a whole. The analysis of an association's lending operations and portfolio risk management should include a review of portfolio objectives and risk tolerance levels, portfolio diversification and concentrations, loan policies, loan administration practices, underwriting and documentation requirements, and internal credit portfolio risk systems, including internal asset review function, MIS and internal controls to evaluate the association's asset quality. Under a risk focused examination approach the degree of transactions testing should be reduced when internal risk-management processes are determined to be adequate or when risks are minimal. The maintenance of prudent written lending policies and effective internal systems and controls are essential to quality loan production. If an association has concentrations of credit, management should show a heightened degree of diligence in the review of controls and policies.

In evaluating the quality of an association's assets, follow the sampling guidelines in Examination Handbook Section 209. If the sampling review indicates significant asset quality concerns, it may be necessary to expand the review for one or more of the loan portfolios. Section 209 provides several sampling methods to limit the number of assets reviewed while mitigating sampling risks.

If further review is deemed necessary for any of the areas of lending, the sections in the Asset Quality chapter of this Handbook will guide you to perform an assessment of each of the association's lending activities, overall loan portfolio performance, and the adequacy of the ALLL.

You should also consider whether management has implemented an internal compliance review program that focuses on systems, monitoring, assessment, accountability, response, and training or a "SMAART" compliance review program. The SMAART framework is the cornerstone to assessing and managing compliance risk associated with an association's lending operations. (Refer to the Self-Assessment Guide and Examination Handbook Section 1100, Compliance Oversight Examination Program.)

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§1464(5)(c)(1)	Loans or Investments Without Percentage of Assets Limitations
§1464(5)(c)(2)	Loans or Investments Limited to a Percentage of Assets or Capital
§1464(5)(c)(3)	Loans or Investments Limited to 5 Percent of Assets

Code of Federal Regulations (12 CFR)

Part 560	Lending and Investment
§ 560.93	Lending Limits
§ 560.100-101	Real Estate Lending Standards
§ 560.160	Asset Classification
§ 560.170	Records for Lending Transactions
§ 561	Definitions
§ 563.41	Transactions with Affiliates
§ 563.43	Loans by Savings Institutions to their Executive Officers, Directors and Principal Shareholders
§ 563.170	Examinations and Audits; Appraisals; Establishment and Maintenance of Records
Part 564	Appraisals
§ 567.6	Risk-Based Capital

OTS CEO Memoranda

No. 137, Expanded Guidance for Subprime Lending Programs

No. 142, Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions

No. 222, Credit Risk Management Guidance for Home Equity Lending

Office of Thrift (OTS) Supervision Bulletins

RB 3b	Policy Statement on Growth for Federal Savings Institutions
TB 55a	Interagency Appraisal and Evaluation Guidelines
TB 70	Interagency Statement on Sales of 100% Loan Participations
TB 78	Classifying Commercial and Other Loans Under the HOLA
TB 79	Lending Limits Pilot Program

OTS Handbook Sections

Examination Handbook Section 1100, Compliance Oversight Examination Program

FFIEC Interagency Policy Statements

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (11/7/91)

Interagency Policy Statement on Credit Availability and Fair Lending Initiatives (06/10/93)

Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms (03/30/93)

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Specifies GAAP Accounting for Losses and Contingencies
No. 34	Capitalization of Interest Cost
No. 58	Capitalization of Interest Cost in Financial Statements that Included 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
No. 91	Specifies GAAP Accounting for Loan Fees
No. 114	Accounting by Creditors for Impairment of a Loan
No. 118	Accounting by Creditors for Impairment of Loans-Income Recognition and Disclosure – an Amendment to SFAS No. 114
No. 144	Accounting for the Impairment and Disposal of Long-lived Assets

American Institute of Certified Public Accountants Pronouncements

Practice Bulletin 1, Exhibit I, "ADC Arrangement"

AICPA SOP No. 92-3, Accounting for Foreclosed Assets

Other References

Federal National Mortgage Institution Underwriting Guidelines

Compliance Regulatory References

Fair Credit Reporting Act: 15 USC 1681-1681(u)

Truth in Lending Act: 12 CFR Part 226; FRB Reg Z

Real Estate Settlement Procedures Act: 12 CFR Part 3500; HUD Reg X

Homeowners' Protection Act: 12 USC 4901-4910

Consumer Leasing Act: 12 CFR 213; 15 USC 1667

Flood Disaster Protection Act: 12 CFR Part 572

Fair Debt Collection Practices Act: 15 USC 1692

Unfair and Deceptive Acts: 12 CFR Part 535; 15 USC 45

Homeownership Counseling Procedures: 12 USC 1701x(c)(5)

Electronic Banking: FFIEC Interagency Guidance on Electronic Financial Services and Consumer Compliance

Advertising: 12 CFR 563.27; Part 328 FDIC

Fair Lending and Nondiscrimination: 12 CFR Part 528

Equal Credit Opportunity Act: 12 CFR Part 202; FRB Reg B

Fair Housing Act: 42 USC 3601 et. Seq.

Home Mortgage Disclosure Act: 12 CFR Part 203; FRB Reg C

Lending Overview

Program

EXAMINATION OBJECTIVES

To identify the savings association's strategic lending plan and risk tolerance levels.

To identify the savings association's loan portfolio diversification strategies, and limitations and guidelines for credit concentrations.

To identify the asset quality programs that you should complete in order to properly evaluate the association's lending function.

To determine the adequacy of policies, practices, procedures, and controls regarding the association's lending activities.

To assess management's and lending personnel's conformance with established policies and procedures.

To assess the adequacy of the association's portfolio risk management practices and systems relative to the size and complexity of the association's lending activities.

To assess the accuracy, timeliness and sufficiency of management and board reports.

To evaluate the overall risk profile of the loan portfolio for credit quality, collectibility, and sufficiency of loan collateral.

To assess the scope and adequacy of the internal asset review function.

To ensure compliance with applicable laws and regulations.

To identify the overall strengths and weaknesses of the lending function(s).

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

EXAMINATION PROCEDURES

The examination procedures in this section help examiners accomplish the above objectives and to guide the asset quality review while avoiding duplication of effort within the various loan related programs by facilitating an exchange of information and examination results between examiner(s) responsible for various asset quality sections.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Lending Overview
Program

WKP. REF.

LEVEL I

1. Review the PERK information, the scoping material, and electronic loan data related to this area.

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

3. Discuss with management their lending activities, strategies, portfolio diversification and risk tolerance levels; future lending plans; portfolio risk management practices; and portfolio performance and quality, including any problems such as unusual delinquency levels, operating costs, etc., relating to its lending programs or activities.

4. Determine that the savings association's lending policies comply with the following:

   - Are in writing.
   - Are approved by the board of directors.
   - Consistent with the association's strategic plan, risk tolerance, staff expertise and diversification guidelines.
   - Promote safe and sound lending.
   - Are adequate for the type and volume of lending.
   - Where applicable, comply with 12 CFR § 560.100-101.

5. Determine that the association's portfolio risk management practices:

   - Provide for timely and accurate board reporting.
   - Ensure that reviews and reports address all of the association's material risks.

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- Provide for strong internal controls.
- Rely on appropriate key assumptions, data sources and procedures.

6. In conjunction with the Examiner-In-Charge (EIC) or examiner(s) performing the board and management reviews (Examination Handbook Sections 310 and 330) determine who will review the loan committee minutes and board reports (or equivalent) and report their findings to the examiner(s) responsible for asset quality.

7. Review the association's loan portfolio (including electronic loan data, Uniform Thrift Performance Report (UTPR), board reports, etc.) to determine the type and volume of lending that the association engages in and that the portfolio conforms to regulatory limits including loans to one borrower (LTOB), loan policies and diversification strategies.

8. Be alert to:

- Identified problems within the various portfolios.
- Portfolios with low credit scores, poor performance, or lax underwriting standards.
- Concentrations of risk.
- Internally classified loans.
- Significant delinquency trends.
- Any large increase in lending since the preceding examination.

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9. If the association has a mortgage banking operation, the EIC or assisting examiner(s) responsible for asset quality should coordinate the overlapping loan underwriting policies and procedures with the examiner(s) assigned the review of secondary marketing and servicing to avoid duplication of efforts and ensure an exchange of information.

10. The EIC or assisting examiner(s) responsible for asset quality will coordinate the sampling of loans within each portfolio in accordance with Section 209, Sampling, and the responsibilities of Section 260, Classification of Assets.

11. Determine that management reconciles all loan trial balances, including undisbursed loan proceeds (LIP) and contingency and escrow accounts to the general ledger and reviews reconciling items for reasonableness. Also, determine if there are any unusual or old unreconciled items.

12. Compare electronic loan data balances with balances reported on the Thrift Financial Report. Have association personnel reconcile significant variances.

13. In conjunction with the examiner(s) performing the review of the audit programs (Sections 340, 350, and 355) and internal loan review system, review the scope and depth of the work performed by the various parties in the various lending areas, with specific emphasis on high-risk areas. Obtain a list of any deficiencies noted in their latest review.

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14. In conjunction with the examiner’s review of the associations compliance management and compliance self-assessment programs, identify any material compliance deficiencies and their impact on the risk or overall quality of the lending operations.

15. Based upon these results, assign the appropriate asset quality programs for review and completion. Specifically, the review should focus on evaluating the association’s major areas of risk in order to assign a supportable asset quality rating and render a conclusion regarding the adequacy of loan policies, credit administration, internal asset review, and the allowance for loan and lease losses.

LEVEL II

1. Based upon Level I examination procedures of the asset quality programs assigned, expand scope when deemed necessary.

2. Coordinate the completion of the various lending questionnaires for each program completed.

3. Ensure that your review meets the Objectives of this and the other assigned asset quality handbook sections. State the findings and conclusions in the Report of Examination.

EXAMINER’S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Lending Overview

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 accomplish the following:		
• Clearly state the board's general credit philosophy?	☐	☐
• Establish loan authority of committees and individual lending officers?	☐	☐
• Define the duties and responsibilities of the loan officers and loan committee?	☐	☐
• Define acceptable types of loans and collateral?	☐	☐
• Establish maximum loan terms and amortization requirements for various types of loans?	☐	☐
• Establish loan pricing objectives?	☐	☐
• Applies loan underwriting standards to loans purchased and participation loans? (The association cannot delegate this responsibility to another lender.)	☐	☐
• Establish minimum financial information required before the closing of the loan? (The level of data will vary depending on loan type and portfolio.)	☐	☐
• Establish policies for any automated underwriting and credit scoring standards in use?	☐	☐
• Establish a written appraisal policy in conformance with 12 CFR § 564 and Section 208 of the Examination Handbook?	☐	☐
• Establish documentation standards for underwriting analysis and approval decisions?	☐	☐
• Establish written collection standards?	☐	☐

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		Yes	No
2.	Does the association review its loan underwriting policies and procedures at least annually and does management determine if the loan underwriting policies and procedures are congruent with changing market conditions?	☐	☐
3.	Does the association have review and approval procedures for all reports before submission to the board or its committee?	☐	☐
4.	Do management reports include the following items:		
	• A recap of new lending by portfolio and type?	☐	☐
	• A listing of loan commitments and other contingent liabilities?	☐	☐
	• A detailed loan performance and asset classification report?	☐	☐
	• A listing of other loans and assets requiring special attention?	☐	☐
	• A listing of concentration risks?	☐	☐
5.	Has the association established minimum documentation standards for each loan type?	☐	☐
6.	Do loans on all borrowers contain the following information:		
	• Written applications for all loans that show the purpose of the loan?	☐	☐
	• The planned repayment schedule?	☐	☐
	• The disposition of the loan proceeds?	☐	☐
	• Disbursement authorizations?	☐	☐
	• Credit and trade checks on the borrower?	☐	☐
	• Signed financial statements (including income statements, W-2, tax returns, and other sources or repayment) for the borrower, guarantor, and significant related parties?	☐	☐

	Yes	No
• Collateral evaluations where applicable?	☐	☐
• Lien releases where applicable?	☐	☐
• Written credit memorandum or approval form supporting the loan decision and attesting that the loan meets the institution's underwriting guidelines or is an approved exception loan?	☐	☐
• Information on the borrower's other loan and depository account relationships?	☐	☐
• Other pertinent documents or correspondence relating to the loan?	☐	☐
7. Does the association maintain a system to ensure that it requests and receives current financial information for commercial borrowers whose loan repayment is dependent on business income?	☐	☐
8. Does the association require submission of audited financial statements based on dollar amount of commitment or other criteria? If so, state the requirement. _____ _____	☐	☐
9. Does the association perform a credit investigation on proposed and existing borrowers?	☐	☐
10. Does the association require that all loan commitments be in writing?	☐	☐
11. Does the association review and update lines of credit at least annually?	☐	☐
12. Does the association check borrowers' outstanding liabilities to appropriate lines of credit before granting additional advances?	☐	☐
13. Is the administrative system independent of the lending function (it may be a function of the loan servicing or internal audit department) that covers each department and accomplishes the following:		

		Yes	No
	• Reexamines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?	☐	☐
	• Determines that loans are in compliance with loan policies and are within the association's lending authority?	☐	☐
	• Determines that the loan officer initially approves the loan?	☐	☐
	• Ascertains that loans to corporations are within the limitations set for the borrower by corporate resolution?	☐	☐
	• Ascertains that loans are within loans to one borrower limits?	☐	☐
	• Rechecks the preparations of maturity and interest notices?	☐	☐
	• Ensures that personnel follow procedures to protect notes and documents from theft or damage?	☐	☐
	• Maintains a tickler file that will give at least 30 days advance notice before expiration of hazard insurance, public liability insurance, flood insurance, and take-out commitments?	☐	☐
	• Confirms collateral and loans with customers on a test basis?	☐	☐
14.	Has the association established an adequate system to maintain loan documentation, including a checklist to ensure that the institution received required documents and that they are on file?	☐	☐
15.	Does the association ensure that a person who does not handle cash examines and prepares entries to various general ledger and other loan controls?	☐	☐
16.	Does the association prohibit loan officers from processing loan payments?	☐	☐
17.	Does the association segregate and identify records and files for serviced loans?	☐	☐
18.	Does a person who does not issue checks or drafts or handle cash prepare and test loan fee and interest income?	☐	☐

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		Yes	No
19.	Does the association reconcile subsidiary loan records daily with the appropriate general ledger accounts?	☐	☐
20.	Does a person who does not handle cash investigate reconciling items?	☐	☐
21.	Does the association mail to borrowers, at least annually, a detailed statement of account balances and activity?	☐	☐
22.	Does the association have a loan review section, or the equivalent?	☐	☐
23.	Does the association retain loan records in accordance with their record retention policy and legal requirements?	☐	☐
24.	Does the association microfilm, scan, or otherwise record new notes daily?	☐	☐
25.	Does the association maintain records in sufficient detail to generate the following information by type of advance:		
	• The cost of funding loans?	☐	☐
	• The cost of servicing loans, including overhead?	☐	☐
	• The cost factor of probable losses?	☐	☐
	• Profit margin for each loan program?	☐	☐
26.	Overall, are the association's underwriting policies, procedures, and controls adequate to prevent unsafe and unsound lending practices?	☐	☐

Comments

____

____

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Portfolio Diversification

Questionnaire

	Yes	No
General Questionnaire		
1. Does the association have written goals and objectives for loan portfolio diversification?	☐	☐
2. Does the policy include the following items:		
• Aggregate limits by type of loan and portfolios?	☐	☐
• Limits for loans to one borrower?	☐	☐
• Aggregate limits on loans purchased and sold, including those from a single source?	☐	☐
• Concentration limits for credit within specific industries?	☐	☐
• Geographic lending areas?	☐	☐
• Pricing, term, and collateral requirements for all types of loans?	☐	☐
• Guidelines for loans to affiliated persons, organizations, and industries?	☐	☐
• Standards of staff expertise in the various lending areas in which the association is active?	☐	☐
• Maximum advances as a percentage of collateral value or purchase price?	☐	☐
• Minimum down payments and/or equity for various loans offered?	☐	☐
3. Is the loan policy compatible with business plan and conditions?	☐	☐
4. If the association does not have a written policy that addresses loan portfolio diversification and/or concentrations, ask management to elaborate upon the following:		
• The percentage of loans to assets/deposits that the association strives to maintain.	☐	☐
• Portfolio composition goals.	☐	☐

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	Yes	No
• The geographic areas where the association originates or purchases loans.	☐	☐
• Concentrations identified by association personnel.	☐	☐
5. Do these concentrations expose the association to more than acceptable risk? If yes, provide an explanation. ______	☐	☐
6. What efforts has the association taken to reduce risky concentrations and/or minimize credit concentration risk? ______		
7. Has management considered the need to employ personnel with specialized experience when needed?	☐	☐
8. Despite written or unwritten policies, has the association instituted controls to monitor the following types of concentrations:		
• Loans to one borrower?	☐	☐
• Loans dependent upon one industry?	☐	☐
• Loans to consumers working for the same employer or the same industry?	☐	☐
• Loans to commercial companies that are dependent on the same manufacturers or suppliers, or sell to the same customer?	☐	☐
• Loans dependent on one crop or herd?	☐	☐
• Loans predicated on the collateral support afforded by a debt equity issue of a corporation?	☐	☐
• Loans considered out of their normal lending area?	☐	☐
• Loans purchased or sold from specific sources?	☐	☐
• Loan participations purchased and sold from specific sources?	☐	☐

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		Yes	No
9.	What management reports does the association use to monitor these various concentrations of credit? ____________		
10.	Does the board of directors or equivalent committee receive these same reports to review?	☐	☐
11.	Are there areas of the loan portfolio mix that the institution anticipates changing in the next 12 to 24 months? If yes, state dollar and percentages. ____________	☐	☐
12.	Does management anticipate introducing a new loan product within the next 12 to 24 months?	☐	☐
13.	Does management anticipate originating or purchasing loans from any new geographic locations?	☐	☐
14.	What means does the association use to monitor the economic conditions of loans in territories outside its lending areas? ____________		
15.	List the sources from which the association purchases a significant volume of loans. ____________		
16.	If a concentration exists predicated upon a particular industry, does the association make a periodic review of industry performance and trends?	☐	☐
17.	If a concentration exists predicated on a particular crop or herd of livestock, does the association attempt to diversify the inherent potential risk by means of participations or arrangements with government agencies such as guarantees or lending arrangements?	☐	☐
18.	Describe any risk reduction efforts and factors besides diversification that the association uses to limit risk from concentrations. ____________		

Yes No

Comments

Real Estate Appraisal

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.

LINKS
Program
Questionnaire
Appendix A

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 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

[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.

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 association 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 explains 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 institution 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 appraisal: (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. Beginning 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)

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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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Reviewed By:	
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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

1. Complete appraisal line sheets, either as a separate review procedure or in conjunction with the completion of the One- to Four-Family Residential Real Estate 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.

2. From discussions with examiners assigned to the Classification of Assets, Lending Overview, and One- to Four-Family Residential Real Estate Lending programs, determine the need to review:

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

3. 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

1. 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.

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

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
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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? ☐ ☐

   (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? ☐ ☐

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	Yes	No
— 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?	☐	☐
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?	☐	☐

	Yes	No
• 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? ______________________		
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:		

Exam Date: ______________
Prepared By: ______________
Reviewed By: ______________
Docket #: ______________

	Yes	No
• report all three approaches to value, or contain an explanation that supports the omission of one or more approaches?	☐	☐
• 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?	☐	☐
• 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?	☐	☐

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
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	Yes	No
— 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"?	☐	☐
• "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?	☐	☐

Exam Date: ____________
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	Yes	No
• do operating expenses appear reasonable?	☐	☐
• 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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Exam Date: ____________

Prepared By: ____________

Reviewed By: ____________

Docket #: ____________

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.

Sampling

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:

LINKS
Program
Appendix A
Appendix B
Appendix C
Appendix D
Appendix E

- 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 Examination 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

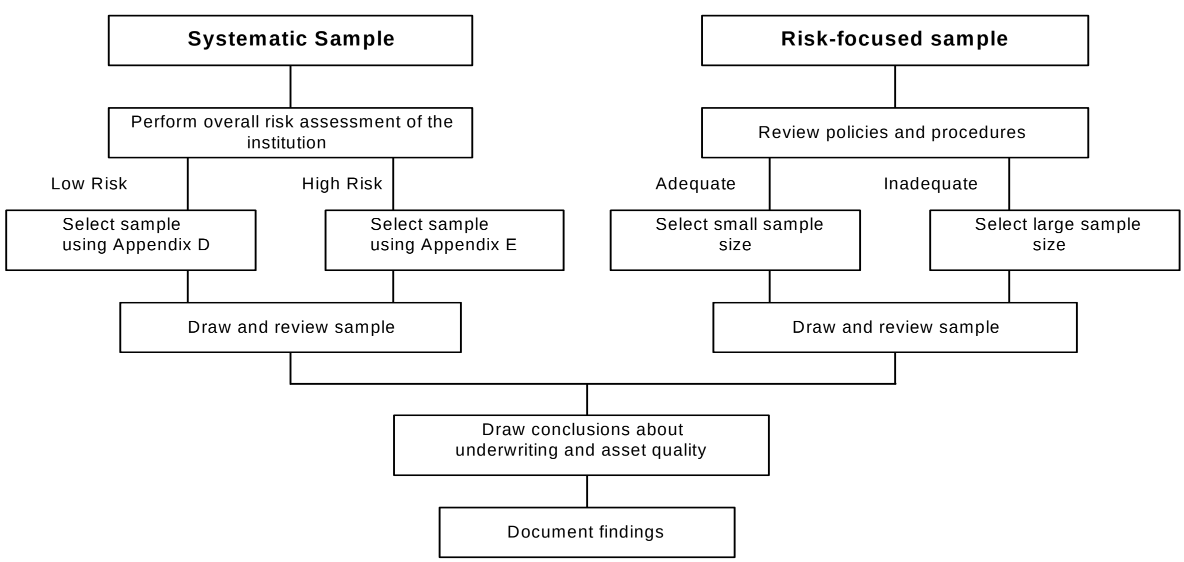
Institutional Risk Profile	Low Risk	High Risk
Adequate Underwriting Policies and Controls	**Minimum**	**Larger**
Inadequate Underwriting Policies and Controls	**Larger**	**Largest**

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 there is a trend and whether material non-compliance 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:

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[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.

[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.

- 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 under-written 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.

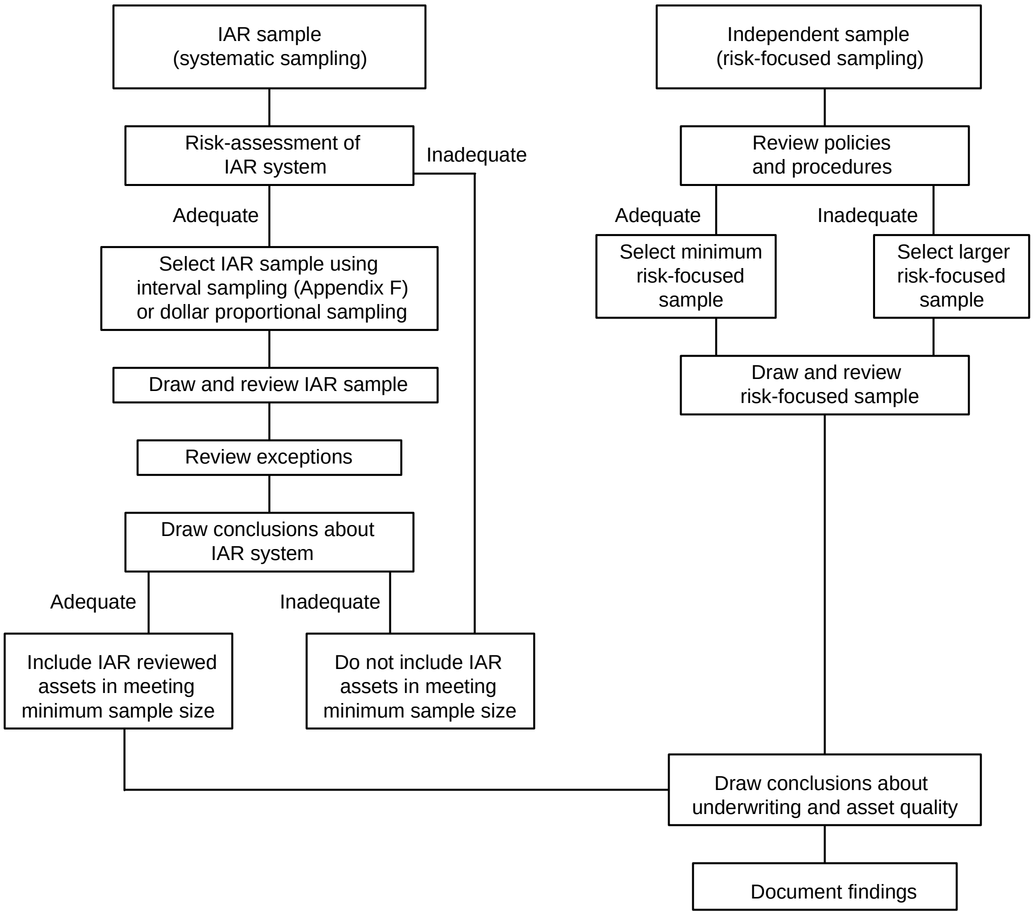
SAMPLING METHODOLOGIES FOR NON-HOMOGENEOUS ASSETS

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 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.

Exhibit 3
Sample Selection for Non-Homogeneous Assets



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. Attachment 1 of Appendix A to Section 261, Adequacy of Valuation Allowances, provides 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 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

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)

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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.

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WKP. REF.

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

For homogeneous assets reviewed under the institution's IAR program, determine whether the institution's classifications are based primarily on delinquency status. 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.

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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.

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.

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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.

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.

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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.

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.

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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

Exam Date:	
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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 certain 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 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 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.

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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 Examination 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 Examination 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.

Loans To One Borrower

Lenders create a form of concentration risk when they extend a significant amount of credit to any one borrower or to borrowers who are related in a common enterprise. As such, savings associations are subject to regulatory limitations on loans to one borrower (LTOB), as specified in 12 CFR § 560.93. Borrower lending limitations are a critical safety and soundness standard enacted by Congress to prevent federally insured banks and savings associations from placing themselves at risk by concentrating too great a portion of their assets in any single borrower.

A savings association's compliance with the regulatory limitations, however, does not diminish regulatory scrutiny over high risk loans within the legal lending limit nor does it relieve the association's board of directors from exercising due diligence. While the LTOB regulation places a limitation on the aggregate dollar amount of an association's loans to each "borrower," it does not limit the number of loans to any one borrower with that aggregate dollar limitation.

LINKS
Program

Management must ensure, and examiners should verify, that lending staff is conversant with the lending limitations applicable to savings associations, that the lending limitations are clearly set forth in underwriting guidance, and that management's practices, recordkeeping and internal controls regarding LTOB limits are adequate and provide a high degree of confidence that the association is in compliance with LTOB regulatory requirements.

This Handbook Section provides an overview of the LTOB regulations applicable for federal savings associations and various exceptions that authorize associations to exceed the LTOB limits.

Overview

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 revised the LTOB requirements for savings associations (HOLA 5(u)) to parallel the lending limitations applicable to national banks. Section 5200 of the Revised Statutes, (12 USC 84), establishes lending limits measured as a percentage of an institution's capital and surplus. The Office of the Comptroller of the Currency's (OCC) implementing regulations are located at 12 CFR Part 32. OTS codifies these requirements for savings associations in its regulations at 12 CFR § 560.93 and incorporates the lending limits of 12 CFR Part 32.

Section 560.93 of the regulations applies to loans and extensions of credit made by a savings association and its subsidiaries. It does not apply to loans made by a savings association or its GAAP-consolidated subsidiary to subordinate organizations or affiliates of the savings association. The terms *subsidiary,* *GAAP-consolidated subsidiary, and subordinate organization* have the same meanings as specified in 12 CFR § 559.2. The term *affiliate* has the same meaning as specified in 12 CFR § 563.41.

General Lending Limit

Under the general lending limitation an association's total loans and extensions of credit outstanding to one borrower at one time shall not exceed 15 percent of the association's unimpaired capital and unimpaired surplus. The savings association can have an additional ten percent for loans and extensions of credit fully secured by readily marketable collateral having a market value, as determined by reliable and continuously available price quotations, at least equal to the amount of the funds outstanding. To qualify for the additional ten percent limit, the association must perfect a security interest in the collateral under applicable law, and the collateral must have a market value at all times of at least 100 percent of the loan amount that exceeds the 15 percent general limit.

Under the general lending limitation an association's total loans and extensions of credit outstanding to one borrower at one time shall not exceed 15 percent of the association's unimpaired capital and unimpaired surplus.

The Director of OTS may impose more stringent restrictions on a savings association's loans to one borrower if OTS determines that such restrictions are necessary to protect the safety and soundness of the association under the HOLA at 12 USC § 1464(u)(3).

Calculation of General Lending Limit

To calculate an association's general lending limitation you should utilize the most recent Thrift Financial Report filed with the OTS prior to the date of granting or purchasing the loan (unless there has been a significant change in capital). The general lending limit is 15 percent of unimpaired capital and unimpaired surplus, which are defined as: core capital and supplementary capital included in total capital, plus any Allowance for Loan and Lease Losses (ALLL) not included in supplementary capital, plus the amount of investment in, and advances to, subsidiaries not included in calculating core capital.

EXCEPTIONS TO GENERAL LENDING LIMIT

$500,000 Exception

If a savings association's general lending limitation, as calculated above, is less than $500,000, such savings association may have total loans and extensions of credit, for any purpose, to one borrower outstanding at one time not to exceed $500,000.

Statutory Exceptions

The following exceptions to the lending limits, as set forth in 12 USC 84 and 12 CFR Part 32, are applicable to savings associations in the same manner and to the same extent as they apply to national banks.

Loans Subject to Special Lending Limits

In addition to the amount allowed under the general lending limit, the following loans have special lending limits under 12 CFR § 32.3, subject to the qualifications in that section:

- Loans secured by bills of lading – 35%
- Discount of installment consumer paper – 10%
- Loans secured by documents covering livestock – 10%
- Loans secured by dairy cattle – 10%.

Refer to 12 CFR § 32.3(b) for a full discussion.

Loans Not Subject to the Lending Limits

Section 32.3 also defines loans that are not subject to the lending limits, provided they meet the qualifications in the subsections of 12 CFR § 32.3(c). Refer to 12 CFR § 32.3(c) for a detailed discussion. Such loans are as follows:

- Loans arising from discounts of negotiable commercial paper that evidences an obligation of the person negotiating the paper.
- Banker's acceptances.
- Loans secured by U.S. obligations.
- Loans to or guaranteed by a federal agency.
- Loans to or guaranteed by a general obligation of a State or political subdivision.
- Loans secured by segregated deposit accounts in the lending institution.
- Loans to financial institutions with permission of the OTS Director.
- Loans to the Student Loan Marketing Association.

- Loans to industrial development authorities, which will be deemed a loan to the lessee.

- Loans to leasing companies, where a security interest in the leases is perfected and several other conditions are met.

Exception for Loans to Develop Domestic Residential Housing Units

Pursuant to 12 CFR § 560.93(d)(3), a savings association may make loans to one borrower to develop domestic residential housing units, not to exceed the lesser of $30,000,000 or 30 percent of the savings association's unimpaired capital and unimpaired surplus, including all loans made under the general lending limit, provided that:

- The association must be, and continue to be, in compliance with its capital requirements pursuant to 12 CFR Part 567.

- If the association falls out of compliance with this capital requirement it may no longer avail itself of this exception until it again qualifies and, if eligible, submits a notice or, if ineligible for the notice procedure, applies for and receives approval from the Regional Director. OTS will permit lenders to continue funding a legally binding loan commitment made under this exception if the association should fall out of compliance with its capital requirement, provided such binding commitment to the borrower was made when the association was in capital compliance.

- A savings association eligible under 12 CFR Part 516 for using the notice procedure must submit a notice prior to using the higher limit and must have received a written approval by the Regional Director. An association that is not eligible under 12 CFR Part 516 to file a notice, must submit an application to the Regional Director requesting prior approval to use the exception for domestic residential housing development.

- Such approvals do not constitute a "waiver" of the LTOB limits, but merely permission to use the exception under 12 CFR § 560.93(d)(3), and may contain additional requirements or set forth additional conditions or restrictions governing the exercise of this exception.

- All loans made under this exception are limited in the aggregate to 150 percent of the savings association's unimpaired capital and unimpaired surplus.

- Loans made by an association under this exception must comply with the loan-to-value requirements applicable to federal savings association under 12 CFR § 560.101.

Definitions

"Residential housing unit" has the same meaning as the term *residential real estate* in 12 CFR § 541.23, which means: 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; or leasehold interests in the above real estate.

“Single-family dwelling unit” has the meaning set forth in 12 CFR § 541.25.

The term “domestic,” as used in this section, includes units within the fifty states, the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and the Pacific Islands.

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:

- Acquisition, development, and construction
- Development and construction
- Construction
- Rehabilitation
- Conversion.

Domestic residential housing units must be the end product. The acquisition of real estate for holding or for later developing does not fulfill the requirement of this exception.

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

Guidelines for Approval of Use of Exception For Domestic Residential Housing Development

A Regional Director may provide a blanket approval for an association 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 association.

Notices and applications for approval must include sufficient information to permit a thorough evaluation of the merits and risks of approving the higher LTOB limits.

Notices and applications for approval of use of the exception for domestic residential housing development will be processed in accordance with Section 820 of the Applications Processing Handbook, Lending Exceptions - Loans to One Borrower.

SPECIAL LENDING LIMITS FOR ONE- TO FOUR-FAMILY RESIDENTIAL LOANS, SMALL BUSINESS LOANS, AND SMALL FARM LOANS

> The special lending limits program allows banks and savings associations to request expanded LTOB lending authority up to an additional ten percent of unimpaired capital and unimpaired surplus.

In 2001, the OCC, recognizing that many states have higher limits for the banks they charter, implemented a pilot program for one- to four-family (1-4) residential real estate and small business loans to allow national banks to compete more effectively with state-chartered banks. The pilot program was extended for an additional three years in 2004 and also amended to include small farm loans to the loans eligible for the special lending limits. In June 2007, OCC published an interim final rule that removed the expiration date from the program. Because the lending limits of 12 CFR Part 32 is incorporated in OTS's lending limits at 12 CFR § 560.93, eligible savings associations may participate in the special lending limits under this program.

The Rule

The OCC's special limits provision for 1-4 family residential loans, small business loans, and small farm loans is codified in 12 CFR § 32.7. You should read it carefully. This Handbook Section only clarifies some eligibility and application procedures for savings associations to use this program.

The program covers perfected first lien 1-4 family residential (either owner-occupied or not) real estate mortgages in the amounts that do not exceed 80 percent of the appraised values of the collateral at the time the loans are made, small business loans, and small farm loans.

For 1-4 family residential mortgages, the lending limit under the program for approved OTS institutions is based on the state's lending limit for state-chartered banks for residential real estate loans or unsecured loans. For small business and small farm loans, the lending limit is based on the state's lending limit for state-chartered banks for small business, small farm, or unsecured loans. In general, the expanded limits are available for commercial loans as described in the instructions for the Thrift Financial Report, and small farm loans as defined below. [1]

The lending limits of 12 CFR § 560.93 and 12 CFR Part 32 are limits on loans that a savings association may make to one borrower. The limits do not affect the percentage of assets or capital lending and investment limits specified in the Home Owners' Loan Act. The lending limits of the state where the approved savings association's home office is located establish the limits for the institution, regardless of the state in which the borrower or branch is located.

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[1] OCC defines farm loans as: "loans or extensions of credit secured by farmland (including farm residential and other improvements) or loans or extensions of credit "to finance agricultural production and other loans to farmers."

Loans or extensions of credit made under this program must be secured by residential real estate, or must be small business or small farm loans. The residential loan needs to be a first lien and not exceed 80 percent of appraised value. The small business and small farm loans are to be full documentation loans and not to be originated under a low documentation program.

In addition to amounts that it can already loan under the general lending limits, an approved savings association may make qualifying 1-4 family residential, small business, and small farm loans to a single borrower, that are the lesser of:

- Ten percent of its unimpaired capital and surplus, or
- The percentage of its capital and surplus, in excess of 15 percent, that a state bank is permitted to lend.

Additionally:

- The total outstanding amount of all loans and extensions of credit to any one borrower cannot exceed 25 percent of the savings association's unimpaired capital and surplus, and
- The additional outstanding amount of loans and extensions of credit to all borrowers made under this program cannot exceed 100 percent of the savings association's unimpaired capital and surplus.

Eligibility

An eligible savings association is "well capitalized," has a composite rating of 1 or 2 in connection with its most recent examination or subsequent review, and has a rating of at least 2 for both asset quality and for management, and typically will have experience and expertise in making loans of the types for which it is applying for the additional lending authority.

Application Process

This program is intended for well-capitalized savings associations who compete with state chartered institutions that have higher single borrower limits. The association must file an application and receive prior approval from its Regional Office before using the program's special lending limits. The application must include a certification that the institution is eligible, a citation to the relevant state law or regulation, a copy of the written resolution by the majority of the board of directors approving of the use of the program's special lending limits, and a description of how the board will oversee the use of the special lending limits. Specific guidance on the details of the application procedures and the approval process is located in Section 850 of the Applications Processing Handbook.

This program is directed towards savings associations with a proven management team and board of directors, stable operations, and a demonstrated history of prudent lending over an extended period of time. The Regional Office may approve a completed application if it finds that the savings association meets the requirements of the program and the approval is consistent with safety and soundness.

Savings associations that were approved under the pilot program continue to be approved under the expanded program unless they become ineligible or are advised otherwise by their Regional Office.

Regional Offices have the discretion to deny an application from a savings association whose past performance or current credit culture raise questions or concerns regarding its ability to operate in a safe and sound manner with the enhanced lending limit authority, even if the savings association meets the eligibility requirements detailed above.

A savings association that has received OTS approval may make loans and extensions of credit under the special lending limits as long as it remains eligible. An approved institution must cease making new loans or extensions of credit in reliance on the special limits if it becomes ineligible or OTS rescinds its authority.

Any loans made by the savings association to a borrower in compliance with the requirements of this program will not be deemed a lending limit violation and will not be treated as nonconforming if the savings association becomes ineligible, its authority to participate in the program is rescinded, or the program is terminated or discontinued.

Ongoing Monitoring

Approved institutions should maintain current data on the number and amount of small business, small farm, and 1-4 family residential loans made under the special lending limits program and the percentage of the institution's capital and surplus that the additional lending represents. Periodically, the Regional Offices may contact approved institutions for these data.

Approved institutions that extend credit or make loans under the additional lending authority should also monitor such activities to ensure that they are conducted in a safe and sound manner, that there is no adverse effect on the savings association's operations or capital, and that the loans and extensions of credit comply with all other relevant laws, regulations, and policies.

Termination for Supervisory Reasons

OTS may terminate a savings association's authority to extend credit or make loans under this additional authority if the savings association's continued participation in the program raises supervisory concerns about credit quality, undue concentrations, or concerns about the savings associations overall credit risk management, systems, or controls.

Other LTOB Exceptions

Government Sponsored Agency obligations

The HOLA at 12 USC § 1464(c) authorizes savings associations to invest in debt and equity issues of Fannie Mae, Freddie Mac, Sallie Mae, Ginnie Mae, and the Federal Home Loan Banks, or in the obligations issued by, or fully guaranteed as to principal and interest by, any agency of the United States. Although § 560.93 of the OTS regulations does not specify limitations on such investments, the investments must be prudent and appropriate for the association. OTS may establish individual limits on such investments if an association's concentration presents a safety and soundness concern.

Commercial Paper and Corporate Debt

Commercial paper and corporate debt securities are obligations of commercial entities and are treated as loans or extensions of credit for purposes of the LTOB rules. OTS regulation 12 CFR § 560.40 addresses the requirements for commercial paper and corporate debt securities. It states: A federal association's investment in the commercial paper and corporate debt securities of any one issuer, or issued by any one person or entity affiliated with such issuer, together with other loans (of the issuer), shall not exceed the general lending limit contained in 560.93(c). Notwithstanding the general lending limits, savings associations may invest ten percent of unimpaired capital and unimpaired surplus in the obligations of one issuer evidenced by commercial paper that is rated by at least two nationally recognized investment rating services in the highest category; and corporate debt securities that are rated in the two highest grades by a nationally recognized investment rating service, provided the obligations may be sold with reasonable promptness at a price that reasonably reflects their fair value.

Asset-backed Securities, Loan Sales, and Loan Participations

Typically, OTS considers asset-backed securities, loan sales, and loan participations obligations of the borrowers of the underlying loans that collateralize the security. There are exceptions, however. When the association relies on the credit of the issuer (or seller) for repayment of the obligation, the LTOB limits will apply. This may be demonstrated under the following conditions:

- When the loans, leases, or securities are sold with recourse.
- When the association relies on the seller/issuer (as opposed to a reliable independent third party) to service the underlying loans or leases and remit payments from the borrowers.
- When the association purchases loans or leases or participation interests in pools of loans or leases and the seller services the loans or leases, retains the collateral documents, and the buying association has not perfected a security interest in the assets.

Bank Owned Life Insurance (BOLI)

Savings associations should limit their BOLI investments in any one carrier to the 15 percent of their unimpaired capital and unimpaired reserves. (See TB 84, Interagency Statement on the Purchase and Risk Management of Life Insurance.)

RECORDKEEPING

Section 560.93(f) addresses requirements for documenting compliance with the LTOB limitations. When a savings association or its subsidiary makes a loan or loans to any one borrower that, in aggregate, exceed the greater of $500,000 or 5 percent of the association's unimpaired capital and surplus, it must include documentation showing that such loans were made within the limitations of 12 CFR § 560.93.

DEFINITIONS

For purposes of applying the lending limitations under 12 CFR § 560.93, savings associations shall apply the definitions and interpretations promulgated by the OCC at 12 CFR Part 32 including those discussed below.

Borrower

The term *borrower* has the same meaning as the term *person* set forth in 12 CFR Part 32. For purposes of determining LTOB limitations, a *"borrower"* means a person who is named as a borrower or debtor in a loan or extension of credit, or any other person, including a drawer, endorser, or guarantor, who is deemed to be a borrower under the "direct benefit" or the "common enterprise" tests set forth in 12 CFR § 32.5.

Generally, loans or extensions of credit to one borrower will be attributed to another person and each person will be deemed an individual borrower when either of the following occurs:

- The proceeds of a loan or extension of credit are to be used for the direct benefit of the other person. *Direct benefit* will be attributed to the other person when the proceeds, or assets purchased with the proceeds, are transferred to another person, other than in a bona fide arm's length transaction.

- A common enterprise is deemed to exist between the persons.

  A common enterprise will be deemed to exist and loans to separate borrowers will be aggregated when any of the following occur:

  — The expected source of repayment for each loan or extension of credit is the same for each borrower and neither borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid.

— Loans or extensions of credit are made:

  ✓ To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and

  ✓ Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence is deemed to exist when 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with the other borrower. Gross receipts and expenditures include gross revenues and expenses, inter-company loans, dividends, capital contributions and similar receipts of payments.

— Separate persons borrow from an association to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests, in which case a common enterprise is deemed to exist between the borrowers for purposes of combining the loans.

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. Refer to 12 CFR § 32.5(d) for a discussion of special rules for loans to a corporate group and loans to partnerships, joint ventures and associations.

Debt guaranteed by a person is attributed to the guarantor if the guarantor becomes an obligor under the terms of the guarantee.

Loans

Loans and extensions of credit mean an association's direct or indirect advance of funds to or on behalf of a borrower based on an obligation of the borrower to repay the funds. Loans and extensions of credit include all of the following:

- A contractual commitment to advance funds.
- A maker or endorser's obligation arising from an association's discount of commercial paper.
- An association's purchase of securities subject to a repurchase agreement.
- An association's purchase of third-party paper subject to an agreement that the seller will repurchase the paper upon default or at the end of a stated period.
- An overdraft but not an intra-day overdraft for which payment is received before the close of business.
- Fed Funds sold with a maturity of more than one business day.

Refer to 12 CFR § 32.2(k) for further explanation of these definitions.

Contractual Commitment

The limitation on loans and extensions of credit includes all obligations where the savings association has a contractual commitment to advance funds. This includes the savings association's obligation to:

- Make payment (directly or indirectly) to a third person contingent upon the default of the association's customer in performance of their obligations.
- Guarantee or act as surety for the benefit of a person.
- Advance funds under a standby letter of credit or similar arrangement.
- Advance funds under a qualifying commitment to lend.

A *qualifying* commitment to lend means a legally binding written commitment to lend that, when combined with all other outstanding loans and qualifying commitments to the borrower was within the association's lending limits when entered into, and has not been disqualified. If the association subsequently chooses to grant a loan to the borrower, which when added together with all outstanding loans and commitments exceeds the LTOB limit, then those commitments in excess of the limit become permanently disqualified. The association can advance funds only to the extent that with the advancement of new funds the association remains in compliance with regulatory limitations. Refer to 12 CFR § 32.2(f) for additional details.

> The limitation on loans and extensions of credit includes all obligations where the savings association has a contractual commitment to advance funds.

Savings associations often grant construction or other loan commitments that are scheduled to repay within a certain timeframe. The association may then grant a subsequent loan to the same borrower that, combined with the first, would exceed its LTOB limit, if it were funded prior to the repayment of the first loan. In order to avoid a lending limit violation and as a prudent business practice, savings associations should include in all appropriate loan commitments a clause that releases them from the obligation to fund the commitment if funding would cause an LTOB violation.

Loans to Facilitate Sales

OTS's policy concerning sale financing for any asset 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 12 CFR § 560.93. OTS does not object to sale financings that do not involve an advance of funds or 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 lender owning the asset in question.

Renewals

The lender's renewal of a loan does not constitute a new loan for lending limit purposes provided the lender does not advance new funds to the borrower and does not substitute a new borrower for the original obligor. When the lender renews a nonconforming loan, he or she has an opportunity 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 lender must make and document best efforts to bring the loan into conformance prior to renewal. If these efforts are unsuccessful, however, the lender may renew, restructure, or modify the nonconforming loan, provided that there is no substitution of borrowers or additional advance of funds.

Upon the expiration of a partially funded loan commitment, the association may renew only the funded portion if this amount exceeds the association's lending limit and only if best efforts were first made to bring it into compliance. The association will then treat this renewed portion as a legal, although nonconforming, term loan. If the borrower subsequently repays a portion of the outstanding balance owed to the lender, the lender may not advance new funds to the borrower until the outstanding balance of the loan is brought within the association's lending limits.

Other Exclusions

The following items do not constitute loans or extensions of credit for LTOB purposes (see 12 CFR § 32.2(k)(2)):

- Additional funds advanced for the benefit of a borrower by a savings association for payment of taxes, insurance, utilities, security, and maintenance and operating expenses necessary to preserve the value of real property securing the loan, consistent with safe and sound banking practices.

- Accrued and discounted interest on an existing loan or extensions of credit.

- Amounts paid against uncollected funds in the normal process of collecting.

- That portion of a loan or extension of credit sold as a participation on a nonrecourse basis, provided that the participation results in a pro rata sharing of credit risk proportionate to the respective interests of the originating and participating lenders.

Use of Salvage Powers

Traditionally, salvage powers have provided the legal justification for federal savings associations to hold, operate (if necessary), and invest additional funds (when necessary) in property acquired as a result of, or in lieu of, foreclosure prior to resale of that property.

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 that the steps taken:

- Are an integral part of a reasonable and *bona fide* salvage plan; and
- 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.)

Accordingly, a savings association may use its salvage powers to exceed the LTOB limitation provided it is able to demonstrate that it is making excess investments 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 board of directors should expressly approve the salvage plan. State-chartered savings associations have similar authority under state law.

A federal savings association that intends to make a salvage powers investment in excess of its LTOB limitation must first contact its OTS regional office to ensure that the Regional Director does not object to the association's judgment that the proposed salvage plan is necessary and appropriate.

A federal savings association that intends to make a salvage powers investment in excess of its LTOB limitation must first contact its OTS regional office to ensure that the Regional Director does not object to the association's judgment that the proposed salvage plan is necessary and appropriate. (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. However, it should still document that such action is necessary and appropriate.)

Regional Directors will take into consideration the risks posed by proposed salvage plans, an association's past history of salvage operations, the financial condition of the association and its ability to undertake the risks attendant to salvage operations. The level of scrutiny given to a salvage plan will also vary depending on the foreclosue status of the asset being salvaged.

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, 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 an association has exceeded its LTOB limit, OTS will aggregate all of a federal 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 normal 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 staff will consider whether the plan meets the following criteria:

- Is necessary to enable the association to salvage its existing investment.
- Is necessary to protect the value of the foreclosed property (e.g., the additional investments will result in a more marketable property).
- Is in the best interest of the association.
- 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 federal 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.

Any advance of funds, even those to protect the value of the collateral are considered loans to the borrower and subject to the LTOB lending limits. Thus, a federal savings association may not invest in such properties any amounts that would exceed the LTOB limits until it has acquired title to the property. Any valid exceptions, such as when funds need to be immediately disbursed to maintain hazard insurance to protect the association's interest in the property, for example, must be approved by the OTS Regional Office. To obtain such approval, the association must demonstrate that the need for and timing of its proposed investment (i.e., before foreclosure) are reasonably necessary.

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
§ 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	Components of Capital, Appendix A

Part 32: Lending Limits (for National Banks)

§ 32.2	Definitions
§ 32.3	Lending Limits
§ 32.4	Calculation
§ 32.5	Combination Rules
§ 32.6	Nonconforming Loans
§ 32.7	Special Lending Limits for 1-4 Family Residential Loans, Small Business Loans, and Small Farm Loans
§ 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

Part 541	Definitions
Part 560	Lending and Investment
§ 560.30	General Lending and Investment Powers
§ 560.93	Lending Limitations
§ 560.101	Real Estate Lending Standards
§ 561.19	Financial Institution
§ 563.41	Transactions with Affiliates
Part 567	Capital Requirements

OTS Bulletins

TB 84	Interagency Statement on the Purchase and Risk Management of Life Insurance

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Loans To One Borrower

Program

EXAMINATION OBJECTIVES

To determine the adequacy of an association's risk management practices and controls regarding loans to one borrower (LTOB) limits.

To ensure the adequacy of the association's recordkeeping with respect to LTOB.

To assess management's and lending personnel's conformance with established guidelines.

To ensure compliance with applicable laws and regulations.

EXAMINATION PROCEDURES

WKP. REF.

You should conduct the following Level I examination procedures in conjunction with Examination Handbook Section 201, Lending Overview, to bring together a review of the entire lending function(s) of an association. As such, the examiner-in-charge (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

1. Review the PERK information and the scoping material related to this area.

2. Determine whether management has taken appropriate corrective action to address any deficiencies noted during the prior examination.

3. Participate in the appropriate Level I procedures of Section 201 or discuss the findings with the EIC and/or his representative.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

4. Review board and management reports used to monitor high dollar loans and concentrations among affiliated borrowers.

5. Assess the adequacy of the association's documentation for loans in excess of five percent of its unimpaired capital and surplus. (This may be done during the review of large loans.)

6. Determine if the association is in compliance with applicable regulatory LTOB limits and any board imposed "house" limits.

7. Determine the adequacy of reporting to the board and management on LTOB limitations and exceptions.

8. Review the association's large loans and commitments to determine if any approach the legal lending limit and assess management's monitoring of such loans.

9. Determine whether the combination rule of 12 CFR § 32.5 applies to any of the association's borrowers.

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

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Loans To One Borrower

Program

WKP. REF.

LEVEL II

1. Review any loans made under the exceptions for domestic residential housing development or the lending limits applicable to the special lending limits program of 12 CFR § 32.7. Determine that appropriate notice or application was provided and approval received.

2. Determine whether loans originated under such programs were made in accordance with applicable policy and regulation.

3. In situations where the association has exercised its salvage powers to exceed the LTOB limitations, ensure that the association has adequate justification and appropriately notified the OTS regional office.

4. Summarize findings, comment on any violations, obtain management responses, and update programs and the continuing examination file (CEF) and/or electronic CEF (ECEF) with any information that will facilitate future examinations.

5. 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.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

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One- to Four-Family Residential Real Estate Lending

The primary business of the thrift industry is residential real estate lending. Section 5(c)(1)(B) of the Home Owner's Loan Act (HOLA) authorizes federal savings associations to invest in loans secured by "residential real estate" — subject to safety and soundness considerations. Residential real estate loans include permanent mortgage loans, construction loans, or other loans secured by single- and multi-family residential dwellings. This Handbook Section focuses on permanent mortgage lending secured by one- to four (1-4) family residential properties. We discuss construction and multifamily loans in Handbook Section 213.

LINKS

- Program
- Questionnaire
- Appendix A
- Appendix B
- Appendix C
- Appendix D
- Appendix E
- Appendix F

The single-family residential mortgage market is a highly competitive market and one that offers a wide variety of loan products to meet consumer demand. Loan products are, on the one hand, highly standardized as a result of the secondary market, along with innovations in automated underwriting and credit scoring. On the other hand, competition and demand have produced an array of mortgage loan product options for consumers ranging from fixed-rate to variable-rate loans, interest-only loans, negatively amortizing loans, subprime loans, and reverse mortgages. Each of these products brings different underwriting, risk, and portfolio management considerations.

From a credit risk perspective, well-underwritten loans to creditworthy individuals secured by their personal residences are among the safest loans in a savings association's portfolio[1]. While annual loan loss rates for prime 1-4 family permanent loans fluctuate over time, they are typically below 20 basis points, which is generally lower than the loss rates for any other class of loans. Portfolios of such loans generally present much less credit risk than commercial real estate loan portfolios because:

- The risk of default is spread over many moderately sized loans rather than a few large loans.
- Savings associations generally use standardized underwriting criteria, which makes overall performance more predictable.
- Default risk is low and diversified. It is generally not dependent on the success of a particular business or industry.

[1] Initially, we will focus our discussion on prime mortgage loans with loan-to-value (LTV) ratios of less than 90 percent or with private mortgage insurance. Subprime mortgage lending and high LTV lending will be discussed later in this section.

- The amount of loss given default is generally lower because the loans are well secured by the borrower's home.

Single-family mortgage loans do entail risks. These risks include interest-rate risk, an increased default risk if underwriting standards are weak or are not followed, and the risk that properties in a particular community or during an economic downturn may experience price declines. Price declines may lead to both higher defaults and greater losses in each default. The risks inherent in a real estate mortgage loan depend on:

- The borrower's creditworthiness (or ability and willingness to pay) over the loan term.
- The loan amount relative to the value of the security property (LTV) over the life of the loan.
- The loan's terms and interest rate over the loan term.

Lenders can mitigate risk by establishing and adhering to sound lending standards and portfolio diversification strategies; maintaining high quality loan servicing and collections departments; regularly assessing portfolio risk and monitoring portfolio performance; and making changes or taking remedial action as necessary.

This Handbook Section has two parts:

- **Real Estate Lending Policies and Operations**: an overview of real estate lending standards, loan portfolio risk management, and other underwriting considerations.
- **Underwriting Considerations for Specific Loan Products**: subprime mortgage lending, adjustable rate mortgages including negatively amortizing loans, interest-only loans, home equity loans, manufactured housing loans, and reverse mortgage loans.

REAL ESTATE LENDING POLICIES AND OPERATIONS

Real Estate Lending Standards

As indicated in Handbook Section 201, one of the first steps in creating a sound lending program is the establishment of safe and sound lending policies and prudent underwriting criteria. On December 31, 1992, OTS, in concert with the other federal banking agencies, adopted the *Real Estate Lending Standards Rule (RELS), 12 CFR § 560.100-101*. The rule requires each insured depository institution to adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate or are made for the purpose of financing the construction of a building or other improvements to real estate. Such policies must be consistent with safe and sound banking practices, appropriate to the size of the institution and the nature and scope of its operations, and reviewed and approved by the board of directors. The rule also requires that the lending policies must establish:

- Loan portfolio diversification standards.
- Prudent underwriting standards, including loan to value (LTV) limits that are clear and measurable.
- Loan administration procedures.
- Documentation, approval, and reporting requirements to monitor compliance with the savings association's lending standards.

In addition, savings associations must monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions. The rule also requires that the real estate lending policies reflect consideration of the *Interagency Guidelines for Real Estate Lending Policies (*Interagency Guidelines). The Interagency Guidelines in Appendix A to § 560.101 state that an institution's written lending policy should contain an outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made. In particular, the institution's policies should address the following:

- Geographic lending areas.
- Loan portfolio diversification strategies.
- Prudent underwriting standards that are clear and measurable.
- Appropriate terms and conditions by type of real estate loan.
- Loan origination and approval procedures.
- Loan review and approval procedures for loan exceptions.
- Loan administration procedures.
- Monitoring and reporting procedures.
- Appraisal and evaluation program.

The institution should consider both internal and external factors in the formulation of its loan policies.

The institution should consider both internal and external factors in the formulation of its loan policies, including the expertise and size of its lending staff, market conditions, and compliance with real estate related laws and regulations.

Appendix A to this Handbook section contains answers to commonly asked questions about the RELS and Interagency Guidelines. While the Interagency Guidelines apply to all real estate loans, not just 1-4 family residential real estate loans, we incorporate the guidance relevant to single-family mortgage lending in the following discussion.

Underwriting Standards

Prudently underwritten real estate loans should reflect all relevant credit factors including:

- The capacity and creditworthiness of the borrower.
- The value of the security property.
- Borrower equity.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (guarantees, private mortgage insurance, etc.).

The underwriting standards should also address:

- Maximum loan amounts.
- Maximum loan maturities.
- Amortization schedules.
- LTV limits.
- Pricing structures.
- Credit scores.
- Debt-to-income requirements for loans originated, loans purchased and loans sold in the secondary market.
- The use of automated underwriting and credit scoring systems in the underwriting process.

Documentation Standards

OTS expects savings associations to document loans to establish a record of each transaction, demonstrate loan quality, and secure its interest in any collateral pledged for the loan. OTS designed its documentation requirements to be flexible and based on the size and complexity of the savings association's lending operations. Pursuant to 12 CFR § 560.170, each savings association, including its operating subsidiaries and service corporations, should establish and maintain loan documentation practices that:

- Ensure the association can make an informed lending decision and can assess risk on an ongoing basis.

- Identify the purpose of and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.

- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.

- Demonstrate the appropriate administration and monitoring of its loans.

- Take into account the size and complexity of its loans.

The purpose of this rule is not to mandate a list of required loan documents, but to ensure that the association maintains the necessary documents to protect its interest in the loan and verify management's determination that each borrower has the willingness and ability to repay their obligations in accordance with the loan's contractual terms. OTS modeled these documentation requirements after the *Interagency Guidelines Establishing Standards for Safety and Soundness*. (See 12 CFR Part 570.)

Typical Documentation

For residential real estate lending, savings associations typically obtain the following documentation:

- A signed loan application.

- A signed and dated promissory note and mortgage (or deed of trust).

- A title insurance policy or opinion of title to evidence the recording of the loan and the lender's security interest in the property.

- An appraisal or evaluation, in accordance with 12 CFR Part 564, evidencing the value of the security property.

- Evidence that the borrower obtained adequate hazard insurance and a certification that the borrower will retain such insurance for the life of the loan.

- A credit report or financial statement evidencing the borrower's other credit obligations and payment history.

- Verification of the source of down payment, and a verification of borrower income and employment.

- Debt-to-income ratio calculation, to document the borrower's ability to repay the loan.

- An underwriting or approval memorandum or form (signed off by the person(s) or committee authorized to approve the loan) that documents the loan's compliance with the savings association's underwriting requirements, rules, and regulations.

Some savings associations may require additional documentation such as bank statements, pay stubs, W-2 forms, and income tax returns.

Documentation and Underwriting Standards for Loans Originated for Sale

When lenders originate loans for sale, they will typically document loans in accordance with the needs or requirements of the intended purchaser. For example, when a savings association originates loans for sale to Freddie Mac or Fannie Mae, the lender may use the underwriting requirements and documentation required by those organizations. In some cases, underwriting and documentation requirements may be less stringent than what the lender requires for loans it plans to hold in its portfolio. Some lenders use the loan underwriting and documentation requirements of the purchaser when they plan to sell the loans and have a written loan purchase agreement with the purchaser. However, virtually all loan sales have contractual representations and warranties that allow the purchaser to "put back" loans that have documentation errors or omissions, where fraud is involved, or when a loan becomes delinquent during the warranty period. The warranty period typically is for 120 days after the sale; however some sales contracts require longer periods and may be up to 12 months after the sale.[2]

If an investor's underwriting standards are less stringent than the institution's, a loan is more likely to become delinquent during the reps and warranty period, and the lender may be required to repurchase the loan. Moreover, many lenders use mortgage brokers to supplement their own originations, so that they may not have as much control over the production process and the information in the loan files. Where information is missing or inaccurate, purchasers may be able to require the lender to repurchase loans long after the sale. This can expose a savings association to much greater credit risk than it would have from its "held for investment" portfolio.

It has been and remains OTS policy that savings associations use prudent underwriting and documentation standards for all loans they originate, both for those to be held in portfolio and those originated for sale. OTS expects that loans originated for sale will be underwritten to comply with both the institution's Board-approved loan policies for such programs and with all existing regulations and supervisory guidance governing the documentation and underwriting standards for residential mortgages.

Experience has shown that the level of pipeline, warehouse, and credit-enhancing repurchase exposure for mortgage loans originated for sale to non-government sponsored enterprise purchasers can constitute a concentration risk that should be aggressively identified, measured, monitored, controlled, and reported to the Board. Given the concentration risk, the Board-approved loan policy should

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[2] Selling a loan with reps and warranties that exceed 120 days from the date of loan purchase result in recourse such that the seller must maintain capital for the entire loan until the reps and warranties expire.

establish a limit for aggregate pipeline, warehouse, and credit-enhancing repurchase exposure from such lending programs. A savings association will receive closer supervisory review of its concentration risk when such exposure exceeds its Tier 1 capital.

Reduced Loan Documentation

In recent years, some savings associations reduced loan documentation requirements to meet customer demand for such products, expedite loan approval, and reduce administrative costs. Savings associations and examiners have raised questions about whether "low-doc" and "no-doc" loans meet OTS's documentation requirements.

The following definitions are useful in the discussions of this issue:

Well-documented loans. A well-documented loan has the documentation necessary to: record the loan and secure the lender's interest in the collateral, support the borrower's willingness and ability to repay the loan, and establish the sufficiency of the collateral to liquidate the loan, if it should become necessary.

Low-doc loans. A "low-doc" loan has the documentation necessary to record the loan and secure the lender's interest in the collateral, and the sufficiency of the collateral to liquidate the loan, if necessary. However, it may not have all of the documentation lenders typically require to support the borrower's ability to repay the loan. For example, a lender may ask borrowers to state their income rather than require full income verification such as payroll statements, W-2's, or tax returns.

No-doc loans. A "no-doc" loan generally has the documentation necessary to record the loan and the lender's interest in the collateral, but has no documentation to support the borrower's willingness and ability to repay the loan or the sufficiency of the collateral to liquidate the loan, if necessary (e.g., no income verification, credit report, or appraisal.)

Regardless of the savings association's name for such programs, you should focus on the actual documents required and the credit risks involved. OTS has long held that no-doc residential real estate lending, as defined above, is unsafe and unsound. Low-doc lending programs, as defined herein, vary greatly and require careful scrutiny.

> OTS has long held that no-doc residential real estate lending, as defined above, is unsafe and unsound.

Savings associations that make low-doc loans should demonstrate that such loans are prudently underwritten and meet OTS's documentation requirements. Well-managed low-doc residential lending programs typically offset the higher risk undertaken by not fully evaluating the borrower's source of repayment with other mitigating credit factors. For example, if the association does not ask for or verify the borrower's income, it should use other means to demonstrate the borrower's willingness and ability to make timely loan payments, such as higher borrower down payments (lower LTV ratios) and higher credit scores. Some lenders may determine ability to repay a mortgage by comparing the applicant's new mortgage payments with his or her current rent or mortgage payments, or they may ask for two or three months of the applicant's checking account statements and review the activity.

While there can be much debate over which documents are needed to support the loan decision, the ultimate proof of whether the association's loans are adequately underwritten lies in the performance of its portfolio relative to similar but well-documented portfolios. If an association offers a low-doc loan product, it should ensure appropriate risk-based pricing and regular monitoring of loan performance, and limit the volume of production until it has experience with the product and it demonstrates adequate performance.

Supervisory Loan-to-Value Limits

As set forth in the Interagency Guidelines, permanent mortgage or home equity loans on owner-occupied, 1-4 family residential property whose LTV ratio equals or exceeds 90 percent at origination should have appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral. On a case-by-case basis, associations may make loans in excess of supervisory LTV limits based on the support provided by other credit factors and documented in the loan file.

On October 8, 1999, the banking agencies issued *Interagency Guidance on High LTV Residential Real Estate Lending*. (See Appendix D.) High LTV loans are defined as any loan, line of credit, or combination of credits secured by liens on or interests in owner-occupied, 1-4 family residential property that equals or exceeds 90 percent of the real estate's appraised value. The exception is a loan that has appropriate credit support such as mortgage insurance, readily marketable collateral, or other acceptable collateral, that reduces the LTV ratio below 90 percent. Through this policy statement, the agencies clarified that any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent, and does not have the additional credit support, should be considered an exception to the Guidelines and included in the association's calculation of loans subject to the 100 percent of capital limitation. (See 12 CFR § 560.101, and Appendices A and D of this section for additional information.)

Exceptions to the General Lending Policy

Lending policies may provide for prudently underwritten loan approvals that are exceptions to its standard lending policies. The board of directors is responsible for establishing standards for review and approval of such exceptions. A written justification that clearly sets forth all the relevant credit factors that support the underwriting decision should support the loan approval. Tracking of the aggregate level of exceptions helps detect shifts in the risk characteristics of the loan portfolio. When viewed individually, underwriting exceptions may not appear to increase risk significantly; however, when aggregated, even well-mitigated exceptions can increase portfolio risk. Management should regularly analyze aggregate exception levels and report them to the board. An excessive volume or a pattern of exceptions may signal an unintended or unwarranted relaxation of the association's underwriting standards.

Loan Administration

The loan administration function is responsible for receiving and recording payments, recording security agreements, retaining loan documentation, and maintaining escrow accounts. Associations should establish procedures to monitor the payment of real estate taxes and insurance and to arrange for interim or blanket hazard insurance policies to cover any lapse in coverage. This becomes more important with seriously delinquent loans because borrowers may have less incentive and ability to make such tax or insurance payments. Loan administration procedures for real estate lending should address:

- Documentation requirements.
- Collateral administration, including the type and frequency of collateral evaluations.
- Loan closing and disbursements; payment processing; and loan payoffs.
- Escrow monitoring and administration.
- Collection procedures and timing, including foreclosure procedures.
- Claims processing.
- Servicing and participation agreements.

Timely collection of delinquent loans is a critical factor in portfolio performance. An association's written policies should provide for enhanced collection efforts as delinquency problems become more serious.

You should look for indications of delinquency problems where staff and management are:

- Unaware of delinquency problems.
- Inaccurately reporting such problems to the board.
- Not taking appropriate action to collect on the loan or foreclose, where appropriate.

Real Estate Appraisal and Evaluation

Experience has shown that the lower the LTV, the lower the likelihood of default and the lower the amount of loss in the event of default. While the sale of collateral is not an acceptable *primary* source of repayment, the borrower's equity in the home is an important factor in borrower motivation and should be integrated into the lending decision. Real property provides protection to the lender should the borrower's circumstances change and he or she is unable to service the debt.

Thus, an adequate system of collateral appraisal or evaluation and review in accordance with 12 CFR Part 564 is an essential element in sound real estate lending. A real estate appraiser should base the market value estimate contained in the real estate appraisal or evaluation on the conveyed interest in real estate on a cash or cash equivalent basis. Handbook Section 208 provides guidance and examination procedures on real estate appraisals and evaluations.

Portfolio Risk Management

Loan Review and Monitoring

A sound real estate lending policy should be augmented by strong and effective internal controls.

A sound real estate lending policy should be augmented by strong and effective internal controls. These controls should emphasize proper segregation and independence of duties between:

- Loan officers who assist the customer and facilitate the application process.
- Loan administration personnel who disburse funds, collect payments, and provide for the timely receipt, review, and follow-up of all necessary mortgage loan documentation.
- Accounting staff that record loan transactions.
- Loan review and internal audit staff.

To monitor credit quality and compliance with board established policies and procedures, the savings association should implement a system of internal loan review commensurate with its size, risk, and the complexity of its lending and investment activities. Management's inadequate response to problem loans or lending practices can often be traced to an inadequate loan review function, or one that is poorly structured or that is not sufficiently independent of the officers who made the loans. Unfortunately, such weaknesses surface when credit problems emerge that an effective Internal Asset Review (IAR) system could prevent.

The *Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)* contains an attachment on loan review systems. Refer to Appendix A in Handbook Section 261 for the ALLL policy statement. The loan review section sets forth guidelines for establishing a prudent internal loan review program that:

- Promptly identifies loans with potential credit weaknesses so that timely corrective action can be taken to minimize losses.
- Assesses relevant trends that may affect collectability.
- Provides information to assess the adequacy of the ALLL.

- Assesses the adequacy of and adherence to internal loan policies.
- Evaluates the activities of lending personnel.
- Provides management and the board of directors with objective, accurate, and timely information on the portfolio's quality.
- Includes all loans, whether originated or purchased.
- Includes sample coverage that is statistically valid and includes periodic reviews of high-dollar, high-risk loans.

The purpose of the internal loan review or IAR is to assess overall asset quality, and identify specific problem assets so that association management may implement corrective action. An effective IAR should enable management to identify weaknesses in the loan portfolio and take appropriate corrective actions when necessary, both with respect to individual loans and any weaknesses in the association's loan policies and procedures.

The guidelines list several important elements to an effective loan review system. These are:

- Qualifications and independence of loan review personnel.
- Frequency, scope, and depth of reviews.
- Management review of findings and follow-up corrective action.
- Report distribution to appropriate staff, management, and the board of directors.

While each of these elements is important to an effective loan review function, one of the most critical elements is independence. Often, the initial loan review function is given to loan officers because they are the most familiar with their loans and can spot weaknesses early. This is acceptable as a first line of review. However, associations should avoid over-reliance on loan officers and their line supervisors for identification of problem loans. Senior management and the board of directors should ensure that loans are also reviewed by individuals who do not have control over the loans they review and are not part of, or influenced by, anyone in the approval process.

Please refer to Appendix A in Handbook Section 261 for a further discussion of an effective internal loan review system.

Management Information Systems

Accurate and timely management information reports are key to a successful lending operation. Management information systems (MIS) reports should enable management and the board of directors to assess the performance of each loan product type (LTV, credit score, originating office, loan officer, geographic location, and profitability); and the performance of the portfolio as a whole. This will enable management to make changes to poorly performing, or unprofitable programs.

MIS reports may include:

- Summary reports showing trends in outstanding loans, new loan volume, delinquencies, and portfolio yield by different product types and LTV.
- Credit scoring distribution reports by portfolio, new volume, delinquency, and losses.
- Past due, nonaccrual, trial balance, and collections reports.
- Extension and renewal reports.
- Reports on the volume and significance of underwriting exceptions.

You should ensure that MIS reports are:

- Used to monitor loan performance or improve the portfolio.
- Timely, accurate and appropriate to the size and complexity of the association's operations.
- Provided to both management and the board.

Automated Underwriting Considerations

Using automated underwriting allows lenders to lower their costs, simplify the application process, and save time.

Some savings associations use automatic underwriting programs when they plan on selling loans in the secondary mortgage market. Automated underwriting uses historical loan performance, statistical models, and known risk factors to evaluate whether a loan can be sold into the secondary market. The most widely used automated underwriting services are Freddie Mac's Loan Prospector® and Fannie Mae's Desktop Underwriter®.

Mortgage lenders use automated underwriting to help them:

- Determine the terms under which the loan can be sold into the secondary market.
- Evaluate the credit, collateral, and capacity of borrowers to make their monthly mortgage payments.
- Identify the appropriate type of loan for the borrower.

Using automated underwriting allows lenders to lower their costs, simplify the application process, and save time. It also helps lenders weigh all the strengths and weaknesses of the loan appropriately, in accordance with historical experience so that worthy borrowers with minor weakness are not unjustly rejected.

When a savings association designs and uses its own automated underwriting program, it should test and validate the program prior to placing it in use and regularly thereafter.

A savings association may use such automated underwriting to facilitate loan analyses and verify that such loans can be sold to the intended investor; however, it must perform its own underwriting to determine if such loans are prudently underwritten and meet OTS and interagency guidelines.

Interest Rate Risk Considerations

In addition to credit risk, mortgage lending, particularly long-term fixed rate loans, expose the savings association to interest rate risk; that is the risk that the savings association's liabilities will reprice faster than its assets as interest rates rise, causing net interest margins and thus earnings to decline. In addition to establishing sound lending policies, the association can mitigate other portfolio risks such as interest rate and market risk, by hedging, by expanding its loan products to include adjustable-rate mortgage (ARM) loans and 15-year mortgages, and by selling some or all of its most interest-rate sensitive mortgages. Moreover, many savings associations sell residential mortgage loans in the secondary market to reduce the interest-rate risk associated with funding long-term, fixed-rate assets with short-term liabilities. This can also provide future fee income if the loans are sold with servicing retained. These activities represent unique risks and are addressed in the Mortgage Banking sections of the Handbook.

Compliance Considerations

As part of a sound lending program, the association must ensure that all loans are made in accordance with federal laws governing credit transactions. OTS regulation 12 CFR § 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of loans originated. Loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair Housing Act, the Equal Credit Opportunity Act, Regulation B, or OTS Nondiscrimination regulations. The Truth-In-Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are subject to specific restrictions. Loans are also subject to evaluation under the Community Reinvestment Act and implementing regulation as part of the association's performance in meeting the credit needs of its community. (See the Compliance Sections of the Examination Handbook for further discussion.)

Capital Considerations

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines a qualifying mortgage loan as a loan that:

- Is fully secured by a first lien on a 1-4 family residential property.

- Is underwritten in accordance with prudent underwriting standards, including standards relating to the ratio of the loan amount to the value of the property (LTV ratio). See Appendix to 12 CFR § 560.101.

- Maintains an appropriate LTV ratio based on the amortized principal balance of the loan.

- Is performing and is not more than 90 days past due.

If a savings association holds both the first and junior liens on a residential property, and no other party holds an intervening lien, the transaction is treated as a single first lien loan for purposes of determining the LTV and appropriate risk weighting under § 567.6(a).

In essence, 1-4 family residential mortgages that are performing, are prudently underwritten, and have loan-to-value ratios at origination of less than 90 percent, or are covered by private mortgage insurance, may qualify for the 50 percent risk weighting. OTS has not specifically defined the term "prudently underwritten" for purposes of determining compliance with 12 CFR § 567.1; however, OTS has long held that to be prudently underwritten, a loan must be made in a safe and sound manner to ensure that the borrower has the ability and willingness to repay the loan in a timely manner.

OTS allows savings associations flexibility in underwriting their loans, based on many factors, including borrower equity or LTV, the borrower's credit standing (as evidenced by a credit report and credit score), sufficient cash flows to service the debt (as evidenced by an acceptable debt-to-income ratio or other appropriate information), combined with other factors, such as a guarantee from a financially responsible third party, private mortgage insurance, or evidence of other borrower assets that could be used to liquidate the loan.

Low-doc Residential Loans

OTS will consider low-doc residential mortgage loans prudently underwritten for purposes of meeting the 50 percent capital risk weighting requirements for qualifying residential mortgages, provided the following conditions are met:

- The loans otherwise meet the requirements of § 567.1.

- The association adequately documents the value of the security property pursuant to the requirements of 12 CFR Part 564.

- The association adequately documents its analysis of each borrower's credit history (as evidenced by a credit report or credit score, for example).

- The association obtains borrower income and employment information on the signed application and uses that information to determine the borrower's ability to repay the loan. (No income, no asset loans do not meet this requirement.)

- The loan possesses other credit strengths, such as high credit score or low LTV that mitigate risks from limited documentation.
- Private mortgage insurance is required for loans with LTVs of 90 percent or more.
- The association performs ongoing risk analysis to monitor performance and risk of low-doc lending and implements adequate and timely corrective action when needed.
- OTS has no major safety and soundness criticisms of the association's lending program.

To retain the 50 percent risk weighting, the loans should perform as well as well-documented qualifying mortgages, given their risk profile, loss variance, and profitability. Should the performance on a portfolio of low-doc mortgage loans decline to a level that presents safety and soundness concerns, OTS may direct the savings association to risk weight some or all of the low-doc mortgages at 100 percent or higher.

Subprime Mortgage Loans

The interagency policy statement *Expanded Guidance for Subprime Lending Programs* addresses the capital requirements for subprime mortgage loans. (OTS CEO Memo 137, issued February 2, 2001.) The guidance states: "Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an association would hold capital against such portfolios in an amount that is one and one half to three times greater than what is appropriate for non-subprime assets of a similar type." Therefore, if such programs otherwise meet the above requirements, OTS expects associations to hold capital of one and a half to three times the 50 percent risk weighting for qualifying 1-4 family mortgages (or more, depending on the overall risks involved).

UNDERWRITING CONSIDERATIONS FOR SPECIFIC LOAN PRODUCTS

> Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies.

Subprime Mortgage Lending

The term *subprime* refers to the credit characteristics of the individual borrower. Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. Generally, subprime borrowers will display a range of credit risk characteristics that may include one or more of the following:

- Two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months.
- Judgment, foreclosure, repossession, or charge-off in the prior 24 months.

- Bankruptcy in the last five years.

- Relatively high default probability as evidenced by, for example, a credit bureau score of 660 or below (depending on the product or collateral), or other bureau or proprietary scores with an equivalent default probability likelihood.

- Debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers.

With subprime lending programs, financial institutions target subprime borrowers and offer them loans at higher interest rates and loan fees than that offered to prime borrowers, based on the risk of the loan. Since lenders charge a premium for the added risk of default, subprime loans can be more profitable than standard risk loans, provided that the lender has accurately estimated default and loss rates and has adequately priced the loans.

The banking agencies believe that responsible subprime lending can expand credit access for consumers and offer attractive returns. However, the elevated levels of credit and other risks arising from these activities require more intensive risk management and, often, additional capital. A savings association that is or plans to become engaged in subprime mortgage lending (or the purchase of such loans) must consider the additional risks inherent in this activity. It must determine if these risks are acceptable and can be controlled, given its staff, financial condition, size, and level of capital support. If management and the board decide to enter the subprime lending business, they must establish board-approved policies and procedures, and internal controls to identify, measure, monitor, and control the additional risks.

In March 1999, the OTS, together with the other banking agencies issued *Interagency Guidance on Subprime Lending*, which provides detailed guidance to examiners on subprime lending activities. (See Appendix A of Handbook Section 217.)

On February 2, 2001, the Agencies issued the *Expanded Guidance for Subprime Lending Programs (CEO Memo 137)*. This expanded guidance discusses supervisory expectations for the ALLL regulatory capital, examination review of subprime activities, classification of risk, and documentation for re-aging, renewing, or extending delinquent accounts. This guidance also discusses regulatory expectations for the review and treatment of certain potentially abusive lending practices.

Adjustable Rate Mortgage Loans

Unlike fixed-rate mortgages, where the interest rate does not change over the life of the loan, the interest rate on an adjustable rate mortgage (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 margin. The combination of the index rate and the margin is 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 (llth 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. These are called interest rate "caps," "ceilings," and "floors."

For most ARM loans, the borrower's monthly payment amount is recalculated periodically to assure full amortization of the loan over its remaining life at the current fully indexed interest rate.

Teaser Rates and Interest Rate Buy Downs

One feature commonly associated with some ARM products is the "teaser" or low introductory interest rate. This includes situations where borrowers receive a short-term subsidy or "buy down" on the loan rate from the home seller or lender. Teaser rates are used to attract borrowers to do business with the home seller or lender and help borrowers qualify for the loan. Teaser rates reduce the initial interest accrual and monthly payment while the teaser rate is in effect, usually 12 to 36 months. At the expiration of the teaser-rate term, the borrower's monthly interest accrual is calculated at the fully indexed rate.

OTS regulations place no specific restrictions on the structure of ARM loans. The adjustable rate mortgage provisions of 12 CFR § 560.35 do not set limitations on periodic and lifetime interest-rate adjustments. Thus, management has the flexibility to develop a buy down program provided it underwrites and structures the program in a safe and sound manner.

Qualifying ARM Borrowers

Loans that have adjustments to higher interest rates may lead to steep increases in payment burdens and subsequent delinquencies if borrowers were originally qualified at low introductory rates, particularly borrowers with initial high debt-to-income payment burdens. It is important that associations assess a borrower's ability to qualify for the loan by measuring that borrower's current income against projected amortizing payments that will result from a fully indexed or current market interest rate.

Using the deep teaser rates to qualify a borrower will enable some borrowers to qualify for loans that they would not qualify for under normal circumstances. OTS is concerned about the potential payment shock to borrowers after the teaser rate term expires, particularly when other credit risk factors, such as high LTVs, poor credit histories, high debt-to-income, and low documentation are present. Savings associations should qualify borrowers at an amortizing payment based on the fully indexed or market mortgage rate as of the date of commitment.

Pricing of ARMs

The pricing of products and services offered by savings associations should be competitive, provide sufficient yield to cover the operating expenses, funding costs, expected losses, and a reasonable risk adjusted return on invested funds. The pricing of products and services should foster safe and sound lending.

Some lenders may incorrectly price ARMs because of a lack of understanding of the "options" or risks associated with ARMs. Lenders should price "promotional" mortgage loans, such as adjustable "teaser" rate mortgages, to yield a sufficient return over the life of the loan. Mortgage documents should state precisely which index is used and when the rate may be adjusted.

Some lenders may incorrectly price ARMs because of a lack of understanding of the "options" or risks associated with ARMs.

One method to determine if lenders are appropriately pricing ARMs is to compare the expected returns on originated ARMs with yields on comparable ARMs in the secondary market. Specifically, you can compare secondary market data to determine whether the points the association receives for originating the ARM compensate it for the discount that the secondary market requires to accept the risks of that ARM. If the required discount is larger than the fees the association receives for originating the ARM, you might conclude the association is not pricing its ARMs appropriately.

Accounting Treatment

Where the buy down payment is in the form of a single, lump sum representing a portion of the interest due during the buy down period, the association should include the payment with other deferred fees and loan costs to determine the net deferred fees for the loan. The association should amortize such net deferred fees over the life of the loan using the interest (level yield) method pursuant to SFAS No. 91. Such accounting is required for any type of loan, whether fixed-rate or adjustable-rate, in connection with making a buy down payment.

Savings associations should take into consideration the existence of any buy down arrangement in determining the value of the property. If the amount of the buy down 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 buy down is offered, then the appraisal should reflect this fact.

Alternative or Nontraditional Mortgage Products (AMP)

Lenders have developed a variety of AMPs designed to reduce interest rate risk, make mortgages more affordable, and avoid the payment fluctuations typically associated with conventional adjustable rate mortgages. On October 4, 2006, the OTS, together with the other bank and credit union regulatory agencies issued *Interagency Guidance on Nontraditional Mortgage Product Risks.*

The Guidance applies to all federally insured depository institutions, their subsidiaries, and affiliates. It also applies to loans purchased from or sold to others. While it specifically applies to nontraditional mortgages, the principles in the guidance apply to all mortgage loans with similar features. See Appendix F for the full text of the Guidance.

The Guidance defines the alternative mortgage products as:

- "Interest-only" mortgages – a borrower pays no loan principal for the first few years of the loan.

- "Payment option" adjustable-rate mortgages (ARMs) – a borrower has flexible payment options with the potential for negative amortization.

The Guidance instructs institutions to review and analyze several factors when underwriting these types of loans. Additionally, the Guidance sets forth supervisory expectations for institutions that originate or service alternative mortgage loans, including:

- **Portfolio and Risk Management Practices**. Financial institutions should have strong risk management practices, capital levels commensurate with risk, adequate allowances for loan losses, and strong systems and controls for establishing and maintaining relationships with third parties.

- **Loan Terms and Underwriting Standards**. Institutions should establish prudent lending policies and underwriting standards for alternative mortgage products that include consideration of a borrower's repayment capacity.

  — OTS recognizes that an institution's underwriting criteria are based on multiple factors that are jointly considered in the qualification process, and that a range of reasonable tolerances may be developed for each factor.

  — Savings associations should set the initial interest rate or start rate for alternative mortgage products in a manner consistent with prudent risk management practices, since a start rate substantially below the accrual rate for the loan may lead to negative amortization or payment shock.

- **Risk Layering**. Financial institutions that layer multiple product features may increase the potential risks of alternative mortgage products. Institutions should perform adequate underwriting analysis and consider strengthening borrower qualification standards when loan products have several higher risk features or credit risk factors. These may include:

  — Reduced or no documentation, or no customer verification.

  — High LTV's.

  — Borrowers with poor credit histories.

  — Simultaneous second mortgages.

- **Consumer Protection**. Institutions should implement programs and practices designed to ensure that consumers receive clear and balanced information to help them make informed decisions while shopping for and selecting alternative mortgage loans.
  - Providing this information to consumers serves as an important supplement to disclosures required under the Truth in Lending Act, Regulation Z, or other laws.
  - Such information should apprise consumers of, among other things, the potential for negative amortization, whether prepayment penalties apply, and the costs associated with reduced documentation mortgages.

Many savings associations have successfully offered alternative mortgage products for many years. OTS is aware that the experience of these institutions provides insight into successful risk management practices and disclosures. The Guidance provides flexibility in the methods and approaches an institution can incorporate into its underwriting standards to appropriately mitigate risks associated with alternative mortgage products. Accordingly, institutions should strive to incorporate the standards set forth in the Guidance and balance any inherent risks through sound risk management practices, implementation of strong control systems, prudent underwriting, and portfolio monitoring to offset the risks of negative amortization.

Following is a discussion of alternative mortgage product features.

Negative Amortization

Lenders may structure some ARM products such that they negatively amortize under certain interest rate scenarios. With conventional fixed-rate mortgages, 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 loans have flexible payment features, such as option ARMs, where borrowers have the option of making fully amortizing payments, interest only payments, or a low, minimum payment. The minimum required payment remains constant for a specified period; then the loan recasts so the loan fully amortizes over the remaining loan term. If the borrower only makes the minimum required payment during the option period, any unpaid interest is added to the principal balance, thus increasing the outstanding loan amount. The minimum payment on option ARM loans typically increases 7.5 percent each year during the option period. Option ARM loans also have caps that limit the loan balance increases, because of negative amortization, to 110 percent to 125 percent of the original loan amount.

Negatively amortizing mortgages give borrowers payment flexibility, the option of reduced monthly payments, and if borrowers are qualified at the low, minimum payment, allows them to borrow more than they could otherwise afford. It also allows them to free up monthly income for other purposes.

The disadvantage of negatively amortizing loans is that the monthly payment will increase significantly after the option period expires, the loan is recast, and the amortization period begins. This may place borrowers in danger of default if they cannot afford the higher monthly payments. In addition, there is the risk that the borrower’s equity will decrease if they make only the minimum required payments during the option period. This decline in borrower equity will accelerate during periods when interest rates are high.

Another disadvantage is that negatively amortizing loans are less liquid than fully amortizing loans when borrowers make only the minimum required payments.

Savings associations that offer negatively amortizing mortgages should establish identify, measure, monitor and control the risks associated with these loans. Associations should implement sound underwriting criteria and property valuation standards, as well as controls to monitor and manage the additional risks from negatively amortizing lending.

Savings associations should also ensure that the borrowers are able to make the higher required payments after the loans are recast. In general, savings associations should qualify borrowers at an amortizing payment based on the fully indexed or market mortgage rate as of the date of commitment.

Rather than focusing on loan products with negative amortization features, you can better evaluate risk by focusing your attention on loans where borrowers are only making the minimum required payments. Borrowers that chronically make only the minimum payment may be at risk should rates increase or they experience financial difficulties. You should also determine the amount of mortgages in the portfolio that actually negatively amortize as opposed to those where the loan contract merely allows it.

NegAm loans should not be considered high LTV loans (pursuant to 12 CFR §§ 560.100-101) just because of a commitment by the lender to allow the loan balance to negatively amortize to a level that exceeds the supervisory LTV limits. Because the NegAm commitment is conditional and because the borrower may elect to pay a higher payment so that negative amortization does not occur or would be limited, the loan would only become a high LTV loan if the loan balance actually increases to 90 percent or higher of the real estate's value at origination.

See Appendix C for a more detailed discussion of negatively amortizing loans.

Interest-only Mortgage Loans

> It is extremely important that savings associations that offer I/O mortgages establish sound underwriting criteria to ensure that the borrowers are well suited for these loans.

Interest-only (I/O) mortgages are becoming increasingly popular. With a typical 30-year fixed-rate mortgage, a portion of the borrower's monthly payment pays the interest accrued each month, and a portion of the payment reduces the principal amount of the loan. Over the term of the loan, the principal balance is repaid in full. In comparison, with an I/O mortgage, the borrower's monthly payments are structured to repay the interest accrued each month, with no portion to reduce the principal. Thus, the loan balance does not decrease during the interest-only period. Most I/O mortgages have an interest-only period and an amortization period. Typically the I/O period is five years, and the amortization period is 25 years. I/O loans often have a 5-year fixed interest rate, which is lower than the interest rate on a typical 30-year fixed-rate mortgage. The loan then has a 25-year adjustable-rate, fully amortizing period.

I/O mortgages allow borrowers to reduce their monthly payments, often allowing them to borrow more than they could otherwise afford, or to free up their income for other purposes. The disadvantage of I/O loans is that the monthly payment will inevitably increase significantly after the interest-only period expires and the amortization period begins. This may place borrowers in danger of default if they cannot afford the higher monthly payments.

I/O loans are also less liquid than fully amortizing loans, because the borrower pays no principal for the first five years. This may be an advantage or a disadvantage, depending on the association's liquidity needs and its other investment alternatives.

It is extremely important that savings associations that offer I/O mortgages establish sound underwriting criteria to ensure that the borrowers are well suited for these loans. The primary factor to consider is the borrower's ability to make higher payments after the expiration of the I/O period.

Qualifying I/O Borrowers

It is important that associations qualify borrowers by measuring current income against projected larger, amortizing payments after the interest rate and the I/O period expires.

As with any lending program, OTS expects savings associations to identify, measure, monitor, and control the risks of their lending activities. Therefore, a prudent strategy may be to limit the association's investment or sell most I/O production until management fully understands and can control the risks involved with this product.

You should review I/O programs and assess whether management is conducting the program in a safe and sound manner, identifying and controlling the risks, and monitoring the performance of the I/O portfolio. Appropriate MIS and performance reporting to management and the board of directors is an essential element in this process.

Home Equity and Second Mortgage Loans

For years, savings associations accommodated homeowners' needs by allowing them to take out second mortgages to make improvements to their homes, finance education, consolidate bills, start a business, or other purposes. Typically, a lender offers second mortgage or home equity loans for shorter terms and higher rates than they offer for their first mortgage loan products. When home equity and second mortgage loans originally were offered in the marketplace, the maximum amount financed would typically be 80 percent of the value of the home, less the amount of the borrower's first mortgage. Savings associations have generally had excellent performance experience with these loans.

Over the past few years, lenders have offered various higher risk home equity products, such as subprime home equity loans and home equity lines of credit up to 100 percent of the value of the home, when combined with the first mortgage. Some lenders (many of them unregulated) offer home equity loans up to 125 percent of the value of the borrower's home. The higher risks associated with this lending is discussed in the *Interagency Guidance on High LTV Residential Real Estate Lending*. (See Appendix D.)

Because of the higher risk associated with subprime and high LTV home equity loans, savings associations should consider the *Credit Risk Management Guidance for Home Equity Lending* issued by the OTS together with the other banking agencies on May 16, 2005. (See Appendix E.) The guidance outlines OTS's expectations for savings associations with home equity lending programs to implement sound risk management practices. Savings associations should also adhere to the Interagency Guidelines and the RELS Rule, as well as other applicable rules and guidelines. The association should determine whether such a program is appropriate taking into account its staff resources, capital levels, and other risk exposures inherent in the association's asset structure. Savings associations should establish prudent lending standards, credit management, servicing and collections procedures to identify, measure, monitor, and control the risks associated with such lending.

- **Lending Standards.** Savings association lending policies relating to its home lending program should be appropriate given the size and financial condition of the association, the expertise, and size of the lending staff, the need to avoid undue concentrations of risk, market conditions, and compliance with real estate laws and regulations. The policy should also clearly state the goals of the association's home lending program.

  Some high LTV home equity lenders offset the higher credit risks inherent in low security or unsecured lending by requiring higher credit bureau scores. Lenders may also use other strategies such as setting maximum debt to income ratios that limit a borrower's total monthly debt burden to prudent levels, and establishing maximum loan amounts and length of employment standards. Since these products are often ARMs with no caps, it is also appropriate to consider the guidance on ARM lending in this Handbook Section.

- **Credit Management.** Once loans are on the books, a savings association should perform periodic risk assessments through loan review and portfolio monitoring. Monitoring should include the evaluation of trends in loan volume, delinquencies, nonperforming and classified loans, as well as losses and the adequacy of the ALLL. At a minimum, associations should segregate portfolios by LTV ratio (such as 80 to 89 percent, 90 to 99 percent, and 100 to 109 percent) and analyze them separately. When the first mortgage is with another lender, associations should include the mortgage balance with the other lender in calculating LTV. It is not necessary that an exact first mortgage balance be obtained for this purpose; associations may use the balance of the first mortgage at origination or a reasonable approximation based on expected amortization. If an association approves loans using credit scores, it should track performance by periodic credit score updates. The association should make adjustments to underwriting standards and loan administration and collection procedures when performance does not meet expectations or economic cycles dictate added concern.

- **Servicing and Collections.** Because foreclosure is seldom a cost effective option, lenders that engage in high LTV home equity lending often need to make special efforts to develop and maintain effective servicing and collection procedures. Lenders involved in subprime lending stress that their collection efforts focus on quickly contacting a delinquent borrower, understanding the reason for the delinquency, and providing borrower counseling when necessary. Associations need to ensure they can absorb the costs associated with a more intensive loan servicing and collection function.

- **Other Strategies to Minimize Risk.** To further minimize risk, associations may want to adopt strategies more pertinent to the unique nature of subprime or high LTV home equity loans. For example, when a borrower uses the loan to consolidate other debts, borrowers may reload on credit card debt after taking out the home equity loan. Lenders might design procedures to prevent this, such as paying off other creditors directly from the loan proceeds and limiting "cash out" funds. Lenders may also monitor subsequent charge account activity by updating credit bureau reports on a regular basis. When credit report data indicates a decline in the borrower's credit standing, lenders should consider taking action to limit their exposure, such as curtailing further advances on open-end lines of credit.

Addendum to Credit Risk Management Guidance for Home Equity Lending

In September 2006, the federal banking agencies amended the *Credit Risk Management for Home Equity Lending* guidance to provide additional guidance for managing risks associated with open-end home equity lines of credit (HELOCs) that contain interest-only features. While HELOCs with these features may provide flexibility for consumers, OTS is concerned that consumers may not fully understand the product terms and associated risks. This addendum (See Appendix F) provides guidance addressing the timing and content of communications with consumers obtaining interest-only HELOCs. These consumer protection recommendations are similar to the guidance contained in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (September 2006) for closed-end home purchase, refinance, and home equity mortgage products.

Manufactured Home Financing

Congress designated the term "manufactured housing" to describe homes built to Housing and Urban Development (HUD) building code (HUD code) established in the Manufactured Home Construction and Safety Standards Act of 1976. HUD code pre-empts local building codes. Manufactured homes have a permanent chassis. Modular, panelized, kit and other homes without a permanent chassis are not considered manufactured homes. Modern manufactured homes have evolved from their distant origins as travel trailers or mobile homes, and are almost never moved from their original site. Today, about three-fourths of new unit sales are multi-section homes, and two-thirds are placed on the buyer's land.

In most states, manufactured homes are originally titled as personal property or chattel. To be considered real estate, the home's wheels, axles, and hitch must be removed and the home must be permanently attached to the land. In such cases, personal property title is surrendered and the home converted to real property in accordance with state and local requirements.

Pursuant to section 5(c)(1)(J) of the HOLA, a federal savings association may invest in manufactured home chattel paper[3] and interests therein without limitation as to percentage of assets. This authority includes dealer inventory and retail financing.

Additionally, a savings association may invest in manufactured homes secured by a combination of the manufactured home and real estate. If the manufactured home is permanently affixed to a foundation, a savings association may treat a loan secured by a combination of manufactured home and lot on which it sits as a home loan and report it as such on its Thrift Financial Reports. Such loans are subject to the LTV and other requirements of the Interagency Guidelines, at 12 CFR § 560.101.

Lenders engaged in manufactured housing finance must carefully manage the risk of collateral depreciation. Savings associations should establish conservative underwriting standards, prudent LTV limits and amortization schedules, and rigorous appraisal standards for manufactured home lending. Professional appraisers with specific experience in valuing manufactured homes should conduct the appraisals. Fannie Mae and Freddie Mac purchase mortgages secured by manufactured homes, subject to specific underwriting guidelines. Mortgage insurance is available from private mortgage insurers and Federal Housing Administration (FHA) for loans secured by manufactured homes.

Reverse Mortgage Loans

Over two-thirds of this country's senior citizens own their homes. While almost 80 percent of the homes are owned free of any liens or encumbrances, many seniors find themselves in the position of being "house rich but cash poor." In response to this problem, some lenders have developed loan products referred to as reverse mortgage loans.

Reverse mortgage loans are a form of credit extension secured by first mortgages on single-family residences. As the term implies, reverse mortgage loans are the reverse of traditional mortgage loans. Instead of borrowing a lump sum and repaying it over time, borrowers receive loan proceeds either in the form of a line of credit (typically about 30 percent to 40 percent of the property's value, which they can draw on when they need it) or in regular monthly advances. The advances may either be for a specified number of months ("term" loans) or may be paid as long as the borrower lives in the home ("tenure" loans). Regardless of the advance feature of the loan (term, tenure, or line of credit), reverse mortgage loans do not have fixed maturity dates. They mature when the borrower either dies or moves. If there are two borrowers, the loan matures when the survivor dies or moves. At that time, lenders are repaid out of the proceeds from the sale of the home, and the lender's recovery from the borrower or the estate will be limited to the proceeds from the sale of the home. As with conventional mortgage loans, the lender accrues interest on the outstanding balance until the loan is repaid.

For a typical mortgage loan, the loan amount is based on a percentage of the appraised value or sales price, and is repaid by the borrower(s) through monthly payments over a fixed loan term, so that the loan amount in relation to the property's value typically decreases over time. Reverse mortgages, on the other hand, start out with a low LTV ratio that typically increases over time as the lender makes advances to the borrower(s) and interest accrues on the unpaid balance.

[3] The term "manufactured home chattel paper" means a document evidencing an installment sales contract or a loan or interest in a loan secured by a lien on one or more manufactured homes and equipment installed or to be installed therein.

The amount of the monthly payments or advances the borrower(s) receive for either term or tenure reverse mortgage loans depends on the estimated loan maturity, the interest rate, and the value of the home. Lenders use mortality and relocation tables to estimate the loan maturity. For tenure loans, the number of months to maturity equates to the number of payments the lender will have to make to the borrower(s). For example, under the FHA reverse mortgage program, a 65-year-old woman, with $100,000 in home equity, might receive $234 per month for life. An 85-year-old woman with $100,000 in home equity might receive $604 per month. The reason for the increase in payment amounts to the 85-year old borrower is that the number of payments the lender expects to pay is much lower than for the 65-year old borrower.

Other factors that affect monthly payments are the expected appreciation or depreciation of the home and whether the borrower receives an up-front advance in addition to monthly payments. The FHA program uses very conservative life expectancy assumptions in its payment model, so monthly payments are often lower than with private programs that use standard life insurance mortality tables.

Reverse mortgage loans are attractive from a consumer standpoint in that they enable borrowers to use the equity in their homes to produce monthly cash income while they remain in their homes. OTS encourages associations to engage in lending programs that meet identified community credit needs, provided the association conducts them in a safe and sound manner. While reverse mortgage loans may be responsive to a particular community's credit needs, their structure presents several challenges to lenders, including:

- The management of risks associated with changes in the value and condition of the property over the life of the loan.
- The uncertainty over the loan term, the number of payments that will be made to the borrower.
- The general lack of experience among many lenders with reverse mortgage products.

Therefore, it is incumbent on management and the board of directors to carefully assess all risks associated with any proposed reverse mortgage-lending program and determine to what degree the association can offset or tolerate such risks.

Furthermore, as with all new lending programs, savings associations should limit their reverse mortgage investments until they gain sufficient experience in dealing with the unusual characteristics of the product. As reverse mortgage loans are secured by real estate, they are subject to the RELS regulation and Interagency Guidelines discussed in this section.

Appendix B contains a more detailed discussion of the risks associated with reverse mortgage loans, as well as accounting and other policy issues.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(5)(c)(1)	Loans or Investments without Percentage of Assets Limitations
§ 1464(5)(c)(2)	Loans or Investments Limited to a Percentage of Assets or Capital

Code of Federal Regulations (12 CFR)

Part 528	Nondiscrimination Requirements
Part 535	Prohibited Consumer Credit Policies
Part 560	Lending and Investment
560.100-101	Real Estate Lending Standards
§ 560.170	Establishment and Maintenance of Records
§ 563.43	Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders
Part 564	Appraisals
§ 567.1	Qualifying Mortgage Loan
§ 567.6	Risk-based Capital Credit Risk-weight Categories
Part 570	Safety and Soundness Standards
§ 590.3	Operations (Preemption)
§ 590.4	Consumer Protection Rules for Federally Related Loans, Mortgages, Credit Sales, and Advances Secured by First Liens on Residential Manufactured Housing Loans

Office of Thrift Supervision Guidance

CEO Memos

CEO 103	Uniform Retail Credit and Account Management Policy
CEO 137	Expanded Guidance for Subprime Lending Programs

CEO 222	Credit Risk Management Guidance for Home Equity Lending
CEO 244	Interagency Guidance on Nontraditional Mortgage Product Risks

Regulatory and Thrift Bulletins

RB 3b	Policy Statement on Growth for Federal Savings Associations
TB 13a	Management of Interest Rate Risk, Investment Securities, and Derivatives Activities
TB 55a	Interagency Appraisal and Evaluation Guidelines
TB 72a	Interagency Guidance on High Loan-to-Value Residential Real Estate Lending

Handbook Sections

Section 208	Appraisals
Section 217	Consumer Lending, Appendix A, Interagency Guidance on Subprime Lending
Section 261	Adequacy of Valuation Allowances, Appendix A, Effective Internal Asset Review Systems
Section 410	Financial Reports and Records
Section 1100	Compliance Examination Oversight Program
Section 1200	Fair Lending
Section 1300	Consumer Loans and Regulations
Section 1400	Compliance Laws and Regulations

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Specifies GAAP Accounting for Losses and Contingencies
No. 34	Capitalization of Interest Cost
No. 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects
No. 91	Specifies GAAP Accounting for Loan Fees
No. 133	Accounting for Derivatives

Other References

Fannie Mae and Freddie Mac Underwriting Guidelines

FHA Underwriting Guidelines

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One- to Four-Family Residential Real Estate Lending Program

EXAMINATION OBJECTIVES

To evaluate the one- to four- (1-4) family residential loan portfolio for credit quality and risk.

To determine if a savings association's lending policies regarding real estate lending activities are adequate, in conformance with the Real Estate Lending Standards (RELS), and appropriate to the size and complexity of the association's lending operations.

To assess management's and lending personnel's conformance with established policies and guidelines, and compliance with applicable laws and regulations.

To determine if a savings association's risk management practices and internal controls regarding residential real estate lending activities are adequate.

To initiate corrective action as appropriate.

EXAMINATION PROCEDURES

You should conduct the following examination procedures in conjunction with the Examination Handbook, Section 201, Overview procedures to bring together a review of the entire lending function(s) of an association. Where a savings association has multiple loan departments (e.g., segregated by lending type(s)) the examiner team will use the aggregate findings to arrive at an overall assessment of the lending function and the credit risk and quality of the entire loan portfolio. As such, the examiner-in-charge (EIC) or assisting examiner responsible for Asset Quality should avoid duplication of efforts by ensuring an exchange of information and results from each examiner responsible for the different asset quality sections.

LEVEL I

WKP. REF.

This section expands on the general lending discussion in Section 201 to address additional policy guidelines specific to 1-4 family residential mortgage lending.

1. Review Section 201 Level I findings to determine whether the loan policies and procedures include guidance related to the types of 1-4 family residential lending programs the association offers, and whether the portfolio risk management practices and internal controls adequately address these programs.

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2. Verify that the lending policies and practices are consistent with the RELS (12 CFR §§ 560.100-101) and the Interagency Guidelines for Real Estate Lending Policies, the Interagency Guidance on High LTV Residential Real Estate Lending (Interagency LTV Guidance) (Appendix D to this Handbook Section), and the Interagency Guidance on Nontraditional Mortgage Product Risks (CEO Memorandum 244). Verify that the lending policies and procedures are appropriate for the nature and risk of the real estate lending activities conducted.

3. Determine the types of 1-4 family residential loan programs and note whether and to what extent the association makes nontraditional, hybrid, or subprime mortgages. Identify any new lending activities, programs, or strategies to evaluate as part of this review.

   - Determine whether the association's lending programs incorporate risk layering features such as high LTV lending, simultaneous second mortgages, or limited documentation.

4. Review loan portfolio performance for the various mortgage products offered. Ensure that the association has properly stratified loans by various risk elements.

   - Identify any performance concerns and determine whether additional review is needed to assess such concerns.

5. Review the audit reports and preceding report of examination and all lending related exceptions noted, and determine if management took appropriate corrective action.

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6. In conjunction with the board and management report reviews in Examination Handbook Sections 260, 310, and 330, ascertain if any problems or concerns regarding real estate lending were noted.

______________________________ ______

7. Review MIS reports related to 1-4 family residential lending to identify potential areas of concern and to assess the adequacy of reporting to the board of directors and management on the performance of the real estate portfolio (trends, delinquencies, exceptions, losses, collections, etc.).

______________________________ ______

8. Verify that the association is properly classifying past due 1-4 family mortgages and home equity loans in accordance with the Uniform Retail Credit and Account Management Policy.

______________________________ ______

9. Participate in the Level I review of Section 208 or discuss findings with the EIC to ensure that the association's appraisal practices are sound and do not otherwise impact the risk of the association's lending operations.

______________________________ ______

10. Coordinate with examiners reviewing compliance management to ensure that the association adequately covers the 1-4 family residential lending within the scope of the compliance management oversight, and that there are no material violations of consumer lending laws or deficiencies in the compliance management function that could impact the risk profile of the real estate loan portfolio.

______________________________ ______

11. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures. Where you determine that the association has sound underwriting policies and practices, and strong internal controls and risk management practices, you might limit your review to higher risk lending activities (e.g., subprime lending), areas with identified

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performance concerns, or newer lending activities or programs (e.g., interest-only loan programs) where the association's track record is limited.

12. Based on your Level I review, determine the need for sampling of homogeneous assets.

LEVEL II

One- to Four-Family Residential Lending

1. Determine whether the association has established procedures to verify borrower provided information (such as sending out verification of deposit letters and verification of income letters).

2. Determine whether the association has established adequate procedures to perfect its interest in the security property.

3. Verify that the association adequately prices mortgage loans to provide sufficient yield to cover the operating expenses, funding costs, and risk premium attendant to the extension of credit.

4. If applicable, determine whether the association has appropriate controls, oversight, and underwriting policies and procedures to address low-doc loan programs.

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5. For FHA-insured and VA-guaranteed loans:

- 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.
- Determine that required delinquency reports are being submitted.

Adjustable Rate Mortgages

6. Verify that the points the association receives for originating the ARM loans compensate the association for the discount that the secondary market would demand to accept the risks of that ARM product.

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7. Determine which index (Treasury bill rate quoted on a discount basis or on the constant-maturity yield rate) the association uses for adjustable rate mortgages (including interest-only mortgages). Verify that association's mortgage documents state precisely which index is used.

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8. For discounted, Hybrid, or "teaser" ARMs:

- Determine if the association's current pricing structure or policy is sufficient to cover the association's operation expenses, funding costs, and risk premium. If not, determine the soundness of management's strategy. Note if any of the following conditions are present:
  - — 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 association.
  - — Refinancing existing ARMs at lower rates offered on new ARMs reduces the opportunity to recoup initial losses in subsequent repricings.

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- Determine if the association's lending policies and procedures and underwriting guidelines adequately address the increased default risk by qualifying borrowers at the fully indexed rate.

9. Verify that the association properly accounts for interest rate buy downs according to SFAS No. 91.

Home Equity Lending

10. If the association originates home equity loans, verify that the association:

- Adheres to the guidance set forth in the Interagency LTV Guidance regarding high LTV loans.
- Has adequate underwriting procedures.
- Has an adequate servicing and collection department and staffing.
- Has adequate monitoring and reporting systems.

Negative Amortization and Interest Only Loans

11. If applicable, determine whether the association has underwriting policies and procedures that adequately address loans with the potential for negative amortization, including limits on the amount of negative amortization allowed on a loan compared with its current market value.

- Determine that the underwriting for such loans conforms with OTS guidance in this section as well as the Interagency Guidance for Nontraditional Mortgage Product Risks.
- Assess the level of such loans with chronic negative amortization.

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12. Determine if the association (and brokers, if applicable) provide borrowers with adequate information concerning the payment options, negative amortization if only the minimum payments are made, and reset provisions of loans with negative amortization features.

Subprime Mortgage Lending

13. If the association is engaging in subprime mortgage lending, verify that the association:

- Segregates its subprime loans to manage risks and monitor performance.
- Follows the Interagency Subprime Lending Guidance and the Expanded Subprime Lending Guidance.
- Has sufficient staff training and resources to manage any additional collection burden.
- Has sufficient ALLL and capital to cover the additional risks inherent in its subprime lending operation.

14. If the association makes hybrid 2-28 or 3-27 ARM loans, verify that underwriting standards require borrowers to qualify at the fully indexed rate, and not the start or "teaser" interest rate.

15. As appropriate, conduct additional subprime lending examination procedures detailed in Appendix B of Handbook Section 217.

16. Select a sample of subprime loans for review and analyses. **Sampling is mandatory for associations with subprime lending programs.**

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Reverse Mortgage Loans

17. Determine if the association engages in reverse mortgage lending. If so, verify that the association:

- Calculates the risk-based capital requirement separately for each reverse mortgage loan.
- Assesses each borrower's life expectancy for each reverse mortgage loan.
- Performs a sensitivity analysis on the reverse mortgage loan program's profitability for:
  - — A range of alternative mortality rates.
  - — A variety of possible appreciation and depreciation scenarios.

18. Determine whether the association structures reverse mortgage loan contracts to withhold the appreciation portion of payment until appreciation actually occurs.

Manufactured Home Financing

19. Determine whether the association engages in manufactured home financing. If so, determine whether the association:

- Is originating residential real estate loans secured by permanently affixed manufactured homes; or investing in retail manufactured home chattel paper that is insured or guaranteed.
- Has adequate underwriting standards, policies and procedures specific to manufactured home financing.
- Has staff with expertise in this area.
- Has adequate loan administrative and collections for this lending activity.
- Has adequate ALLL.
- Uses professional appraisers experienced in manufactured home valuation.

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- Sells manufactured home chattel paper without recourse.

Sampling

20. If concerns are noted in reviews, select for review a sample of 1-4 family mortgages. You should base this decision on the performance of those portfolios, whether the association offers new loan programs, and the adequacy of the association's lending policies, practices, oversight, and controls. Focus transactional testing on the higher risk areas. Use transactional testing to provide reasonable confidence that the conclusions regarding 1-4 family residential lending are valid.

CONCLUSIONS

1. 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.

2. 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.

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:
   - Geographic lending areas? ☐ ☐
   - Acceptable types of properties? ☐ ☐
   - Lending authority of committees and individual officers? ☐ ☐
   - Minimum financial information required for borrowers of specific types of mortgage loans? ☐ ☐
   - Minimum appraisal standards for real estate mortgage loans? ☐ ☐
   - Maximum advance as a percentage of appraised value or purchase price? ☐ ☐
   - Limits on the amount of negative amortization allowed on a mortgage compared with its current market value? ☐ ☐
   - Maximum loan maturities? ☐ ☐
   - Sound review standards for real estate loan applications that require the underwriting analysis/decision be documented? ☐ ☐
   - Minimum standards for loan documentation? ☐ ☐
   - Limitations on the number or amount of loans involving any individual borrower or contractor? ☐ ☐
   - Limitations on the number, type, or amount of loans purchased or sold by the institution? ☐ ☐
   - Minimum standards for qualification of borrowers for various loan products (ARMs, Teaser Rate, etc.)? ☐ ☐
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? ☐ ☐

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	Yes	No
4. Does the institution have a written schedule of fees, rates, terms, and collateral requirements for all new loan?	☐	☐

Appraisal Practices

	Yes	No
1. Has the board of directors:		
• Adopted an appraisal policy?	☐	☐
• Developed written hiring policies for appraisers?	☐	☐
• Developed a review system for appraisers?	☐	☐
2. Has the board of directors adopted a current approved appraiser list and are appraisers approved before they are used?	☐	☐
3. Are current agreements of sale, option, or listing information made available to appraisers?	☐	☐
4. Are appraiser's fees based upon a set fee and not the granting of the loan or the appraised value of the property?	☐	☐
5. 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?	☐	☐
6. If appraisers who are not employees of the institution are used, does the institution adequately investigate their report quality, reputation, and qualifications?	☐	☐
7. Do loan approval and appraisal functions maintain adequate independence internally?	☐	☐
8. Does the institution not use borrower-supplied appraisal reports?	☐	☐
9. Are appraisal review personnel identified and given specific guidelines to determine the adequacy of the appraisal?	☐	☐
10. Are appraisers paid the same amount whether or not the loan is granted?	☐	☐

Collateral

	Yes	No
1. Does the institution have a sound policy of cross-collateralizing security properties for major borrowers?	☐	☐
2. Are loan advances supported by written evidence or reinspection of property?	☐	☐

	Yes	No
3. If supplemental collateral is held on loans, is it secured and a record of its status maintained?	☐	☐
4. Is written acknowledgment obtained from the borrower for the pledging of savings accounts or the assignment of life insurance policies?	☐	☐

Loan Documentation

1. Do the institution's loan documentation policies and procedures comply with 12 CFR § 560.170?	☐	☐
2. Does the institution verify each applicant's income, employment, and financial condition prior to loan commitment?		
3. Are procedures in effect to ensure compliance with the requirements of government agencies insuring or guaranteeing the loans?	☐	☐
4. Has a system for maintaining adequate loan document files been established including:		
• A check sheet to assure that required documents are received and on file?	☐	☐
• Inspection performed by internal loan review personnel?	☐	☐
5. Are procedures in effect to protect loan documents from theft, damage, or inappropriate release?	☐	☐
• Are collateral releases executed only after required payments have been cleared?	☐	☐
• Are lien releases approved reviewed by an officer or officers based on the size of the loan?	☐	☐
6. Are all real estate loan commitments issued in written form?	☐	☐
7. 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 loan commitment or legal lending limit?	☐	☐

Loan Interest and Commitment Fees

1. Is the preparation of interest earned or loan fees subsidiary journals reviewed by personnel who do not issue checks or handle cash?	☐	☐
2. Are interest and fee computations made and tested by persons who do not also issue checks/drafts or handle cash?	☐	☐

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		Yes	No
3.	Does the institution properly account for deferred and earned loan fees?	☐	☐

Recordkeeping

		Yes	No
1.	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?	☐	☐
2.	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?	☐	☐
3.	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?	☐	☐
4.	Are detailed statements of account balances and activity mailed to mortgagors at least annually?	☐	☐
5.	Are inquiries about loan balances received and investigated by persons who do not also handle cash?	☐	☐
6.	Are documents supporting recorded credit adjustments checked or tested by persons who do not also handle cash?	☐	☐
7.	Is a daily record maintained summarizing loans made, payments received, and interest collected to support applicable general ledger accounts?	☐	☐
8.	Are note and liability ledger trial balances prepared and reconciled to controlling accounts by employees who do not process or record loan transactions?	☐	☐
9.	Are records and files for serviced loans segregated and identifiable?	☐	☐
10.	Is an overdue accounts report generated on a timely basis?	☐	☐
11.	Are loan officers prohibited from processing loan payments?	☐	☐
12.	Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?	☐	☐
13.	Are advance loan payments adequately controlled if they are not immediately credited to the loan account?	☐	☐

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	Yes	No

Insurance and Escrow

		Yes	No
1.	Does the institution require escrows for taxes and insurance, and include such payments when qualifying borrowers?	☐	☐
2.	Does the institution have a mortgage blanket hazard insurance policy?	☐	☐
3.	Is there an effective, formalized system for determining whether insurance premiums are current on collateral properties?	☐	☐
4.	Does the institution require that insurance policies include a loss payable clause to the institution?	☐	☐
5.	Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursements?	☐	☐
6.	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?	☐	☐

Subprime Lending

		Yes	No
1.	Does the institution have a subprime lending program?	☐	☐
	If so:		
	• Does the institution track performance of subprime loans based on product type, combined LTV, credit score, documentation, and originating officer/office, or broker?	☐	☐
	• Does the institution use the same underwriting standards for sold or held-for-sale loans as it does for its portfolio loans?	☐	☐
	• Does the institution sell loans without any form of implicit or explicit recourse?	☐	☐
	• Are representations and warranties standard and limited to 120 days?	☐	☐
	• Where repurchase obligations are significant, does the institution maintain adequate reserve accounts for such contingencies?	☐	☐
	• Has the institution had to repurchase a significant amount of sold loans?	☐	☐

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Yes No

COMMENTS

Questions and Answers on Real Estate Lending Standards (RELS) Regulation and Guidelines

1. **What is the private mortgage insurance (PMI) requirement for owner-occupied, one- to four- (1-4) family residential and home equity mortgage loans?**

   Owner-occupied, 1-4 family residential and home equity mortgage loans of 90 percent 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 percent. If an association makes a 95 percent LTV loan and requires PMI that insures losses down below 90 percent, the loan would not be considered a high LTV loan for purposes of the real estate lending standards policy.

2. **Can a savings association originate 100 percent LTV ratio loans without PMI?**

   A savings association can originate 100 percent LTV home mortgage loans without PMI, though they would be included in the "Loans in excess of the supervisory LTV limits" category, which must be reported to the board of directors and limited, in aggregate, to 100 percent of capital. While examiners would not take exception to a moderate amount of such loans, they may criticize the association if the loans are underwritten in an unsafe and unsound manner.

3. **What is the loan category for a loan 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?**

   The association should treat the loan as a land development loan. Although the purpose of the loan is not to develop the lots, the end product is the same. OTS expects savings associations that make higher-risk loans to do so at lower LTV ratios. Those with lower risk, such as loans to purchase finished lots, could be made at the maximum LTV ratio.

4. **Do uninsured deposits that are in excess of the FDIC insurance limit (currently $100,000) count as "financial instruments" for "readily marketable collateral?"**

   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**?

For cross-collateralized loans, the maximum loan that the association can make within the supervisory LTV ratio limits is based on the following formula: [(Value of each property X appropriate maximum LTV ratio) less any 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?**

A construction-permanent loan secured by a single-family residence to the owner-occupant is treated as a permanent mortgage loan for purposes of categorizing the loan in the supervisory LTV ratio limits. In other words, if the LTV ratio equals or exceeds 90 percent, 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 is treated as a 1-4 family construction loan (with an 85 percent supervisory LTV ratio limit) until construction is complete and the permanent lender refinances the loan. If the permanent lender is a closely held affiliate of the construction lender, then the loan can be treated as a permanent loan. Of course, as in all construction loans, a lender should always maintain appropriate disbursement controls during the construction period.

7. **Are unsecured loans (with loan proceeds used to purchase or improve real estate) subject to the rule?**

Yes. In drafting the statutory language that required the banking agencies to draft regulations requiring federally insured depository institutions to issue regulations on real estate lending standards, Congress was concerned that, without a requirement to include unsecured loans used to finance real estate transactions, some institutions would be tempted to make unsecured loans to avoid having to comply with the rule.

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?**

Yes. The "abundance of caution" exception only applies when a loan is otherwise well collateralized, such as a loan to purchase an automobile that is collateralized by the vehicle, and the underwriting criteria and loan terms were more indicative of an auto loan.

9. **How should associations categorize, for supervisory LTV ratio limit purposes, mortgage loans that are not principal residences?**

Unless such residences meet the Internal Revenue Service (IRS) test of residency, the loans are considered improved property loans (85 percent LTV ratio limit) since they are not owner-occupied, 1-4 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 percent, it is placed in the larger 100 percent of capital "bucket" (which does not have a principal residence requirement).

Loans that meet the IRS test of residency are treated as owner-occupied, 1-4 family residences.

10. **How should loans under the FHA Title I program be treated?**

Similar to the OTS capital rule treatment of such loans, FHA Title I program loans are not considered guaranteed loans, so if the association makes loans with LTV ratios of 90 percent or higher without PMI, they would go in the loans in excess of the supervisory limits "bucket."

11. **Does the RELS rule cover manufactured homes?**

The rule applies to real estate loans. Loans secured by "manufactured homes" that are not affixed to real property are not real estate loans and the RELS rule does not apply to them. Other "similar" personal property – mobile homes, RVs, etc. – are chattel and are not considered home loans under the rule. If a mobile home and a lot secure the loan, the security property is categorized as chattel and land, and the lot loan would be subject to the RELS rule. If a manufactured loan is permanently attached to the property, it is a home loan and covered by the rule.

12. **How should loans guaranteed by 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?**

All loans, or portion of 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, any portion of a loan that is so guaranteed should not be categorized as a high LTV loan.

13. **Do we include non-owner-occupied, 1-4 family loans in the 100 percent of capital exception bucket?**

Yes. Non-owner-occupied 1-4 family loans are subject to the 85 percent LTV ratio for improved property loans; such loans with LTV ratios greater than 85 percent are placed in the 100 percent exception bucket.

14. **Are loans in excess of the supervisory LTV limit secured by developed lots for 1-4 family residential homes placed in the 100 percent of capital exception bucket?**

    Yes. All loans related to 1-4 family residential properties go into the 100 percent exception bucket. For developed lots, the lots should be in a 1-4 family residential subdivision and properly zoned to be treated as 1-4 family residential properties.

15. **Should home improvement loans be treated like permanent mortgages or construction loans?**

    Yes, home improvement loans should be treated like permanent mortgages for purposes of determining the maximum supervisory LTV.

16. **If an association 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)?**

    No, because the borrower has not met the conditions of the ultimate lender (complete construction, obtain an occupancy permit, etc.).

17. **How do you determine the supervisory LTV ratio limits for multi-stage projects?**

    The maximum LTV ratio for multi-stage projects is ultimately limited by the LTV ratio applicable to the final stage of the loan. Associations should establish, as part of their loan administration policies, procedures on loan disbursements, based on the value of the project less the cost to complete it less a completion reserve, during the entire construction process. In general, prudent loan disbursement means that funding of the initial acquisition of raw land should not exceed 65 percent of the cost of the land and funding the development stage should not exceed 75 percent of the costs of development, etc.

18. **For cross-collateralized loans, we calculate the maximum LTV ratio based on a weighted average method. If one loan in the pool is over the LTV ratio limits, what goes into the high LTV ratio "bucket?"**

    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 association has "excess LTV ratio cushion" in one loan to "cover" another loan's lack of LTV ratio cushion. Conversely, if the entire excess cushion is used, then the whole pool presents a higher degree of risk. This will give associations 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 associations should only be making prudent loans.

19. **If a bank makes a loan to a borrower to purchase a property and make improvements that will enhance the value over the original cost, on what value should the LTV be based?**

    In general, the LTV should be based on the original cost plus the improvements, however, use the fair market value (per the appraisal or evaluation) as completed after the improvements are made.

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RISKS AND POLICY ISSUES ASSOCIATED WITH REVERSE MORTGAGE LOANS

Accounting for Reverse Mortgages

The accounting for reverse mortgages, including the recognition of interest and fee income, should be in accordance with instructions provided by the staff of the Securities and Exchange Commission (SEC), in an October 1992 paper, "Accounting for Pools of Uninsured Residential Reverse Mortgage Contracts." In general, the SEC instructions require the grouping of individual reverse mortgages into pools, and then adjusting the carrying value of, and recognizing income on the pools based on the retrospective yield. The retrospective yield is the effective yield from inception of the mortgages, which reflects both actual cash flows to date and expected future cash flows.

The SEC instructions require that estimates of future cash flows incorporate actuarial projections of mortgage terminations, including assumptions about life expectancy, prepayments, and borrower relocation, and projections of collateral values. At each reporting date, the analysis of actual cash flows to date and expected future cash flows is to be updated, and the retrospective yield is to be recomputed. The carrying value of each pool of reverse mortgage loans represents the recorded investment in the loans, adjusted on a cumulative basis for income recognized based on the retrospective yield. Considering the complex accounting issues involved with reverse mortgage lending, savings associations are cautioned against engaging in such programs unless their accounting staffs have the knowledge and experience to deal with such issues.

Classification of Reverse Mortgage Loans

Savings associations should classify reverse mortgage loans in accordance with the OTS Classification of Assets regulation 12 CFR § 560.160 and OTS bulletins and policy statements. The OTS regulation directs federal savings associations to classify assets based on well-defined weaknesses. Assets are classified Substandard, Doubtful, or Loss based on the degree and likelihood that the association would sustain a loss on the assets.

Unlike standard mortgage loans, reverse mortgage loans are repaid from the proceeds of the sale of collateral, not monthly borrower payments. As such, reverse mortgage loans that are not insured by an agency of the federal government should be classified based on the ability of the collateral to support the loan. A loan should be adversely classified if the recorded investment in the loan (including accumulated advances to borrowers, accrued fees, accrued interest, deferred net fees, and any unamortized purchase premium or discount[1]) exceeds the estimated net proceeds from the sale of the

[1] The contra account resulting from the application of the retrospective yield approach, if determined on a pool basis, should not be deducted in arriving at the recorded investment. (Specific valuation allowances, however, can be deducted from the loan balance in arriving at the recorded investment.) This is because the classification decision is made on a loan-by-loan basis. Also, because this contra account is not available to absorb losses in the association's entire portfolio, it cannot be included in the association's allowance for loan and lease losses (ALLL) for purposes of the risk-based capital regulation.

security property, based on the most current value of the property (based on an appraisal or evaluation). Disposition costs, such as real estate commissions, attorney's fees, settlement costs, etc., reduce the amount realized from the sale of the property. Therefore, unless an association can show that its disposition costs will likely be less than 10 percent, it should classify loans with a loan-to-value (LTV) ratio (based on the current appraised value of the property) greater than 90 percent as no less severe than Substandard.[2] It should be noted that loan amounts greater than the expected net disposition value of the property should be netted from the loan by additions to the retrospective yield contra account. Therefore, classifying such amounts Loss is not necessary.

Risk-Based Capital Rule Treatment

Reverse mortgages are treated as follows under the risk-based capital rule:

On-balance-sheet amounts are treated like other mortgage loans. Reverse mortgage loans that meet the requirements for "qualifying mortgage loans" (including LTV ratio and performance requirements) are risk-weighted at 50 percent. Once the loan no longer qualifies as a "qualifying mortgage loan" (such as when the LTV ratio is 90 percent or higher), the loan should be risk-weighted at 100 percent. (The LTV ratio, for the capital rule purposes, is computed using the recorded investment in the loan as the numerator and the original property value as the denominator.)

The off-balance-sheet commitment amount is first converted to an on-balance-sheet credit equivalent amount and then risk-weighted in the same fashion as the on-balance-sheet asset. Savings associations should use the 50 percent credit conversion factor for the off-balance-sheet commitment. (The 50 percent credit conversion factor assumes that the commitment is not cancelable by the association. Unconditionally cancelable commitments do not have to be included in the calculation of risk-weighted assets.) The amount of the off-balance-sheet commitment is determined by multiplying the number of remaining payments[3] by the amount of the advance to be paid each period. The off-balance-sheet commitment amount must be recalculated annually. For line of credit loans, which contain a cap on the dollar amount to be provided to the borrower, the off-balance-sheet commitment is the undisbursed line of credit amount.

Although pool accounting may be used to determine an association's yield on its reverse mortgage investment, the risk-based capital requirement must be calculated separately for each loan.

[2] Because reverse mortgage loans are accounted for using the retrospective yield method, which requires a contra account for uncollectible amounts, it is not necessary that uncollectible amounts be classified Loss. An ALLL is not automatically required on reverse mortgage loans classified Substandard. However, general allowances should be established for reverse mortgage loans if the association is likely to experience losses on the disposition of the security property that are not reflected in the recorded investment. The level of any required ALLL on reverse mortgage loans should be based on the association's historical net loss experience for reverse mortgage loans, adjusted for current conditions and trends.

[3] For tenure loans, the number of remaining payments is usually equal to the estimated number of remaining months of a borrower's life, based on a third-party, independent actuarial table.

Mortality/Relocation Estimates

In order to estimate how long a savings association will have to make payments under the tenure reverse mortgage loan contracts, it must assess each borrower's life expectancy. Such estimates are generally made using mortality rates, published by the U.S. Bureau of the Census, or actuarial tables available from life insurance companies.[4] It is important that an association use current actuarial tables from a reliable and independent source (preferably from a major life insurance company or some other entity that has proven expertise and reliability). Also, consideration should be given to whether national mortality norms can be expected to hold for the association's particular area and mix of borrowers. There is the risk that a particular population will not behave as predicted by national mortality and relocation norms. Persons who apply for reverse mortgages may not be representative of the general population, so there is the potential for the mortality rates of an association's borrowers to deviate significantly from published tables. Therefore, an association should perform a sensitivity analysis on the effect a range of alternative mortality rates would have on the program's profitability.

Some reverse mortgage lenders use both mortality and relocation rates to estimate when the reverse mortgage contract will terminate. Typically, a reverse mortgage loan is expected to terminate when the borrower either moves or dies. Since senior citizens often relocate before they die, the use of relocation rates allow for contract term estimates to be shorter and allow lenders to justify larger payments to the borrower. Federal savings associations are urged to use caution when adopting relocation rates for the general elderly population, because reverse mortgage borrowers may alter their relocation patterns in light of the fact that they will continue to receive monthly payments from the lender as long as they remain in their homes.

Appraisals and the Requirement for Reappraisals

As with other real estate loans, the provisions of 12 CFR Part 564 establish when an appraisal or evaluation is required for a reverse mortgage loan. There are no specific requirements for reappraisals or reevaluations after a loan is made; however, as with other types of real estate loans, the association should periodically assess the value of the collateral supporting its loans. This is particularly important for reverse mortgage loans because the loan balance increases over time and the collateral is the primary source of repayment.

As stated in Thrift Bulletin 55, Real Estate Appraisal and Evaluation Guidelines, the useful life of an appraisal or evaluation will vary depending on the property and the market place. Management should determine if there have been material changes to the appraisal's or evaluation's underlying assumptions that affect the original estimate of value. Factors that could cause material changes in property values include:

- Passage of time.

[4] Insurance companies use actuarial tables (also referred to as annuity tables) to determine the monthly amount they can profitably pay to a purchaser of their annuity products. Actuarial tables differ from mortality tables in that they have built-in assumptions that annuitants will die at a slower rate (generally 65 percent to 85 percent) than indicated by mortality tables. This assumption serves two purposes: (1) it protects the insurance company in the event that annuitants live longer than projected by mortality tables, and (2) it allows the insurance company to build a profit into the annuity product.

- Market volatility.
- Availability of financing.
- The inventory of unsold homes in the marketplace.
- New improvements to, or lack of maintenance on the security property or surrounding properties.
- Zoning changes.
- Changes in the local economy.

If the useful life of an appraisal or evaluation becomes suspect, management should determine whether there is a need for a reappraisal or reevaluation. Where property values have changed significantly from when the loan was originated, a new appraisal or evaluation may be warranted.

This is particularly important if property values have declined or if the loan balance of an individual loan approaches the anticipated market value of the security property. A significant change in property value will result in a corresponding increase or decrease in the estimated net collateral proceeds at contract termination and, therefore, an adjustment to the association's effective yield on the loan.

Property Appreciation Assumptions

Reverse mortgage loan programs often assume that the security property will appreciate over the life of the loan. Integrating property appreciation assumptions into the loan contract allows lenders to offer higher payments to borrowers because the lender would ostensibly receive more funds from the sale of the property when the borrower dies or relocates. While appreciation assumptions may seem reasonable and supported by historical experience, in some markets the anticipated appreciation may not materialize, and, in other markets, properties that have experienced high appreciation rates over the past decade could experience substantial depreciation in the future.

Savings associations should analyze the characteristics and profitability of their reverse mortgage loans under a variety of appreciation and depreciation scenarios, including a "worst case" scenario of property depreciation such as those experienced in parts of California and Boston in the early 1990s. When estimating cash flows for accounting purposes, associations should adjust any appreciation or depreciation assumptions periodically during the life of the loan.

Finally, association management is encouraged to take a very conservative stance toward property appreciation and depreciation assumptions. It may be useful to structure contracts to withhold the appreciation portion of the payment until appreciation actually occurs. The benefit of this structure is that, if appreciation actually occurs, the association could justify higher payments to borrowers later in the contract, which, in effect, would provide borrowers with a hedge against inflation.

Interest-Rate Risk

Interest-rate risk is potentially high for fixed-rate reverse mortgage loans. Because of their negative amortization feature, fixed-rate reverse mortgage loans could have substantially greater interest-rate sensitivity than standard 30-year fixed-rate mortgage loans. The Thrift Financial Report's Consolidated Maturity and Rate Schedule (Schedule CMR) does not have a separate category for reverse mortgages, so they must be reported as they are on Schedule SC. For purposes of Schedule CMR, the savings association should report the outstanding balance of reverse mortgages similar to the manner in which it reports other home mortgage loans, that is, the current outstanding balance (not the estimated future disbursements). The weighted average maturity should be based on the expected life of the loan, given mortality calculations.

Because Schedule CMR may not reflect the interest-rate sensitivity of reverse mortgages, savings associations that plan a significant investment in reverse mortgage loans should conduct an interest-rate sensitivity analysis. Such investment may require associations to undertake an internal interest-rate risk analysis required by Thrift Bulletin 13a, Management of Interest Rate Risk, Investment Securities, and Derivatives Activities.

Taxes and Insurance

To protect the collateral value of the security property, savings associations should ensure that real estate taxes are paid and that adequate hazard insurance is maintained. This becomes critically important as the borrower's equity diminishes, because they may have less incentive to pay real estate taxes. Savings associations are advised to monitor the payment of real estate taxes and insurance and to hold blanket hazard insurance policies to cover any lapse in coverage.

Property Maintenance

Adequate maintenance of the security property is critical to a reverse mortgage program. Although most reverse mortgage loan documents oblige borrowers to keep their property in good repair and otherwise maintain the value of the property, the borrowers may have little incentive or ability to do so. While typical reverse mortgage loan documents grant the lender the authority to make needed repairs and add the costs to the loan balance, such additions to the loan balance only increase the risks that there will be insufficient value in the home upon sale to cover the amount due. While the lender could conceivably declare default if the borrower fails to maintain the property, public relations considerations may preclude such action. Also, there are costs associated with property inspections to ensure that the borrower properly maintains the property. Therefore, lenders should consider the effect of deferred maintenance (or lender funded repairs) on the value of their investment.

Legal Requirements and Legal Risks

While reverse mortgage loans have been available for some time, the product is not in widespread use. Therefore, federal savings associations may not be thoroughly familiar with the statutory and regulatory requirements that will apply if they offer a reverse mortgage program. In addition, the contractual rights and obligations of borrowers and lenders in these transactions will differ significantly from those under, for example, purchase-money mortgage loan contracts. For these reasons, a savings association that offers, or intends to offer, a reverse mortgage program should consult its legal counsel to ensure that the program complies with applicable requirements and that any legal risks associated with these loans are adequately addressed. In this regard, the association should, at a minimum, consider the following laws and statutes:

Basic Authority

Federal savings associations have express authority, under the Home Owners' Loan Act (HOLA) and OTS regulations, to originate or purchase reverse mortgages, notwithstanding any contrary state laws. By virtue of the Alternative Mortgage Transaction Parity Act ("Parity Act"), 12 USC §§ 3801 et seq., state savings associations are also authorized to originate and purchase reverse mortgages even when state law purports to prohibit reverse mortgages, unless the state in question expressly "opted out" of the Parity Act within the three year period beginning on October 15, 1982, and ending on October 14, 1985. In "opt out" states, state law governs the permissibility of reverse mortgages for state savings associations. Federal savings associations are not subject to state law even in states that have exercised their "opt out" option.

Notwithstanding the foregoing, a special rule applies in the state of Texas. The HOLA provides deference to the specific provision in the Texas constitution that prohibits most non-purchase money liens against homesteads.

State Usury Laws

Some reverse mortgage loans have an annual premium feature designed to offset the risks that some borrowers may live longer than the mortality tables predict. If the annual loan fee is significant, the earlier the borrower repays the loan, the higher the effective cost of financing. For example, OTS is aware of some private programs that include an annual loan fee based on the value of the home, not the loan balance. A program with a 5 percent annual loan fee and a 10.5 percent interest rate would result in an effective interest rate of greater than 20 percent should the loan repay within the first 6 years.[5] Therefore, savings associations should determine whether state usury laws apply. Although federal law generally pre-empts the application of state usury laws to mortgage loans (including reverse mortgage loans) that are secured by first liens on residences, 12 USC § 1735f-7a, states were permitted to "opt out" of this pre-emption provision within the three year period beginning on April 1, 1980, and ending on March 31, 1983. Maximum interest rates in "opt out" states will either be governed by state law or the federal Most Favored Lender provision. 12 USC § 1463(g).

Disclosure Laws

Disclosures made to borrowers about reverse mortgage loans must comply with the Truth in Lending Act (TILA) and with the implementing regulation – Regulation Z – promulgated by the Federal Reserve Board. Lenders must provide reverse mortgage borrowers with full and accurate disclosures including, where appropriate, the loan's annual percentage rate and total finance charges. Borrowers must also be notified of their right to rescind the transaction. Also, savings associations should consider

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[5] The OTS would look unfavorably on such aggressive pricing, which may have a negative effect on the association's CRA rating.

making annual percentage rate and finance charge disclosures under varying scenarios of property appreciation and borrower mortality.

In addition, the Community Development Banking Act amends the TILA to require that lenders make certain new disclosures regarding the projected total cost of a reverse mortgage loan to the borrower.

Contractual Provisions

Circumstances unique to reverse mortgage transactions may affect both the borrower's ability to comply with the terms of the reverse mortgage loan contract and the association's ability to recover possession of the security property at the appropriate time. For example, an elderly borrower receiving a modest fixed income may lack the resources to maintain the security property as called for under the reverse mortgage loan contract. A borrower's heirs may be unaware that he or she has taken out a reverse mortgage and may, upon the borrower's death, challenge the association's right to take possession of the property. While no contractual provision can eliminate the possibility that these problems will arise, foresight and careful drafting of the reverse mortgage loan documents may mitigate the legal risk they present for the association. Savings associations may also reduce their legal risk by ensuring that borrowers understand the practical consequences of the rights and obligations that the reverse mortgage loan contract creates. Savings associations should therefore consider encouraging borrowers to seek independent credit counseling as part of their reverse mortgage programs.

Government Guaranteed Reverse Mortgage Programs

The Department of Housing and Urban Development (HUD), through the Federal Housing Association (FHA), offers a reverse mortgage guarantee program that lenders may participate in. The FHA program is similar to reverse mortgage programs discussed above, except that FHA guarantees payment to the borrower (in the event the lender should become unable to meet its payment obligations to the borrower) and guarantees the lender's investment. Under the program, borrowers pay FHA a mortgage insurance premium (MIP), consisting of an up-front fee of two percent of the maximum claim amount, plus an annual premium of one-half of one percent of the outstanding loan balance. Under the FHA program, the maximum claim amount is the maximum dollar amount that the FHA can insure for a particular geographical area. The MIP, which can be financed, provides a fund to absorb losses in the event that the mortgage balance on some loans exceeds the value of the property at the time the loan becomes due and payable.

The FHA guarantee is structured so that once the balance of a guaranteed loan reaches 98 percent of the maximum claim amount, the lender has the option of assigning the mortgage to FHA, thus eliminating the likelihood of loss to the lender. FHA's loan guarantee is limited to a maximum of the lesser of the appraised value of the house or the maximum dollar amount that the FHA can insure for single-family residences in a geographical area (currently $67,500 to $227,550). As mentioned above, the FHA program bases payments on the assumption that a borrower will live to age 100, so monthly payments to a typical FHA program borrower may be lower than payments under programs that use actuarial life expectancies.[6] Also, interest rates on the FHA reverse mortgage program are often lower than the rates charged by private programs.

As with other FHA guaranteed loans, the guaranteed portion of these loans is risk-weighted at 20 percent for the risk-based capital rule.

Another positive aspect of the FHA program is that Fannie Mae will purchase an association's reverse mortgage loans made under the FHA program. Because of the federal guarantee, an association's participation in this or similar government guaranteed reverse mortgage loan programs alleviate many of the safety and soundness concerns discussed above.

[6] The fact that an association's reverse mortgage loan program may have specific features that are very conservative does not ensure that the program as a whole is prudent. Similarly, the fact that the association bases expected loan terms on current actuarial tables, rather than the very conservative mortality assumptions used by the FHA, does not mean that, taken as a whole, the lender's reverse mortgage lending program is imprudent.

NEGATIVELY AMORTIZING MORTGAGES

Introduction

A conventional fixed-rate mortgage holds the interest accrual rate and the payments constant over the life of the loan. A portion of each monthly payment reduces the outstanding principal of the loan. Negative amortization (NegAm) adjustable rate mortgages (ARMs) are structured such that the outstanding principal balance may increase, even though payments are current. Negative amortization occurs when the borrower makes a payment at an interest rate that is lower than the accrual rate; therefore, the monthly payment is insufficient to cover the interest expense, and the difference is added to the principal amount.

If lenders carefully underwrite NegAm loans with prudent loan to value (LTV) percentages and monitor the loans closely, the added credit risk may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns. In addition, the credit performance of NegAm loans is particularly vulnerable in an economic environment of rapidly rising interest rates and stagnant or falling property values.

NegAm Products/Features

Many NegAm loans, also called Option ARM loans, have the following common features:

- Begin with an introductory teaser rate
- Borrower choice of payment amount
- A lagging aggregate interest rate index
- A cap on annual payment increases
- Contain maximum principal accrual limits
- Mandatory recast dates.

Teaser rate. Typically, a savings association originates a NegAm loan with a low introductory "teaser" rate. This may be more than 200 basis points below the fully indexed loan rate. This teaser rate is generally in effect for a period of one to three months. During the teaser rate period, the borrower's payment rate is the same as the lender's accrual rate (interest rate). At the expiration of the teaser rate period, the loan's interest rate immediately rises to the fully indexed rate; however, the minimum required loan payment remains the same until the next payment adjustment. If the borrower only makes the minimum required payment during this period, the loan will typically negatively amortize.

The lender determines the interest rate by adding a margin, stated in the mortgage, to the underlying index rate. This margin over the index varies with competitive pricing pressures, but is usually in the range of 200 to 300 basis points.

Payment amount. Borrowers typically have four payment options available with these loans:

- An amount sufficient to amortize the loan over 30 years.
- An amount sufficient to amortize the loan over 15 years.
- An amount that only covers the monthly accrued interest.
- A minimum payment amount that permits negative amortization.

Index. While the borrower has several payment options, an Option ARM loan's interest rate typically adjusts periodically according to the loan contract. Many contracts allow for interest rate adjustments on a monthly or quarterly basis. Historically, most NegAm interest rates were based on the 11th District Cost of Funds Index (COFI). However, in the last few years, lenders have shifted away from COFI and now use other indexes such as the 12-Month Treasury Average (MTA). Both COFI and MTA have a delayed response to interest rate changes compared with the constant maturity Treasury (CMT) index. This lagged response reduces the potential negative amortization (or payment shock for borrowers wanting to make interest only or amortizing payments). To the extent that an association's liabilities more closely resemble the COFI than the CMT, these indices reduce the association's basis risk from an asset/liability management perspective. However, if the spread between an association's cost of funds and COFI widens for whatever reason, the association may face substantial income compression.

Payment caps. Payment increases or decreases on NegAm loans are typically limited to 7.50 percent per year. If borrowers elect to make only the minimum required payment, and those payments, including the annual 7.5 percent increase, are not sufficient to pay interest accruals, the shortfall is added to the loan balance.

Accrual limits and recast dates. NegAm loans typically recast at the earlier of: (1) every five years, or (2) when the loan balance increases to more than the contractually allowed maximum loan limit, known as the principal accrual limit. This varies by lender and the initial loan-to-value, and typically ranges from 110 percent to 125 percent of the original loan amount. When the loan recasts, the payment will adjust to the amount needed to fully amortize the loan over the remaining 25 years and is not subject to the 7.50 percent annual payment cap. For a $200,000 loan with a 110 percent accrual limit, the recast would occur if the principal balance increased to $220,000. If the initial LTV were 80 percent, the LTV would have increased to 88 percent at the recast date (not considering any increase or decrease in property value). Because loan terms are set by contract, and lenders have varying terms, you may also encounter other maximum principal accrual limits.

NegAm Risks

ARM lending involves a transfer of interest rate risk from the lender to the borrower. As a tradeoff, the lender must assume the additional credit risk associated with a borrower's potential inability to service the loan if interest rates rise. NegAm loan products were developed, in part, to help prevent prepayment or default from occurring due to borrowers being unable to meet their monthly payments because of interest rate spikes. While option-ARM loans may mitigate risks associated with payment shock and prepayment from interest-rate increase, payment shock can still be substantial if the loan is structured with a low teaser rate (a minimum payment based on a start rate during the option period that is well below the filly indexed amortizing rate).

The combination of deep teaser rates, aggressively qualifying borrowers at below fully indexed amortizing rates, high principal accrual limits, no verification of borrower income and liquidity, and high LTVs increase the credit risk to the lender.

Underwriting standards. Lenders try to mitigate the option or credit risk associated with NegAm loans with sound underwriting standards, (including credit, verification, and LTV requirements), loan structure, and terms. Please refer to the main body of this section for guidance on underwriting standards.

Payment shock. NegAm borrowers may face recast payment shock, where the loan payment adjusts upward to fully amortize the principle balance over the remaining life of the loan. Even with the protection of interest rate or payment caps, borrowers may not be able to make the higher payments. This is especially true when lenders qualify borrowers at less than the fully-amortizing, fully indexed payment rate, make NegAm loans to subprime borrowers, or have inadequate underwriting controls.

Capitalized interest. Lenders may record negative amortization as income in the form of capitalized interest. The lender does not actually receive the negative amortization amount as a payment from the borrower. Under generally accepted accounting principles (GAAP) the lender may capitalize (add to the loan balance) the accrued but unpaid interest amount and recognizes it as income as long as the capitalized interest is considered collectible. The collectibility of the interest depends on the borrower's ability and willingness to repay to full principal and interest, which is influenced by the borrower's ability to service the debt and the size of the loan relative to the property value. When borrowers consistently make only the minimum required payments on option ARM mortgages, the increasing capitalized interest balance may indicate increasing credit risk, as it might indicate declining borrower equity and the borrower's inability to make fully amortizing payments. A high level of capitalized interest may also create cash flow or liquidity concerns for the lender.

Credit risk. LTVs can increase over time (if property values decline or the borrower chooses to make only the minimum required payments), which increases the credit risk to the association. Recast requirements are designed to prevent runaway LTVs. If property values do not appreciate and interest rates rise, all lenders may be adversely affected, but NegAm lenders face greater exposure because of escalating LTVs. Additionally, the reported earnings sometimes mask credit risk in a NegAm portfolio, where the association is accruing income at a higher rate than the borrower is paying on the loan. Traditional credit quality monitoring reports of point-in-time delinquency and default data may lag as indicators of asset quality problems because borrowers facing payment problems can opt to reduce their monthly payments without causing the loan to go delinquent or disrupting the income accrual on the loan. Therefore, a strong indicator of potential credit risk is the number of an institution's option-ARN loans that actually negatively amortize.

NegAm Compliance Requirements

Promotion of NegAm loans must comply with OTS and other federal regulatory requirements. Section 563.27 prohibits a savings association from advertising or misrepresenting its services, including the benefits, costs, terms, or conditions of NegAm loans originated. NegAm loans may not be marketed or extended in a manner that causes the lender to discriminate against borrowers on a basis prohibited by the fair lending laws such as the Fair Housing Act, the Equal Credit Opportunity Act, Regulation B or OTS Nondiscrimination regulations. The Truth in Lending Act (TILA), as implemented by Regulation Z and its staff commentary, imposes certain requirements with respect to NegAm loans dealing with the disclosure of teaser rates, ARM loan features, negative amortization conditions, and balloon payments. In addition, certain high-cost mortgages defined by the Home Ownership and Equity Protection Act provisions of TILA are prohibited from having negative amortization features. Moreover, NegAm loans are subject to evaluation under the Community Reinvestment Act and implementing regulation as part of the association's performance in meeting the credit needs of its community.

NegAm Risk Management

Not all NegAm loan portfolios are structured the same or have higher credit risk. If lenders carefully underwrite NegAm loans with prudent LTVs and monitor the loans closely, the added credit risk they face may be small and manageable. However, aggressively underwritten NegAm loans without adequate controls raise supervisory concerns.

Lenders engaged in a NegAm lending program should monitor the quality of the NegAm portfolios closely. Specifically, lenders should track and monitor all loans with the NegAm option and quantify the borrowers' preferences regarding NegAm loan payments. The choice of making the fully amortizing versus the minimum payment is a borrower option, the exercise of which is a revealing indicator of a borrower's ability to service the loan. Additionally, lenders should:

- **Use appropriate underwriting standards**. Underwriting standards for NegAm loans should meet the real estate lending standards set forth in 12 CFR §560.101. Poor underwriting can create loans where the potential risk from negative amortization is excessive.

- **Identify the percentage of borrowers utilizing negative amortization and the associated capitalized interest**. Because capitalized interest may have accumulated over several years, lenders should report balances by loan vintage. If capitalized interest is substantial, its impact on the association's income levels should be analyzed to evaluate the quality of earnings. Excess capitalized interest may also create possible cash flow or liquidity concerns.

- **Track NegAm loan performance by program and origination year**. Point-in-time delinquency reports for NegAm loans can be misleading and mask immediate problems not reflected in delinquency rates. NegAm delinquency rates are generally only meaningful when combined with an analysis of borrower utilization and capitalized interest levels. If NegAm utilization and capitalized interest levels are increasing, future credit problems may arise.

- **Track performance by credit scores**. If warranted, segment the portfolio into different credit score groups to better track performance and risk exposure. Tracking portfolio performance using an average credit score may mask portfolio risk.

- **Monitor the impact of its use of NegAm loans on its record of meeting the credit needs of its community, including low- and moderate-income markets**. While many NegAm loan programs offer expanded credit opportunities to communities, a few may have the effect of significantly eroding borrowers' equity and thus adversely affecting the communities.

Qualifying for the 50 Percent Risk-Based Capital Treatment

OTS regulation 12 CFR § 567.6 establishes a 50 percent risk weighting for qualifying mortgage loans. Section 567.1 defines qualifying mortgage loans as one- to four-family residential first mortgage loans that are performing, are prudently underwritten, and have LTV ratios at origination of 90 percent or less, or are covered by private mortgage insurance. To qualify for a 50 percent risk weighting, NegAm loans should meet the above requirements. Should a portfolio of NegAm mortgages present safety and soundness concerns, OTS may direct the association to risk weight some or all of the NegAm mortgages and any future production at 100 percent or more.

Examination of NegAm Lenders

You should carefully analyze NegAm lending programs and determine if the association has appropriate underwriting controls and standards as described throughout this Handbook Section and Appendix. As with all loan types, you should evaluate the level of credit risk in the association's portfolio and ensure that loan loss reserves and capital are sufficient to support the level of risk.

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Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

October 8, 1999

INTERAGENCY GUIDANCE ON HIGH LTV RESIDENTIAL REAL ESTATE LENDING

PURPOSE

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are jointly issuing this statement to address some of the inherent risks of high loan-to-value (LTV) residential real estate lending. This statement clarifies that the real estate lending standards jointly adopted by the agencies in 1992 apply to these transactions.1 This statement also outlines other controls the agencies expect institutions to have in place when engaged in this type of lending.

Background and Scope

Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 required the agencies to adopt uniform regulations prescribing real estate lending standards. The agencies' regulations and the appended Guidelines require institutions to adopt and maintain comprehensive, written real estate lending policies. The Guidelines describe the criteria, specific factors, and supervisory LTV limits that institutions should consider when establishing their real estate lending policies.

For the purpose of applying the Guidelines to high LTV residential real estate loans, a high LTV residential real estate loan is defined as any loan, line of credit, or combination of credits secured by liens on or interests in owner-occupied 1- to 4-family residential property that equals or exceeds 90 percent of the real estate's appraised value, unless the loan has appropriate credit support. Appropriate

[1] The agencies adopted uniform rules on real estate lending and issued the *Interagency Guidelines for Real Estate Lending Policies* (Guidelines), dated December 1992. See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC); and 12 CFR 560.100-101 (OTS).

credit support may include mortgage insurance, readily marketable collateral or other acceptable collateral that reduces the LTV ratio below 90 percent.[2]

Insured depository institutions have traditionally avoided originating residential real estate loans in amounts exceeding 80 percent of the appraised value of the underlying property unless the amount above 80 percent was supported by private mortgage insurance, a government guarantee or other credit support. However, this trend is changing. Consumers are increasingly using the equity in their homes to refinance and consolidate other debts or finance purchases. By doing so, they can generally obtain favorable repayment terms, lower interest rates, and tax advantages relative to other forms of consumer debt, such as unsecured credit cards. These and other factors have stimulated strong consumer demand for these loans.

Credit Risks Associated with High LTV Loans

High LTV lending can be profitable when risks are effectively managed and loans are priced based on risk. High LTV lending poses higher risk for lenders than traditional mortgage lending. A summary of the primary credit risks associated with this type of lending follows:

- **Increased Default Risk and Losses.** Recent studies indicate that the frequency of default and the severity of losses on high LTV loans far surpass those associated with traditional mortgages and home equity loans.[3] The higher frequency of default may indicate weaknesses in credit risk selection and/or credit underwriting practices, while the increased severity of loss results from deficient collateral protection. In addition, the performance of high LTV borrowers has not been tested during an economic downturn when defaults and losses may increase.

- **Inadequate Collateral.** High LTV loans are typically secured by junior liens on owner-occupied single-family residences where the combined loans frequently exceed the market value of the home, sometimes by as much as 25 to 50 percent. When such a loan defaults and the combined LTV exceeds 90 percent, it is unlikely that the net sales proceeds will be sufficient to repay the outstanding debt because of foreclosure, repair, and selling expenses. Therefore, high LTV lenders are exposed to a significant amount of loss in the event of default.

- **Longer Term/Longer Exposure.** High LTV loans generally have long maturities (up to 30 years). The lender's funds are therefore at risk for the many years it takes the loan to amortize and the borrower to accumulate equity. This leaves lenders vulnerable to future adverse events beyond their control, such as the death, divorce, sickness or job loss of a borrower. Finally, high LTV loans are often underwritten using credit-scoring models. The predictive value of these models is less reliable beyond a two-year horizon and across different economic cycles.

2 Examples of readily marketable collateral and other acceptable collateral are contained in the Guidelines.

3 Moody's Investor Service. "Moody's Home Equity Index Update, Special Report," pp 2, 6 - 8, dated October 2, 1998; "Home Equity Index Update: 3Q98," pp 7-8, dated January 22, 1999; and 1Q99, pp 1-2, 9, dated May 21, 1999; OTS Research and Analysis, "National Mortgage Default Rates and the Vintage Effect," May 19, 1997, p 5.

- **Limited Default Remedies.** Traditional mortgage servicing and collection procedures are not as effective when engaging in high LTV lending because the sale of collateral and customer refinancing are generally eliminated as ways to collect these loans. A delinquent borrower with little or no equity in a property may not have the incentive to work with the lender to bring the loan current to avoid foreclosure. The borrower also may not have the ability to fund closing costs to sell the property as an alternative source of repayment. Therefore, high LTV lenders must intervene early to reduce the risk of default and loss.

Effective Risk Management Programs

Institutions involved in high LTV lending should implement risk management programs that identify, measure, monitor, and control the inherent risks. At a minimum, an institution's program should reflect the existing Guidelines for real estate lending, as well as the other risk management issues discussed within this statement. The following represents a partial summary of the Guidelines. Institutions should refer to the Guidelines for additional guidance on loan portfolio management considerations, underwriting standards, and credit administration.

Loan-to-Value Limits

The Guidelines direct institutions to develop their own internal LTV limits for real estate loans, subject to the supervisory LTV limits. The Guidelines permit institutions to grant or purchase loans with LTV ratios in excess of the supervisory LTV limits provided that such exceptions are supported by documentation maintained in the permanent credit file that clearly sets forth the relevant credit factors justifying the underwriting decisions. These credit factors may include a debt-to-income ratio or credit score. The Guidelines further specify that all loans in excess of the supervisory LTV limits should be identified in the institution's records and should not exceed 100 percent of the institution's total capital. [4]

The Guidelines state that first lien mortgages or home equity loans on owner-occupied, 1- to- 4- family residential property loans whose LTV ratios equal or exceed 90 percent should have appropriate credit support, such as mortgage insurance, readily marketable collateral, or other acceptable collateral. Through this policy statement, the agencies clarify that any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent, and does not have the additional credit support, should be considered an exception to the Guidelines and included in the institution's calculation of loans subject to the 100 percent of capital limit.

CALCULATING THE LOAN-TO-VALUE RATIO

For the purpose of determining the loans subject to the 100 percent of capital limitation, institutions should include loans that are secured by the same property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should

[4] Moreover, within the aggregate limit, total LTV exceptions for all commercial, agricultural, multifamily, or other non-1- to 4-family residential properties should not exceed 30 percent of total capital.

include the recourse obligation of any loan in excess of the supervisory LTV limits that is sold with recourse.

The LTV ratio for a single loan and property is calculated by dividing the total (committed) loan amount at origination by the market value of the property securing the credit plus any readily marketable collateral or other acceptable collateral. The following guidance is provided for those situations involving multiple loans and more than one lender. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.

- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the Guidelines and may be excluded from the institution's 100 percent of capital limitation.

Transactions Excluded from Supervisory Guidelines

The Guidelines describe nine lending situations that are excluded from the supervisory LTV limits, reporting requirements, and aggregate capital limitations. The agencies have received numerous questions from bankers and examiners regarding two of these excluded transactions. These are:

- **Abundance of Caution.** The Guidelines indicate that any loan for which a lien on or interest in real property is taken as additional collateral through an abundance of caution may be excluded from the supervisory LTV and capital limits. The Guidelines specifically state that "abundance of caution" exists when an institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral. Because real estate is typically the only form of collateral on a high LTV loan, the abundance of caution exclusion would not apply to these transactions.

- **Loans Sold Promptly, Without Recourse, to a Financially Responsible Third Party**. The Guidelines state that loans that are to be sold promptly after origination, without recourse, to a financially responsible third party may be excluded from supervisory LTV limits. The agencies have received several inquiries requesting a definition of the word "promptly."

This exclusion provides flexibility to institutions engaged in mortgage banking operations. Institutions engaged in mortgage banking normally sell or securitize their high LTV loans within 90 days of origination. Accordingly, the agencies will generally find that when a lender sells a newly originated loan within 90 days it has demonstrated its intent to sell the loan "promptly" after origination. Conversely, when a lender holds a loan for more than 90 days, the agencies believe that the intent to sell "promptly" has not been demonstrated. Such loans will be included among the loans subject to the overall capital limit. The agencies may also determine that this exclusion is not available for institutions that have consistently demonstrated significant weaknesses in their mortgage banking operations.

Board Reporting and Supervisory Oversight

All exceptions to the Guidelines should be identified in the institution's records, and the aggregate amount, along with performance experience of the portfolio, should be reported to the board at least quarterly. Examiners will review board or committee minutes to verify adherence to this standard.

An institution will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, its regulatory agency will determine if it has a supervisory concern and take action accordingly. Such action may include directing the institution to reduce its loans in excess of the supervisory LTV limits to an appropriate level, raise additional capital, or submit a plan to achieve compliance. The agencies will consider, among other things, the institution's capital level and overall risk profile, as well as the adequacy of its controls and operations, when determining whether these or other actions are necessary.

Other Risk Management Issues

Loan Review and Monitoring. Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a minimum, institutions should segment their high LTV loan portfolio by their vintage (age) and analyze the portfolios' performance for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. Institutions should monitor the ongoing performance of their high LTV loans by periodically re-scoring accounts, or by periodically obtaining updated credit bureau reports or financial information on their borrowers.

On February 10, 1999, the Federal Financial Institutions Examination Council (FFIEC) issued the *Uniform Retail Credit Classification and Account Management Policy*. That FFIEC policy statement established the minimum uniform classification standards for retail credit. Institutions involved in high LTV lending should adopt the standards contained in this policy as part of their loan review program.

Sales of High LTV Loans. When institutions securitize and sell high LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high LTV loans must implement procedures to control the risks inherent in that activity. Institutions should enter into written counterparty agreements that specify the duties and responsibilities of each party and include a regular schedule for loan sales.

Institutions should also develop a contingency plan that designates back-up purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, institutions should also establish maximum commitment limits for the amount of pipeline and warehoused loans, as well as designate alternate funding sources.

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 the subsequent quarterly revaluations.

Compliance Risk. Institutions that originate or purchase high LTV 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 high LTV products for reasons other than the borrower's creditworthiness. Such practices could, for example, violate the Fair Housing Act, Equal Credit Opportunity Act, the Truth in Lending Act (including its special rules and restrictions under the Home Ownership and Equity Protection Act for loans with high rates or closing costs), or the Real Estate Settlement Procedures Act. An adequate compliance management program must identify, monitor, and control the consumer compliance risks associated with high LTV lending.

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National Credit Union Administration

May 17, 2005

CREDIT RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING

PURPOSE

In response to the exceptionally strong growth in home equity lending over the past few years, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration (collectively, the agencies) are issuing this guidance to promote sound risk management practices at financial institutions with home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). The agencies have found that, in many cases, institutions' credit risk management practices for home equity lending have not kept pace with the product's rapid growth and easing of underwriting standards.

Overview

The rise in home values coupled with low interest rates and favorable tax treatment has made home equity loans and lines attractive to consumers. To date, delinquency and loss rates for home equity loans and lines have been low, due at least in part to the modest repayment requirements and relaxed structures that are characteristic of much of this lending. The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that financial institutions may not be fully recognizing the risk embedded in these portfolios. Specific product, risk management, and underwriting risk factors and trends that have attracted scrutiny are:

- Interest-only features that require no amortization of principal for a protracted period;
- Limited or no documentation of a borrower's assets, employment, and income (known as "low doc" or "no doc" lending);
- Higher loan-to-value (LTV) and debt-to-income (DTI) ratios;

- Lower credit risk scores for underwriting home equity loans;
- Greater use of automated valuation models (AVMs) and other collateral evaluation tools for the development of appraisals and evaluations; and
- An increase in the number of transactions generated through a loan broker or other third party.

Like most other lending, home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral valuation management, individual account and portfolio management, and servicing.

Financial institutions should ensure that risk management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for financial institutions that project or have already experienced significant growth or concentrations, particularly in higher risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party generated loans. This guidance describes sound credit risk management systems for:

- Product Development and Marketing
- Origination and Underwriting
- Third-Party Originations
- Collateral Valuation Management
- Account Management
- Portfolio Management
- Operations, Servicing, and Collections
- Secondary Market Activities
- Portfolio Classifications, Allowance for Loan and Lease Losses (ALLL), and Capital

Credit Risk Management Systems

Product Development and Marketing

In the development of any new product offering, product change, or marketing initiative, management should have a review and approval process that is sufficiently broad to ensure compliance with the institution's internal policies and applicable laws and regulations[1] and to evaluate the credit, interest rate, operational, compliance, reputation, and legal risks. In particular, risk management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material changes in the targeted market, origination source, or pricing could have significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, financial institutions should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, refer to the "Third-Party Originations" Section.) Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to increase a line, extend the interest-only period, or adjust the interest rate or term.

Origination and Underwriting

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the agencies' regulations on real estate lending standards,[2] prudently underwritten home equity loans should include an evaluation of a borrower's capacity to adequately service the debt.[3] Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.[4] Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

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1 Applicable laws include Federal Trade Commission Act; Equal Credit Opportunity Act (ECOA); Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); Fair Housing Act; Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

2 In 1992, the agencies adopted uniform rules on real estate lending standards and issued the "Interagency Guidelines for Real Estate Lending Policies." See 12 CFR Part 34, Subpart D (OCC); 12 CFR Part 208.51 and Appendix C (FRB); 12 CFR Part 365 (FDIC) and 12 CFR 560.100-101 (OTS).

3 The OCC also addressed national banks' need to assess a borrower's repayment capacity in 12 CFR 34.3(b). This safety and soundness-derived anti-predatory lending standard states that national banks should not make consumer real estate loans based predominantly on the bank's realization of the foreclosure or liquidation value of the borrower's collateral, without regard to the borrower's ability to repay the loan according to its terms. See also Regulation Z (Truth in Lending – 12 CFR 226.34(a)(4)).

4 "Interagency Guidelines Establishing Standards for Safety and Soundness" also call for documenting source of repayment and assessing ability of the borrower to repay the debt in a timely manner. See 12 CFR 30, Appendix A, II.C.2 (OCC); 12 CFR 208, Appendix D-1 (FRB); 12 CFR Part 364, Appendix A (FDIC); and 12 CFR Part 570, Appendix A (OTS).

HELOCs generally do not have interest rate caps that limit rate increases.[5] Rising interest rates could subject a borrower to significant payment increases, particularly in a low interest rate environment. Therefore, underwriting standards for interest-only and variable rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

Third-Party Originations

Financial institutions often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, an institution should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

Brokers are firms or individuals, acting on behalf of either the financial institution or the borrower, who match the borrower's needs with institutions' mortgage origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the financial institution and the broker. For control purposes, the financial institution should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

Correspondents are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Financial institutions commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a financial institution grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating financial institution should have systems and controls to provide assurance that the correspondent is appropriately managed, financially sound, and provides mortgages that meet the institution's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality control unit or function in the delegating financial institution should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio performance management activities.

Both brokers and correspondents are compensated based upon mortgage origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, financial institutions should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the institution should have adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees

[5] While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 CFR 226.30(b).

contrary to RESPA prohibitions.[6] Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the institution should take appropriate action against the third party, which could include terminating its relationship with the third party.

Collateral Valuation Management

Competition, cost pressures, and advancements in technology have prompted financial institutions to streamline their appraisal and evaluation processes. These changes, coupled with institutions underwriting to higher LTVs, have heightened the importance of strong collateral valuation management policies, procedures, and processes.

Financial institutions should have appropriate collateral valuation policies and procedures that ensure compliance with the agencies' appraisal regulations[7] and the "Interagency Appraisal and Evaluation Guidelines" (guidelines).[8] In addition, the institution should:

- Establish criteria for determining the appropriate valuation methodology for a particular transaction based on the risk in the transaction and loan portfolio. For example, higher risk transactions or non-homogeneous property types should be supported by more thorough valuations. The institution should also set criteria for determining the extent to which an inspection of the collateral is necessary.

- Ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation.

- Implement policies and controls to preclude "value shopping." Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property, the institution should adhere to a policy for selecting the most reliable method, rather than the highest value.

- Require sufficient documentation to support the collateral valuation in the appraisal/evaluation.

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[6] In addition, a financial institution that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the institution can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under ECOA, and for reporting responsibilities under HMDA.

[7] 12 CFR 34, subpart C (OCC); 12 CFR 208 subpart E and 12 CFR 225 subpart G (FRB); 12 CFR 323 (FDIC); 12 CFR Part 564 (OTS); and 12 CFR 722 (NCUA).

[8] Comptroller's Handbook for *Commercial Real Estate and Construction Lending*; SR letter 94-55 (FRB); FDIC (Financial Institution Letter (FIL-74-94), dated November 11, 1994; Thrift Bulletin 55a (OTS); and LTCU 03-CU-17 (NCUA).

AVMs –When AVMs are used to support evaluations or appraisals, the financial institution should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. As part of the validation process, the institution should document the validation's analysis, assumptions, and conclusions.[9] The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a "confidence score" which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Financial institutions that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Institutions should also establish the confidence levels that are appropriate for the risk in a given transaction or group of transactions.

When tax assessment valuations are used as a basis for the collateral valuation, the financial institution should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value as part of the validation process.

Account Management

Since HELOCs often have long-term, interest-only payment features, financial institutions should have risk management techniques that identify higher risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, an institution should have risk management procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account management practices for large portfolios or portfolios with high-risk characteristics include:

- Periodically refreshing credit risk scores on all customers;
- Using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
- Periodically assessing utilization rates;
- Periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;
- Monitoring home values by geographic area; and

[9] National banks should refer to OCC Bulletin 2000-16, "Risk Modeling – Model Validation."

- Obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Financial institutions should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.[10]

Where appropriate, financial institutions should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circumstances.[11] In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances, and (2) as a result of this change, the institution has a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A financial institution's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

Portfolio Management

Financial institutions should implement an effective portfolio credit risk management process for their home equity portfolios that includes:

Policies - The agencies' real estate lending standards regulations require that an institution's real estate lending policies be consistent with safe and sound banking practices and that an institution's board of directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the institution's

[10] Under the agencies' risk-based capital guidelines, an unused HELOC commitment with an original maturity of one year or more may be allocated a zero percent conversion factor if the institution conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See Appendix A to 12 CFR 3, Section 3(b)(4)(ii) for OCC; 12 CFR 208, Appendix A, III.D.4 and 12 CFR 225, Appendix A, III.D.4 for FRB; Appendix A to 12 CFR 325, II(D)(4) (FDIC); and 12 CFR 567.6 (OTS).

[11] Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 CFR 226.5b(f)(3)(vi)(A) – (F).

overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

Portfolio objectives and risk diversification - Effective portfolio management should clearly communicate portfolio objectives such as growth targets, utilization, rate of return hurdles, and default and loss expectations. For institutions with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the institution should analyze the situation sufficiently to enable the institution's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, an institution should analyze the portfolio by segment using criteria such as product type, credit risk score, DTI, LTV, property type, geographic area, collateral valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

Management information systems - By maintaining adequate credit MIS, a financial institution can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations. Financial institutions should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For institutions with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

- Production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type;
- Delinquency and loss distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI);
- Vintage tracking;
- The performance of third-party originators (brokers and correspondents); and
- Market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values.

Policy and underwriting exception systems - Financial institutions should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

High LTV Monitoring - To clarify the agencies' real estate lending standards regulations and interagency guidelines, the agencies issued "Interagency Guidance on High LTV Residential Real Estate Lending" (HLTV guidance) in October 1999. The HLTV guidance clarified the "Interagency Real Estate Lending Guidelines" and the supervisory loan-to-value limits for loans on one- to four-family residential properties. This statement also outlined controls that the agencies expect financial institutions to have in place when engaging in HLTV lending. In recent examinations, supervisory staff has noted several instances of noncompliance with the supervisory loan-to-value limits of the "Interagency Real Estate Lending Guidelines." Financial institutions should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the institution's board of directors. Specifically, financial institutions are reminded that:

- Loans in excess of the supervisory LTV limits should be identified in the institution's records. The aggregate of high LTV one- to four-family residential loans should not exceed 100 percent of the institution's total capital.[12] Within that limit, high LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.

- In calculating the LTV and determining compliance with the supervisory LTVs, the financial institution should consider all senior liens. All loans secured by the property and held by the institution are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property **equals** or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.

- For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the financial institution is legally committed to lend over the life of the loan).

- All real estate secured loans in excess of supervisory LTV limits should be aggregated and reported quarterly to the institution's board of directors.

[12] For purposes of the "Interagency Real Estate Lending Standards Guidelines," high LTV one-to four-family residential property loans include: (i) a loan for raw land zoned for one-to four-family residential use with a LTV ratio greater than 65 percent; (ii) residential land development loan or improved lot loan with a LTV greater than 75 percent; (iii) a residential construction loan with a LTV ratio greater than 85 percent; (iv) a loan on non-owner occupied one-to four-family residential property with a LTV greater than 85 percent; and (v) a permanent mortgage or home equity loan on an owner-occupied residential property with a LTV equal to or exceeding 90 percent without mortgage insurance, readily marketable collateral, or other acceptable collateral.

Over the past few years, new insurance products have been introduced to help financial institutions mitigate the credit risks of HLTV residential loans. Insurance policies that cover a "pool" of loans can be an efficient and effective credit risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The agencies will consider pool insurance as a sufficient credit enhancement to remove the HLTV designation in the following circumstances: 1) the policy is issued by an acceptable mortgage insurance company, 2) it reduces the LTV for each loan to less than 90 percent, and 3) it is effective over the life of each loan in the pool.

Stress testing for portfolios - Financial institutions with home equity concentrations as well as higher risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Institutions should consider stress tests that incorporate interest rates increases and declines in home values. Since these events often occur simultaneously, the agencies recommend testing for these events together. Institutions should also periodically analyze markets in key geographic areas, including identified "soft" markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

Operations, Servicing, and Collections

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit risk management should oversee these support functions to ensure that operational risks are properly controlled.

Lien Recording - Institutions should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

Problem Loan Workouts and Loss Mitigation Strategies - Financial institutions should have established policies and procedures for problem loan workouts and loss mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's "Uniform Retail Credit Classification and Account Management Policy," issued June 2000, and should, at a minimum, address the following:

- Circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes. Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms;

- Circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure; and

- Appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of workout loans. For large portfolios, vintage delinquency and loss tracking also should be included.

While the agencies encourage financial institutions to work with borrowers on a case-by-case basis, an institution should not use workout strategies to defer losses. Financial institutions should ensure that credits in workout programs are evaluated separately for the ALLL, because such credits tend to have higher loss rates than other portfolio segments.

Secondary Market Activities

More financial institutions are issuing HELOC mortgage-backed securities (i.e., securitizing HELOCs). Although such secondary market activities can enhance credit availability and an institution's profitability, they also pose certain risk management challenges. An institution's risk management systems should address the risks of HELOC securitizations.[13]

Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital

The FFIEC's "Uniform Retail Credit Classification and Account Management Policy" governs the classification of consumer loans and establishes general classification thresholds based on delinquency. Financial institutions and the agencies' examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Financial institutions should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, an institution should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for its HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.[14]

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13 Refer to "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations" (May 23, 2002), OCC Bulletin 2002-22 (OCC); SR letter 02-16 (FRB); Financial Institution Letter (FIL-54-2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, dated November 1997. The Federal Reserve also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97-21.

14 See the "Interagency Expanded Guidance for Subprime Lending Programs" issued in January 2001 for supervisory expectations regarding risk management processes, allowance for loan and lease losses, and capital adequacy for institutions engaging in subprime lending programs.

CONCLUSION

Home equity lending is an attractive product for many homeowners and lenders. The quality of these portfolios, however, is subject to increased risk if interest rates rise and home values decline. Sound underwriting practices and effective risk management systems are essential to mitigate this risk.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration

October 4, 2006

INTERAGENCY GUIDANCE ON NONTRADITIONAL MORTGAGE PRODUCT RISKS

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. In the past few years consumer demand has been growing, particularly in high priced real estate markets, for closed-end residential mortgage loan products that allow borrowers to defer repayment of principal and, sometimes, interest. These mortgage products, herein referred to as nontraditional mortgage loans, include such products as "interest-only" mortgages where a borrower pays no loan principal for the first few years of the loan and "payment option" adjustable-rate mortgages (ARMs) where a borrower has flexible payment options with the potential for negative amortization.[1]

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers who may not otherwise qualify for more traditional mortgage loans and may not fully understand the associated risks.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements ("reduced documentation") and are increasingly combined with simultaneous second-lien loans.[2] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

[1] Interest-only and payment option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed rate products. Refer to the Appendix for additional information on interest-only and payment option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit ("HELOCs"), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

[2] Refer to the Appendix for additional information on reduced documentation and simultaneous second-lien loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should:

- Ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;

- Recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and

- Ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice.

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS) and the National Credit Union Administration (NCUA) (collectively, the Agencies) expect institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.[3]

Institutions should use this guidance to ensure that risk management practices adequately address these risks. The Agencies will carefully scrutinize risk management processes, policies, and procedures in this area. Institutions that do not adequately manage these risks will be asked to take remedial action.

The focus of this guidance is on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management, and acceptable portfolio performance will not be subject to criticism merely for offering such products.

Loan Terms and Underwriting Standards

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the agencies' real estate lending standards and appraisal regulations and associated guidelines.[4]

3 Refer to Interagency Guidelines Establishing Standards for Safety and Soundness. For each Agency, those respective guidelines are addressed in: 12 CFR Part 30 Appendix A (OCC); 12 CFR Part 208 Appendix D-1 (Board); 12 CFR Part 364 Appendix A (FDIC); 12 CFR Part 570 Appendix A (OTS); and 12 U.S.C. 1786 (NCUA).

4 Refer to 12 CFR Part 34 - Real Estate Lending and Appraisals, OCC Bulletin 2005-3 – Standards for National Banks' Residential Mortgage Lending, AL 2003-7 – Guidelines for Real Estate Lending Policies and AL 2003-9 – Independent Appraisal and Evaluation Functions (OCC); 12 CFR 208.51 subpart E and Appendix C and 12 CFR Part 225 subpart G (Board); 12 CFR Part 365 and Appendix A, and 12 CFR Part 323 (FDIC); 12 CFR 560.101 and Appendix and 12 CFR Part 564 (OTS). Also, refer to the 1999 Interagency Guidance on the "Treatment of High LTV Residential Real Estate Loans" and the 1994 "Interagency Appraisal and Evaluation Guidelines."

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure risk levels remain manageable.

Qualifying Borrowers – Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as payment shock, this increase is of particular concern for payment option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate,[5] assuming a fully amortizing repayment schedule.[6] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[7]

Federally Insured Credit Unions should refer to 12 CFR Part 722 - Appraisals and NCUA 03-CU-17 – Appraisal and Evaluation Functions for Real Estate Related Transactions (NCUA).

[5] The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (e.g., MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

[6] The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

[7] The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether or not a loan balance has the potential to reach the negative amortization cap before the end of the initial payment option period (usually five years). For example, a loan with a 115 percent negative amortization cap but a small spread between the introductory rate and the accrual rate may only reach a 109 percent maximum loan balance before the end of the initial payment option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

Furthermore, the analysis of repayment capacity should avoid over-reliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the borrower's income, assets, and outstanding liabilities.

Collateral-Dependent Loans – Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.[8] Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

Risk Layering – Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

Reduced Documentation – Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Agencies expect an institution to more diligently verify and document a borrower's income and debt reduction capacity.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

Simultaneous Second-Lien Loans – Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien home equity lines of credit (HELOCs) typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk mitigating factors.

Introductory Interest Rates – Many institutions offer introductory interest rates set well below the fully indexed rate as a marketing tool for payment option ARM products. When developing

[8] A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

Lending to Subprime Borrowers – Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime lending.[9] Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for both the institution and the borrower.

Non-Owner-Occupied Investor Loans – Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.[10]

Portfolio and Risk Management Practices

Institutions should ensure that risk management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should:

- Develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk management expectations;
- Design enhanced performance measures and management reporting that provide early warning for increasing risk;

[9] Interagency Guidance on Subprime Lending, March 1, 1999, and Expanded Guidance for Subprime Lending Programs, January 31, 2001. Federally insured credit unions should refer to 04-CU-12 – Specialized Lending Activities (NCUA).

[10] Federally insured credit unions must comply with 12 CFR Part 723 for loans meeting the definition of member business loans.

- Establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and

- Maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

Policies – An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk management tools for risk mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations – Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk management practices. Monitoring should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as loans with high combined LTV ratios, loans with high DTI ratios, loans with the potential for negative amortization, loans to borrowers with credit scores below established thresholds, loans with risk-layered features, and non-owner-occupied investor loans. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

Controls – An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

Third-Party Originations – Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If appraisal, loan documentation, credit problems or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, or even termination of the third-party relationship.[11]

Secondary Market Activity – The sophistication of an institution's secondary market risk management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary market activities should have comprehensive, formal strategies for managing risks.[12] Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets. In the agencies' view, the repurchase of mortgage loans beyond the selling institution's contractual obligation is implicit recourse. Under the agencies' risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization.[13] Institutions should familiarize themselves with these guidelines before deciding to support mortgage loan pools or buying back loans in default.

Management Information and Reporting – Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by loan type (e.g., interest-only mortgage loans and payment option ARMs); by risk-layering features (e.g., payment option ARM with stated income and interest-only mortgage loans with simultaneous second-lien mortgages);

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[11] Refer to OCC Bulletin 2001-47 – Third-Party Relationships and AL 2000-9 – Third-Party Risk (OCC). Federally insured credit unions should refer to 01-CU-20 (NCUA), Due Diligence over Third Party Service Providers. Savings associations should refer to OTS Thrift Bulletin 82a – Third Party Arrangements.

[12] Refer to "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," May 23, 2002; OCC Bulletin 2002-22 (OCC); SR letter 02-16 (Board); Financial Institution Letter (FIL-54-2002) (FDIC); and CEO Letter 163 (OTS). See OCC's Comptroller Handbook for Asset Securitization, November 1997. See OTS Examination Handbook Section 221, Asset-Backed Securitization. The Board also addressed risk management and capital adequacy of exposures arising from secondary market credit activities in SR letter 97-21. Federally insured credit unions should refer to 12 CFR Part 702 (NCUA).

[13] Refer to 12 CFR Part 3 Appendix A, Section 4 (OCC); 12 CFR Parts 208 and 225, Appendix A, III.B.3 (FRB); 12 CFR Part 325, Appendix A, II.B (FDIC); 12 CFR 567 (OTS); and 12 CFR Part 702 (NCUA) for each Agency's capital treatment of recourse.

by underwriting characteristics (e.g., LTV, DTI, and credit score); and by borrower performance (e.g., payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk tolerance levels.

Stress Testing – Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring and managing risk, as well as developing appropriate and cost-effective loss mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

Capital and Allowance for Loan and Lease Losses – Institutions should establish an appropriate allowance for loan and lease losses (ALLL) for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. In accordance with interagency guidance, the valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.[14]

Consumer Protection Issues

While nontraditional mortgage loans provide flexibility for consumers, the Agencies are concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner – before disclosures may be required under the Truth in Lending Act or other laws – to assist the consumer in the product selection process.

Concerns and Objectives – More than traditional ARMs, mortgage products such as payment option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization that may not be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the "recast" of a payment option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared to a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in it even when the property has appreciated. The concern that consumers may not fully understand these products would be exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risk of payment shock and the risk of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

[14] Refer to the "Interagency Advisory on Mortgage Banking," February 25, 2003, issued by the bank and thrift regulatory agencies. Federally Insured Credit Unions with assets of $10 million or more are reminded they must report and value nontraditional mortgages and related mortgage servicing rights, if any, consistent with generally accepted accounting principles in the Call Reports they file with the NCUA Board.

Legal Risks – Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z.
- Section 5 of the Federal Trade Commission Act (FTC Act).

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages in advertisements, with an application,[15] before loan consummation, and when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[16]

Other federal laws, including the fair lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Agencies note that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[17]

Communications with Consumers – When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when a consumer is shopping for a mortgage – such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products, or when marketing relating to nontraditional mortgage products is provided by the institution to the consumer – not just upon the submission of an application or at

[15] These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

[16] The OCC, the Board, and the FDIC enforce this provision under the FTC Act and section 8 of the FDI Act. Each of these agencies has also issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. *See* OCC Advisory Letter 2002-3 - Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004. Federally insured credit unions are prohibited from using any advertising or promotional material that is inaccurate, misleading, or deceptive in any way concerning its products, services, or financial condition. 12 CFR 740.2. The OTS also has a regulation that prohibits savings associations from using advertisements or other representations that are inaccurate or misrepresent the services or contracts offered. 12 CFR 563.27. This regulation supplements its authority under the FTC Act.

[17] Institutions also should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

consummation.[18] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z or other laws.[19]

Promotional Materials and Product Descriptions. Promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages that can assist consumers in their product selection decisions, including information about the matters discussed below.

- Payment Shock. Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[20] Such information also could describe when structural payment changes will occur (e.g., when introductory rates expire, or when amortizing payments are required), and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest rate index.

- Negative Amortization. When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home).

[18] Institutions also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers considering the nontraditional mortgage products and other loan features described in this guidance.

[19] Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

[20] Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

- Prepayment Penalties. If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the lender about the amount of any such penalty.[21]

- Cost of Reduced Documentation Loans. If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

Monthly Statements on Payment Option ARMs. Monthly statements that are provided to consumers on payment option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment option ARM borrowers to select a non-amortizing or negatively-amortizing payment (for example, through the format or content of monthly statements).

Practices to Avoid. Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest and/or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.[22] Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as: giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; suggesting that initial minimum payments in a payment option ARM will cover accrued interest (or principal and interest) charges; and making misleading claims that interest rates or payment obligations for these products are "fixed."

[21] Federal credit unions are prohibited from imposing prepayment penalties. 12 CFR 701.21(c)(6).

[22] For example, marketing materials for payment option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

Control Systems – Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary, to continue to be able to convey information to consumers in this manner. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third parties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

Appendix: Terms Used in this Document

Interest-only Mortgage Loan – A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM – A nontraditional mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a “start” or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation – A loan feature that is commonly referred to as “low doc/no doc,” “no income/no asset,” “stated income” or “stated assets.” For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower’s income and assets.

Simultaneous Second-Lien Loan – A lending arrangement where either a closed-end second-lien or a home equity line of credit (HELOC) is originated simultaneously with the first lien mortgage loan, typically in lieu of a higher down payment.

Dated: September 25, 2006.

John C. Dugan, *Comptroller of the Currency*.

By order of the Board of Governors of the Federal Reserve System, September 27, 2006.

Jennifer J. Johnson, *Secretary of the Board.*

Dated at Washington, D.C., this 27th day of September, 2006.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman, *Executive Secretary*.

Dated: September 28, 2006.

By the Office of Thrift Supervision.

John M. Reich, *Director*.

By the National Credit Union Administration on September 28, 2006.

JoAnn M. Johnson, *Chairman.*

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration

ADDENDUM TO CREDIT RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING

This addendum to the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending* (interagency HE lending guidance) provides additional guidance for managing risks associated with open-end home equity lines of credit (HELOCs) that contain interest-only features. While HELOCs with these features may provide flexibility for consumers, the Agencies are concerned that consumers may not fully understand the product terms and associated risks. This addendum provides guidance addressing the timing and content of communications with consumers obtaining interest- only HELOCs. These consumer protection recommendations are similar to the guidance contained in the *Interagency Guidance on Nontraditional Mortgage Product Risks* (September 2006) for closed-end home purchase, refinance, and home equity mortgage products.

Credit Risk Management Systems

Product Development and Marketing

When promoting or describing HELOCs that permit interest-only payments, institutions should provide consumers with information that is designed to help them make informed decisions regarding product selection and use. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers.

Communications with consumers, including advertisements, oral statements, promotional materials, and periodic statements, should provide clear and balanced information about the relative benefits and risks of HELOCs with interest-only features. This includes information about the risk of increased future payment obligations.[23] Information about potential increases in payment obligations should address, among other things, circumstances in which interest rates reach a contractual limit.

[23] The Agencies are concerned about increased future payment obligations due to interest rate increases and the end of a non-amortizing payment period, not payment increases due to additional draws on the line of credit.

If applicable, these materials should also alert the consumer to any prepayment penalty,[24] and the need to seek additional information on the amount of any penalty. Consumers should also be informed of any premium that may be charged for a reduced documentation program.

This information should be provided in a timely manner, to assist the consumer in the product selection process. Clear and balanced information should be provided at the time a consumer is shopping for a loan, not just when an application form is provided or at consummation. For example, this information could be provided when a consumer inquires about a home equity product and receives information about products with interest-only features, or when the institution provides the consumer with marketing materials for such products. [25]

[24] For purposes of this guidance, a prepayment penalty for a HELOC is a fee that will be imposed if the borrower pays off the balance and terminates the account in advance of the contractual end date.

[25] Institutions also should strive to: (1) focus on information important to consumer decision making; (2) highlight key information so that it will be noticed; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers.

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Construction Lending

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, One- to Four-Family Residential Real Estate Lending.

LINKS
Program
Questionnaire

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 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 Examination 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:

   - Geographic limits.
   - Lending authority for committee and individual officers.
   - Procedures for reviewing construction loan applications.
   - Borrower financial strength requirements.
   - Acceptable loan types and features.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

WKP. REF.

- Agreements required by borrowers for completion of improvements in accordance with approved construction specifications and cost and time limitations.
- Qualified collateral and minimum margin requirements.
- Acceptable appraisal techniques.
- Acceptable feasibility report standards.
- Inspection procedures.
- Methods of supervising loan proceed disbursements.
- Standards for take-out commitments.
- Completion bonding requirements.
- Minimum standards for documentation.
- 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.
- Collection and charge-off procedures.
- Review and approval by the board of directors at least annually.
- Compatibility with the business plan and current market conditions.
- Aggregate limitation for construction loans.

2. In conjunction with the regulator(s) performing the audit programs (Examination 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 Examination Handbook Section 201, Lending Operations and Portfolio Risk Management, obtain and review the following information and schedules as they pertain to construction lending:

- Lending policy and procedures.
- Appraisal and feasibility report standards for construction projects.
- Construction loan trial balance, undisbursed loan proceeds (LIP) trial balance, and listing of contingency and escrow accounts.
- Past due loans.
- Loans in a nonaccrual status.
- Loans in which interest is not being collected in accordance with the terms of the loan.
- 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.
- Loan participations purchased and sold.
- Loans sold in full since the previous examination.
- Loans considered "problem loans" by management.
- Loans that are overdisbursed.
- Loan commitments and contingent liabilities.
- Extensions of credit to employees, officers, directors, principal shareholders, and their interests.
- Extensions of credit to officers, directors, and principal shareholders of other institutions.
- Current interest-rate structure/loan pricing.
- Level of each officer's current lending authority.

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- 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

1. 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.

2. Using an appropriate sampling technique, select loans for review and transcribe appropriate information to the Construction Loan Review and other line sheets, where appropriate, including indication of any past-due, nonaccrual, or problem status. (For details on sampling, refer to Section 209 of the Examination Handbook.)

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3. 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:

- Loans granted and participations purchased since the previous examination.
- Loans sold in full since the preceding examination.
- Multiple loans to the same borrower or related group of borrowers, particularly those that represent a concentration of credit.
- Loan commitments and other contingent liabilities.
- Loans to affiliated persons.
- Tract loans.
- Out-of-territory loans.

4. 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:

- 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.
- 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.
- The financial strength and reliability of take-out or permanent lenders.
- Whether bonding companies and the permanent lenders have approved of any modifications to the original agreements.

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- Whether properties securing construction loans without prearranged permanent financing will be readily saleable when completed.
- Whether inspection reports are maintained and reviewed by persons independent of the inspector and whether they support disbursements to date.
- Whether the amount of undisbursed loan funds is sufficient to complete the project.
- Whether title records reflect the primacy of the institution's lien position.
- Whether adequate builder's risk insurance is maintained.
- The adequacy of any secondary support afforded by guarantors and endorsers.
- Compliance with established policy and procedures.
- Compliance with applicable laws and regulations.
- Loans not supported by current and complete financial information.
- Loans in which collateral documentation is deficient.
- Compliance with provisions of any loan agreements.
- Whether the original amount of the loan was within the lending officer's authority.
- 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.

5. For participation loans purchased and sold and loans sold in full since the preceding examination:

- Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
- Determine that the books and records properly reflect the institution's liability.

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- 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.
- Investigate any loans or participations sold immediately prior to the examination to determine whether any were sold to avoid criticism during the examination.

6. For FHA-insured loans and VA-guaranteed loans:
   - 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.
   - Determine that required delinquency reports are being submitted.

7. Determine if construction loan agreements for acquisition and development loans require prudent release payments.

8. 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:
   - Establish procedures for reviewing construction loan applications? ☐ ☐
   - Require agreements by borrowers for completion of improvements in accordance with approved construction specifications and cost and time limitations? ☐ ☐
   - Define qualified collateral and minimum margin requirements? ☐ ☐
   - Identify acceptable appraisal or valuation techniques? ☐ ☐
   - Specify inspection procedures? ☐ ☐
   - Define methods of disbursing loan proceeds? ☐ ☐
   - Delineate standards for take-out commitments? ☐ ☐
   - State completion bonding requirements? ☐ ☐
   - Establish minimum standards for documentation? ☐ ☐
   - Outline aggregate limit for construction loans? ☐ ☐
   - 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? ☐ ☐

Construction Loan Applications

3. Does the institution require:
   - A history of the contractor's prior construction experience and a schedule of other projects the contractor currently has under construction? ☐ ☐
   - Trade reputation credit checks, current and historical financial statements? ☐ ☐
4. Do project cost estimates include:

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	Yes	No
• Land and construction costs?	☐	☐
• Related off-site expenses?	☐	☐
• Legal services and insurance expenses?	☐	☐
• 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:		
• Personal guarantees by the borrower?	☐	☐
• Personal completion guarantees by the contractor?	☐	☐

Construction and Loan Agreements

	Yes	No
10. Are construction and loan agreements signed prior to actual loan disbursement?	☐	☐
11. Are construction and loan agreements reviewed by experts:		
• To determine that building specifications conform to appropriate codes, ordinances, and restrictions?	☐	☐
• 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:		
• The contractor not start work until authorized to do so by the institution?	☐	☐

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	Yes	No
• On-site inspections be permitted?	☐	☐
• Disbursement of funds be based upon progress of the project?	☐	☐
• The institution be allowed to withhold disbursements if work is not performed in accordance with approved specifications?	☐	☐
• A portion of the loan proceeds be retained pending satisfactory completion of the construction?	☐	☐
• The lender be allowed to assume prompt and complete control of the project in the event of default?	☐	☐
• The contractor have builder's risk and hazard insurance?	☐	☐
• For projects that are developed in phases, does the institution authorize individual starts and require periodic sales reports?	☐	☐

Collateral

	Yes	No
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

	Yes	No
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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	Yes	No

Inspections

		Yes	No
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

		Yes	No
30.	Does a review of the undisbursed loans in process (LIP) account indicate that there are sufficient funds to complete projects?	☐	☐
31.	Are disbursements:		
	• Advanced on a percentage of completion method?	☐	☐
	• Made only after reviewing complete written inspection reports?	☐	☐
	• Subject to written preauthorization by the contractor, inspector, and authorized officer?	☐	☐
	• Compared with original cost estimates and previous disbursements?	☐	☐
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

		Yes	No
34.	Are take-out agreements reviewed by counsel for enforceability?	☐	☐

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	Yes	No
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

	Yes	No
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:

	Yes	No
• Loan applications?	☐	☐
• Financial statements for the borrower, builder, and guarantors?	☐	☐
• Credit and trade checks on the borrower and builder?	☐	☐
• A copy of plans, specifications, and the building permit?	☐	☐
• A survey of the property?	☐	☐
• Construction and loan agreements?	☐	☐
• Appraisal and feasibility study?	☐	☐
• Up-to-date preliminary title search?	☐	☐
• Assigned tenant leases or letter of intent to lease?	☐	☐
• Copy of take-out commitment?	☐	☐
• Copy of the borrower's application to the take-out lender?	☐	☐
• Inspection reports?	☐	☐

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	Yes	No
• Disbursement authorizations?	☐	☐
• Undisbursed loan proceeds and contingency or escrow account reconcilements?	☐	☐
• Insurance policies?	☐	☐
41. Are standardized checklists used to control documentation for individual files?	☐	☐
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:		
• Take-out commitment?	☐	☐
• Hazard insurance?	☐	☐
• Public liability insurance?	☐	☐

Construction Loan Accounting Records

	Yes	No
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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Other Commercial Lending

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.

LINKS

Program

Questionnaire

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, One- to Four Family Residential Real Estate 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 Examination Handbook Section 212, One- to Four-Family Residential Real Estate Lending. 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

The agencies have issued joint safety and soundness regulations that includes standards relating to credit underwriting. These standards should be useful when you assess the adequacy of an institution's credit underwriting policies. Moreover, savings associations should adopt their own specific sound lending principles and underwriting analyses to their lending process. One example of a time-honored lending analysis is referred to as the five "C's" of credit: whereby the lender performs an analysis of the 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 under-capitalized 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 discussion in Handbook Section 211, Loans to One Borrower, 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 examiner assigned Section 201 examination program, Lending Operations and Portfolio Risk Management, the following reports and schedules, if applicable to the commercial loan area:

- Lending and collection policies and procedures.
- Past due loans.
- Loans in a nonaccrual status.
- Loans on which interest is not being collected in accordance with terms of the loan.
- 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.
- Participations purchased and sold.
- Loans sold in full since the preceding examination.
- Loan commitments and other contingent liabilities.
- Loans secured by stock of other depository institutions.
- Extensions of credit to employees, officers, directors, principal shareholders, and their interests.
- Extensions of credit to officers, directors, and principal shareholders of other institutions.
- Miscellaneous loan debit and credit suspense accounts.
- Loans considered problem loans by management.
- The current interest-rate structure/loan pricing.
- Officers' current lending authority.
- Useful information resulting from the review of minutes of the loan committee.
- Reports furnished to the loan committee.
- Reports furnished to the board of directors.

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- Loans classified at the previous examination.
- List of rebooked charged-off loans.
- 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

1. Reconcile or review the reconcilement of the commercial loan trial balance to the general ledger and review reconciling items for reasonableness.

2. Perform the following using the loan commitment and contingent liability schedule:

   - Reconcile appropriate contingency totals to memorandum ledger controls.
   - Review reconciling items for reasonableness.

3. 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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4. Prepare line sheets for any loans not in the sample that, based on information contained in the above schedules, require in-depth review.

5. 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:

- 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.
- The adequacy of any secondary support afforded by guarantors and endorsers.
- Compliance with established policy and procedures.
- Compliance with applicable laws and regulations.
- Loans not supported by current and complete credit information.
- Loans in which collateral documentation is deficient, including collateral verification and inspection by loan officers.
- Compliance with provisions of any loan agreements.
- Whether the original amount of the loan was within the lending officer's authority.
- 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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6. For participation loans purchased and sold and loans sold in full since the preceding examination:

- Test participation certificates and records and determine that the parties share in risks and contractual payments on a pro rata basis.
- Determine that the books and records properly reflect the institution's liability.
- 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
- Investigate any loans or participations sold immediately prior to the examination to determine whether any were sold to avoid criticism during the examination.

7. 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.

8. 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.

9. Determine projected loan growth.

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10. Determine general distributional characteristics of the commercial loan portfolio by:

- Determining percentage of total loans in specific classes.
- Comparing loan category distributions with policy guidelines.

11. Compare management's list of problem loans with classified loans to determine management's knowledge of its future problems.

12. Determine the causes of existing problems or weaknesses within the system that present potential for future problems.

13. Determine compliance with laws, rulings, and regulations pertaining to commercial lending.

- Review loans to affiliates with respect to adherence to regulatory requirements, institution procedures, and regional office policy statements.
- Review loans to affiliated persons with respect to the regulatory limitation of $100,000 per person (pursuant to 12 USC § 563.43).

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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Other Commercial Lending

Questionnaire

	Yes	No

General Questionnaire

Commercial Loan Policies

1. Has the board of directors adopted written commercial loan policies that:
   - Establish procedures for reviewing commercial loan applications? ☐ ☐
   - Define qualified borrowers? ☐ ☐
   - 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:
   - Issue official checks or drafts singly? ☐ ☐
   - 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? ☐ ☐
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? ☐ ☐

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	Yes	No
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:

	Yes	No
• Issue official checks and drafts singly?	☐	☐
• Handle cash?	☐	☐

13. Are the independent interest computations made and compared or tested with initial interest record by persons who do not also:

	Yes	No
• Issue official checks and drafts singly?	☐	☐
• Handle cash?	☐	☐

Collateral

14. Are multicopy, prenumbered records maintained that:

	Yes	No
• Detail the complete description of collateral pledged?	☐	☐
• Are typed or completed in ink?	☐	☐
• Are signed by the customer?	☐	☐
• 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?	☐	☐
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?	☐	☐

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Yes No

COMMENTS

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Letters of Credit

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.

LINKS
Program
Questionnaire
Appendix A

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 Examination 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
§ 32.2(e)	Standby Letter of Credit

[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."

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

* The reference is to a paragraph number in the Supervisory Service, Savings and Community Bankers of America, Chicago, Illinois.

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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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WKP. REF.

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:

- List the dollar amount of the institution's total outstanding letters of credit (separately for both standby and commercial letters of credit).
- 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.
- 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:

- Letters of credit issued for officers, directors, and their interests;
- Letters of credit issued for officers and directors of other financial institutions;
- Letters of credit criticized during the previous examination;
- Letters of credit that are in excess of percentage of asset limitations; and
- 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:

- Prior examination report comments and prior examination exceptions;
- External and internal audit and internal loan review exceptions; and
- Any enforcement/supervisory actions and directives.

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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

1. 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.

2. 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 Examination Handbook.)

3. 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.

   - Each letter of credit should 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.

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- 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.
- The account party must have an unqualified obligation to reimburse the issuer for payments made under the letter of credit.
- Check to see how verification for authenticity is performed prior to approving the release of funds.

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4. 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
- Revolving
- Transferable

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- Assignable

Note whether the approval application is on file and whether the terms of the letter of credit are in agreement with it.

5. 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:

   - Review compliance with provisions of letter of credit agreements.
   - Compare the amount of letters of credit outstanding with the lending officer's authority.
   - Ascertain compliance with the institution's established commercial loan policy.

6. 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

1. 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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Reviewed By:	
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Letters of Credit

Questionnaire

	Yes	No

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.		

____

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		Yes	No
5.	Has the institution made commitments on letters of credit that are not issued?	☐	☐
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?	☐	☐

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Prepared By: ________________
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Yes No

COMMENTS

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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Floor Plan and Indirect Lending

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.

LINKS
Program
Questionnaire

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 Examination 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. Notify examiners assigned to examination program 201, Lending Operations and Portfolio Risk Management, and 211, Loans to One Borrower, of indirect lending activity so they may be able to assess the appropriate level of review. 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

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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;
   - Schedule of approved floor plan lines for each dealer including outstanding balances;

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WKP. REF.

- 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 examination program 201, Lending Operations and Portfolio Risk Assessment, and 211, Loans to One Borrower, 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.

7. Review adequacy of dealer reserve agreements if applicable.

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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 201, Lending Risk Management 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.

14. 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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Floor Plan and Indirect Lending Program

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LEVEL II

1. Review the reconcilement of the subsidiary ledgers for floor plan loans to the general ledger. Investigate any large reconciling items.

2. Using an appropriate sampling technique, select borrowers for examination. Prepare Loan Review line sheets for dealer loans and retail portfolios. (For details on sampling, refer to Section 209 of the Examination Handbook.)

3. 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:
     - — 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;

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— 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.

4. 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; and
- Delinquency levels provided on reports to the Office of Thrift Supervision.

5. Review recent floor plan checks and determine:

- Are inventory checks performed monthly?
- Are there any units not seen in the last 60 days?

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- 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?

6. 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?

7. 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

1. Select a sample of loans for account balance verification procedures with the borrowers.

2. 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? ☐ ☐
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.? ☐ ☐

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		Yes	No
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

		Yes	No
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?	☐	☐

Loan Administration

		Yes	No
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?	☐	☐

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Yes No

COMMENTS

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Consumer Lending

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.

LINKS
Program
Questionnaire
Appendix A
Appendix B

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.

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

[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.

process and the scope of the internal audit program. (Refer to Examination 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. Examination 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. Examination 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, One- to Four-Family Residential 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 Examination 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 Examination Handbook Section 1355, 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 nonprofit 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 credit-worthiness 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 1300 of this 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.
   - Review of compliance with the consumer lending projections set forth in the business plan.

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- 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.
- Loans classified during the previous examination.
- The nature and extent of loans serviced.

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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.

- 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.

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- 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.
- 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).

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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

1. Test a sample of loans for compliance with established policies and procedures. (For details on sampling, refer to Section 209 of the Handbook.) The extent of testing will depend on preliminary findings, and the review of work performed by the auditors and internal loan review personnel.

2. Review the reconcilement of the subsidiary ledgers for consumer loans with the general ledger. Investigate any large unreconciled items.

3. 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 Handbook Section 211.)

4. Analyze credit files for all borrowers for whom you prepared line sheets for the following concerns:

   - Credit quality (earnings, indebtedness, credit history, loan modifications).

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- 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.

5. 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.)

6. 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.)

7. 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.

8. 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.

9. Determine the adequacy of collection procedures and whether practices conform to policy. Consider whether the institution takes the following steps:

   - 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.

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- 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.

10. Determine projected loan growth.

11. 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

1. Select a sample of accounts and perform direct verification with the borrower.

2. 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? ________________________________

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? ☐ ☐

	Yes	No
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?	☐	☐
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?	☐	☐

Questionnaire

	Yes	No

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? ☐ ☐
    - 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? ☐ ☐

Yes No

COMMENTS

Interagency Guidance on Subprime Lending

March 1, 1999

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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 subprime

[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."

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.

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Subprime Lending
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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, refer to the Consumer Affairs Laws and Regulations Chapter of this 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.

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2. 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.

   - Institution reports on subprime portfolios.

3. 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.

4. 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.

5. Review management's budget and capital plan for subprime products. Assess reasonableness, trends, and actual versus projected performance for the respective products.

6. 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,

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etc.)

- Required/eligible collateral
- Collateral valuation guidelines/methods
- Exception processes
- Credit grading ("A," "B," "C," etc. paper)
- Cure programs (for example, re-agings, extensions, renewals, rewrites)

7. Determine whether all appropriate staff use and adhere to the lending policies and procedures. Determine the adequacy of exception reporting.

8. 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.

9. Evaluate the institution's staffing, training, and compensation plans for its subprime operations. Assess staff adequacy in light of portfolio volume and performance.

10. Review the institution's underwriting process to determine the level of automation, use of credit scoring models, and the override/exception process.

11. Review delinquency and loss reports on a product-by-product basis and by acquisition channel. Determine if delinquency levels are in line with projections.

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12. 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.

13. 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.

14. 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.

1. 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.

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2. 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.

3. 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.

4. 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.).

5. 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.

6. 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.

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7. 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.
  - — Development of necessary controls (for example, restricting access to institution information).

8. 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.

9. Determine the adequacy of the institution’s quality control and internal audit processes (for example, frequency, scope, accuracy, and meaningfulness of conclusions).

10. 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.

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11. Determine if the institution uses and properly applies credit scoring in the subprime lending functions.

12. Assess the structure, management, and staffing of the collections department. Assess the appropriateness of the institution's collection strategies.

13. 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.
- Assess the current and potential impact of such programs on reported performance and profitability, including allowance implications.

14. 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).

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15. 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.

16. Review the institution's most recent quarterly evaluation of the allowance. Determine whether the institution's allowances for subprime portfolios are reasonable and supported.

17. Determine whether the institution funds subprime lending portfolios by securitizing the receivables.

18. 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.

19. 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:

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- 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.

20. 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.

21. Review a sample of investor account reconciliations. Determine whether monthly investor reports are accurate and promptly submitted.

22. 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.

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— Adequacy of control systems, including loan review, audit, and management information systems.

- Deficiencies noted during the examination.

23. 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.

24. 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.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Credit Card Lending

Credit cards are among the most widely used forms of consumer credit. All types of merchants, from department stores to gas stations and grocery stores, now accept credit cards. Generally, credit card products contain terms that include the ability of the lender to reprice individual accounts based on customer payment practices and other performance factors. This, along with the traditionally higher rates of return associated with credit card lending, has led to a significant increase in competition among credit card issuers, putting pressure on their profit margins. In response, issuers have sought to cut costs and increase revenues, possibly elevating their risk exposure.

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Appendix A
Appendix B

The Home Owners' Loan Act (Section 1464(c)(1)(T)) (HOLA) authorizes federal savings associations to invest in credit cards and loans made through credit card accounts without a statutory percentage of asset limitation. While many lenders consider credit card accounts to individuals as consumer loans, HOLA's credit card lending authorization is separate from and in addition to the investment limits for other loans and investments authorized under HOLA. As a result, a federal savings association does not have to aggregate its consumer related credit cards with other consumer loans in determining its compliance with the 35 percent investment limit for consumer loans. Likewise, a federal savings association does not have to aggregate its business related credit card accounts with loans made under HOLA's commercial loan authority.

While there is no statutory percentage-of-assets limitation on credit card loans and investments, OTS may establish an individual limit on a savings association's credit card exposure should its concentration present a safety and soundness concern.

This handbook section focuses on credit card issuers. This role is the most comprehensive and presents the most risk. We divided the discussion of Credit Card Lending into three sections:

- Overview includes guidance on credit card risks and controls, the various product lines, and subprime lending.
- Credit Card Operations includes discussions of underwriting and account management and collection practices.
- Securitizations include discussions of trust structure, recourse and credit enhancements.

OVERVIEW

Credit Card Risks and Controls

Credit card accounts are often unsecured, open-ended extensions of credit and can present a significant amount of credit risk to the issuer. The issuer may manage these risks by extending accounts to those borrowers who have the willingness and ability to repay and setting reasonable account limits based on the risk profile of the account holder. Because of a high level of fixed overhead expenses associated with relatively small loan amounts and a high number of transactions per account, credit card issuers rely on issuing a large volume of cards to maintain profitable operations. One of the greatest challenges to credit card issuers is generating a sufficient volume of accounts to be profitable, while maintaining an acceptable level of credit risk by being selective in granting accounts and credit lines.

High-volume issuers typically use an automated process to approve new accounts. As a result, approval decisions are faster but rely on less verification than other types of lending. Information used to make a credit decision normally consists of credit bureau reports and data from the borrower's application. While it is important for the issuer to verify the information provided by the borrower, the level of verification should depend on the amount of credit extended to the borrower and the level of risk the financial institution is willing to accept and prudently capable of assuming. The larger the amount of credit the financial institution authorizes, the more care it must take in underwriting and verifying borrower information.

Competition among credit card issuers is intense, with the industry competing with other issuers of MasterCard, Visa, Discover Card, American Express, private label cards, and the growing market of smart cards and debit cards. Most prospective account holders receive many credit offers. This increased availability of credit increases the risk that some borrowers will become overextended, especially during periods of financial stress. In addition, increased competition often leads to more aggressive pricing and account management practices that increase the risk profile of the credit card portfolio. Therefore, constant monitoring of account performance and activity is essential for a sound credit card operation.

A prudent credit card program requires strong management and controls throughout the life of the account.

A prudent credit card program requires strong management and controls throughout the life of the account, including underwriting, acquisition, account management, and collections. Controls should include regular reviews of the credit card operation by management as well as periodic reviews by internal audit, and the credit risk, loan review, and compliance review functions. Given its importance to a credit card operation, management information systems (MIS) and controls should be strong.

Product Lines

Financial institutions offer many different types of credit card accounts. Broad product lines include general use cards, affinity cards, business cards, private label cards, and secured cards.

- **General use credit cards** – Issuers offering general use credit cards are usually members of Visa, MasterCard, Discover, or American Express. The issuer pays a fee to utilize the worldwide interchange systems, which provide interbank settlements of credit card transactions and point of sale authorization systems.

- **Affinity or co-branded cards** – Usually an issuer is in partnership with businesses, associations, and nonprofit groups that provide Visa or MasterCard credit. Issuers emboss the cards with the partner's logo, and the partner may offer cardholders some financial incentives, such as rebates or discounts. The partner receives a portion of the income generated by the accounts, usually part of the interchange fee. Use of the card may also generate additional business. An affinity program offers the issuer an additional marketing avenue to help increase receivable balances.

- **Business or corporate cards** – A company issues credit cards to its employees. A contract between the issuer and the company establishes credit lines, repayment terms, and whether or not the company guarantees the loans. The employee generally uses the card for business purposes such as travel and entertainment, but sometimes uses the card for general corporate expenses. Business credit cards carry the same level of risk as corporate loans and require the issuer to carefully underwrite the sponsoring corporation.

- **Private label cards** – Retailers, such as department stores or gas stations, may issue private label cards in partnership with a financial institution. Retailers generally issue private label cards for use only at their stores. Thus, private usage cards are more limited than general use credit cards.

- **Secured cards** – Secured cards are general use credit cards fully or partially secured by cash deposits. Issuers provide these cards to applicants with poor or limited credit histories who may not qualify for a regular credit card. While fees and charges are usually higher than regular credit cards, a secured card allows a cardholder to establish or reestablish a good credit standing. A secured card program generally involves lower line amounts and more transactions per account than a standard card program, which increases overhead expenses. Underwriting, monitoring of over-limit accounts, and strong collections practices are particularly important for this type of account. In addition, financial institutions should establish a security interest in the collateral deposit and monitor the deposit over the life of the account.

Each of these products involves different types and levels of risk. Therefore, in addition to having strong policies, procedures, and controls, a savings association involved in credit card lending must have a well-defined strategy for each product line it offers.

Subprime Lending

Savings associations may choose to target their credit card lending activities to subprime borrowers, including borrowers that have weakened credit histories or severe credit problems such as charge-offs, judgments, and bankruptcies. Such loans have a higher risk of default than loans to prime borrowers.

Since lenders typically charge a premium for the added risk of default, subprime loans can generate more income than standard risk loans, provided that the lender has accurately estimated default and loss rates and priced the loans accordingly. While responsible subprime lending can expand credit access for consumers and offer attractive returns to financial institutions, the elevated levels of credit and other risks arising from these activities requires more intensive risk management and capital that is proportionate to the risk.

In March 1999, OTS, together with the other banking agencies, issued *Interagency Guidance on Subprime Lending* to provide detailed guidance to examiners on subprime lending activities (See Appendix A of Handbook Section 217). On February 2, 2001, the agencies issued *Expanded Guidance for Subprime Lending Programs* (CEO Memo 137). This expanded guidance discusses supervisory expectations for the ALLL, regulatory capital, classification of risk, documentation for re-aging, renewing or extending delinquent accounts, and regulatory expectations for the review and treatment of potentially abusive lending practices.

While this handbook section discusses credit card lending in general, savings associations engaging in a subprime credit card lending program will be expected to establish ALLL and hold capital in accordance with the requirements set forth in the 2001 Expanded Guidance (CEO Memo 137). They are also expected to establish a risk management system commensurate with the risk of the lending activity and that conforms to the interagency guidance.

Roles of Savings Associations

Savings associations can have three major roles in credit card lending: a card issuer, a merchant acquirer, or an agent. A card issuer assumes responsibility for solicitation, issuance, servicing, and collection of the accounts. A merchant acquirer collects deposits related to credit card transactions for the merchants and assumes some risk related to customer charge-backs. Charge-backs occur when a customer refuses to acknowledge a charge, claiming either a problem with the goods or services received or the validity of the charge itself. If a business that has been granted merchant privileges has many charge-backs, yet does not have sufficient resources to pay them, the bank that issued credit card privileges to the merchant may incur all or a portion of the charge.

An agent is the most limited form of participation. An agent solicits applicants for an issuer's credit card program without assuming any credit or transaction related risks, and may act as a depository for merchants.

CREDIT CARD OPERATIONS

> Credit card operations include numerous activities that the issuer can separate and perform by itself or contract with third-party servicers.

Credit card operations include numerous activities that the issuer can separate and perform by itself or contract with third-party servicers. A savings association may perform some or all of the following functions:

- Screening and solicitation of cardholders.

- Underwriting/credit score modeling.
- Issuance and embossing of cards.
- Solicitation of merchants to accept cards.
- Acceptance and accounting for merchant deposits.
- Payment and statement processing.
- Performing collection activities.

Underwriting and Account Acquisition

Issuers originate credit card accounts in three ways: preapproved offers, approval upon application, and portfolio acquisitions.

Preapproved offers

Preapproved offers are solicitations of credit card accounts to a preselected group of prospective applicants, either by direct mail or by telemarketing. Savings associations select these applicants either from their current borrowers or, more commonly, through the purchase of a list of individuals from a list vendor or credit bureau. These lists often comprise individuals who meet specific institution criteria. Factors used to determine if an individual meets the criteria include credit score, geographical area, income, or card usage. The primary advantages of preapproved offers are higher response rates and faster application processing, making marketing more efficient. However, consumer laws restrict the ability of issuers to deny credit to preapproved applicants. Therefore, it is important that an association carefully screen prospective applicants to whom it sends preapproved offers.

Approval Upon Application

An issuer may also approve an account after it receives an application. In this method, issuers solicit applicants by mail, telemarketing, "take-one" applications, or through media advertisements. The issuer then processes completed applications using its underwriting criteria and makes a decision to grant or deny the account. Issuers may use a judgmental process, an automated scoring system, or a combination of both to make the credit decision. In each case, it is important that the issuer have well-defined credit approval criteria to ensure that underwriting standards are appropriately and uniformly followed.

Savings associations should typically obtain and consider the following credit factors from the application and credit report. They are important elements in any credit card underwriting policy or credit scoring model.

- Length of time in a credit bureau file.

- Types of credit in file (i.e., mortgages, bank cards, department store credit).
- Payment status of current debt.
- Number, severity, and recency of past delinquencies.
- The existence and amount of past collections or judgments.
- The existence of bankruptcy filings.
- The number and balances of bank cards currently outstanding.
- The number of inquiries from other lenders in the past six months.
- The applicant's debt to income ratio and/or estimated disposable income (typically not available from the credit report).
- The applicant's income and job stability.

When using a credit scoring system, many of the aforementioned elements are factored into the applicant's credit score.

Credit Scoring Models

Most issuers now rely on credit scoring models to evaluate the credit risk of applicants. The issuer uses these scores, along with other selected criteria, to develop lists of potential applicants, make credit decisions, and/or to evaluate accounts once they have issued the cards. Credit scoring models use complex scoring algorithms to evaluate credit bureau data, applicant information, and past experience with borrowers. Lenders use the resulting scores to predict the number of accounts within a selected population that are likely to become seriously delinquent or be charged off. Savings associations and scorecard developers use extensive statistical testing of previously originated accounts to develop these models. Associations and vendors develop scoring models by observing the relationship between the initial information on those accounts and their performance over time.

Credit scoring models can range from the following:

- Generic models based solely on credit bureau information from a wide range of applicants.
- Custom-designed scorecards that incorporate bureau information, applicant provided information, and the lender's own payment experience with its borrowers.

Savings associations can also develop their own scoring models to estimate default rates, bankruptcy, other cardholder behavior, and portfolio profitability. The institution or model developer must periodically retest the models to ensure that they continue to accurately predict portfolio performance.

Because the credit card market changes rapidly, borrower attributes that have successfully predicted performance in the past may become less reliable over time. Model developers should revalidate their models frequently and provide "odds charts" for management to evaluate the models. Odds charts list the statistical likelihood that borrowers within a particular credit score range will become seriously delinquent. Management should also compare the savings association's actual experience of accounts granted using such scoring systems with the results predicted by the model.

Scoring models take the available credit information in various combinations, weight it according to its importance, and arrive at a final score. Management then sets additional parameters, such as score cut-offs or minimum income, to select a group of applicants for solicitation. When the association receives the applicant's acceptance of the card offer, it should perform a post-screening analysis by rescoring and reevaluating the account based on the updated information.

Scoring models take the available credit information in various combinations, weight it according to its importance, and arrive at a final score.

A significant deterioration in the applicant's score or an increased use of credit may warrant a rejection of the account or a limitation on the offer. The association may also use the updated information to select a line assignment (of how much credit to grant) for the account. Appropriate assignment and management of the credit line amount are important factors in controlling losses. (See Account Management in this Handbook Section.)

To protect against fraud, associations should match names, addresses, and social security numbers in the credit report and application before it approves or opens an account.

Testing Marketing Strategies

Due to the significant credit risk involved and the rapidly changing nature of the credit card environment, the association should carefully plan and test its solicitation strategies prior to full implementation or "roll-out." The association should test such strategies (such as changing a score cut-off or offering "teaser-rate" products) on a smaller representative sample of accounts prior to mass solicitation. Management should ensure that policies and procedures exist to control the level of risk associated with such tests. The sample size should depend on the association's size, condition, and capital level.

Policies should require management to prepare and analyze profitability projections for each test and to establish procedures to limit tests to an appropriate amount. Associations should terminate tests that produce undesirable accounts.

Financial institutions often compete by offering products with low introductory "teaser" rates and no annual fees. They also target balance transfers from a cardholder's other accounts. Improper assessment of the credit risk of such accounts could result in unprofitable business or losses due to the high and immediate usage of the accounts. Solicitation strategies should also include a consideration of the effect of balance transfers to other card issuers. An issuer may have to extend teaser rate periods to retain balances or face losing accounts, causing a product to be much less profitable than projected. Moreover, losing a significant portion of "good accounts" will heighten the risk profile of the remaining accounts and likely result in higher than expected charge offs as a percentage of the portfolio.

Proper testing and analysis of account behavior can mitigate the adverse effects of these problems. Savings associations should maintain records of profitability analyses.

Portfolio Acquisitions

Savings associations sometimes acquire credit card accounts from other issuers through bulk acquisitions to quickly expand an existing program, take advantage of excess servicing capacity, and/or diversify their product lines or geographic markets. Savings associations should have strong portfolio acquisition policies, procedures, and controls to ensure that each prospective portfolio is properly assessed and valued. Management should properly evaluate the portfolio's credit characteristics, performance, legal structure, and the seller's operation.

The acquirer should understand the seller's operations to ensure that it can reasonably integrate the accounts with its own. Management should support account purchase offers with a well-documented due diligence process as well as a performance and profitability analysis of the portfolio. The due diligence should include, among other things, portfolio-wide performance and credit score analysis as well as a representative sample of individually reviewed accounts using updated credit bureau information. The association should also have sufficient control systems in place to ensure that it consistently follows its acquisition policies and procedures and that internal audit periodically reviews them.

Management should carefully assess intangible assets created in connection with an acquisition, known as "purchased credit card relationships" (or PCCRs), and document the financial analyses and assumptions used in valuing them. PCCRs represent a premium paid for credit card accounts and reflect the benefits associated with the ongoing opportunity to lend to and otherwise do business with account holders. PCCR premiums have been ten percent or higher. However, the value of the premium paid, if any, should be based on conservative and realistic assumptions about the profitability of the accounts.

The purchase price of a portfolio (and any PCCR) is based on various factors or "drivers" that, in the aggregate, determine the cash flows from the portfolio.

Examples of drivers include the following:

- Portfolio yield
- Fee income
- Attrition rates
- Charge off rates

- Processing and overhead costs
- Funding costs
- Fraud costs

Valuations are based on the discounted present values of the future net cash flows generated by the purchased accounts. Savings associations should use reasonable and supportable discount rates to estimate the value of the future net cash flows. They should perform re-valuations quarterly. They should base the current value of PCCRs on periodic analyses of the account relationship, account balance, and profitability.

The association's accounting policy for PCCRs should include:

- Parameters for PCCR valuation models.
- Frequency of valuations (usually quarterly).
- Amortization standards for the life and benefit of the account relationship and the maximum allowable amortization period.
- Impairment determination.

Associations should amortize PCCRs over the estimated useful lives of the purchased accounts. Generally accepted accounting principles (GAAP) require that amortization periods not exceed ten years; however, since most prepayments occur in early years, savings associations should use an accelerated amortization schedule commensurate with the effective life of the purchased portfolio.

Management should be able to demonstrate that the credit card and other products related to PCCRs are ongoing and profitable.

Management should be able to demonstrate that the credit card and other products related to PCCRs are ongoing and profitable. Otherwise, you should presume that the valuation assumptions pertaining to the PCCRs were overstated or are now invalid, and the association must charge off excess/unsupported PCCRs.

Regulations limit the inclusion of PCCRs in regulatory capital, and require that their carrying value not exceed the lower of cost or fair value, less selling costs, which must be evaluated at least quarterly. Specifically, the association cannot include PCCRs in the calculation of tangible capital and may only include PCCRs up to a maximum of 25 percent of core capital. Complete details regarding these limitations and guidelines are specified in the capital regulations at 12 CFR Part 567.

Consumer Considerations

Unfair or Deceptive Acts

Savings associations should ensure that credit card marketing, as well as account management practices, do not involve practices that may be unfair or deceptive acts or that may expose the association to excessive compliance and reputation risks. In particular, management should carefully scrutinize the following types of practices:

- The practice of soliciting credit cards with credit limits "up to" a maximum dollar amount, when that credit limit is seldom granted, or when the "up to" maximum for targeted consumers who have limited or poor credit histories is significantly higher than the credit limit they would likely receive.

- The practice of using promotional rates in credit card solicitations without clearly disclosing the significant restrictions on the applicability of or fees associated with those rates.

- The practice of increasing a cardholder's annual percentage rate when the circumstances that would trigger the increase have not been fully disclosed.

- The practice of not adequately informing consumers of the costs, terms, risks, and limitations of the product being offered. For example, offering secured credit card products in which the security deposit or applicable fees are charged to the card. As a result, the changes substantially reduce the amount of initial available credit and card utility to the consumer, contrary to representations made.

Bankruptcy Act Truth-in-Lending Act (TILA) Amendments

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the Bankruptcy Act) amends the TILA's disclosure requirements for credit cards.[1]

Applications and Solicitations

For open-end credit secured by a dwelling, it will no longer be sufficient to recommend that the borrower consult with an advisor concerning the deductibility of interest. The Bankruptcy Act requires specific disclosures concerning limitations on tax deductibility of interest where the total of all extensions of credit secured by the dwelling exceed its fair market value. Advertisements and applications must contain these disclosures.

There are also new disclosures when a creditor offers introductory rates. Generally, the application or solicitation to open a credit card account offering an introductory rate must use the term "introductory" in immediate proximity to each use of the temporary APR. In close proximity to the

[1] These requirements become effective 12 months after the Federal Reserve publishes a final rule implementing them.

first use of the introductory APR, the creditor must state when the introductory rate will end and either the new APR that will apply (if fixed) or an APR that was used within the last 60 days (if variable). If the creditor can revoke the temporary APR, it must include a general statement of the grounds for revocation and clearly and conspicuously disclose the post-revocation APR.

The Bankruptcy Act also has provisions relating to Internet credit card solicitations. Required disclosures made through the Internet must be clear and conspicuous, readily accessible to consumers, in close proximity to the solicitation, and updated regularly.

Periodic Statements

The Bankruptcy Act requires creditors to include minimum payment disclosures on periodic statements. The disclosurers must explain the time it would take to pay off a balance accruing interest at 17 percent. The examples vary depending on the minimum payment required by the creditor. If the creditor requires minimum payments of 4 percent or less, the example must assume a balance of $1000 and a 2 percent minimum payment. If the creditor requires a minimum payment of more than 4 percent, the example assumes a balance of $300 and a minimum payment of 5 percent. The creditor may use an interest rate greater than 17 percent in its example and a creditor requiring a minimum payment of greater than 4 percent may use an example based on 2 percent minimum payment.

If the creditor imposes late payment fees, the billing statement must clearly and conspicuously state the date the payment is due or, if different, the first date on which it will charge the late payment fee.

Account Termination

The Bankruptcy Act prohibits a creditor from terminating an account prior to its expiration date because a consumer does not incur finance charges. A creditor can terminate an account if it is inactive for three or more consecutive months.

Future versions of the TILA handbook section will incorporate these changes.

Account Management

A successful credit card operation does not stop with the acquisition of the accounts. Because marketing and data processing costs incurred in acquiring the accounts are high, management must be effective in retaining good accounts, minimizing losses on poor performing accounts, and taking prudent actions to enhance portfolio profitability.

Credit card issuers manage credit card accounts in a number of ways, including:

- Making credit line increases/decreases, with appropriate authorizations.
- Adjusting allowable over-limit amounts, with appropriate authorizations.
- Suspending charging privileges.

- Adjusting rebate programs.
- Initiating various campaigns to promote usage.
- Initiating monitoring and anti-fraud techniques.

You should understand the savings association's account management strategies through a review of its account management reports and discussions with senior managers.

Effective account management depends on accurate monitoring and analysis of the portfolio. Management must have timely information about trends in factors affecting the credit quality of the accounts, including delinquencies, charge offs, over-limit accounts, bankruptcies, and fraud losses.

Management must also actively manage profitability. For example, some issuers use risk-based pricing, where they change interest rates and fees based on changes in the status of the account or in the cardholder's credit profile. Management should monitor profitability factors such as average yield, average balance, credit line usage, and account attrition. Larger operations often use behavioral modeling to predict losses and the profitability of groups of accounts.

Many issuers use automated account management strategies, allowing credit decisions (such as automatic 20 percent line increases or ten percent over-limit approval) to be implemented on a large number of accounts with minimal manual intervention. As with account acquisition, however, prudent management will test such strategies on a smaller number of accounts prior to mass implementation. Issuers often use "champion/challenger" scenarios to test various account management strategies against one another. In this scenario, the institution develops new "challenger" strategies and tests them against a current successful "champion" strategy. If a challenger proves to be more effective, the institution adopts it, and it becomes the new champion. This allows management to continually refine its account management practices and to test strategies prior to full implementation.

Managing problem accounts is important and we discuss it in the next section, Collections and Workouts.

Although marketing typically drives the timing of account management initiatives, the risk management or credit policy function should establish the credit criteria used in acquiring accounts. If the program involves extending a significant amount of credit or a deviation from established underwriting practices, senior management should review and approve changes before implementation.

In January 2003, OTS, together with the other banking agencies, issued joint guidance relating to the account management of credit card lending. The "*Account Management and Loss Allowance Guidance*" addresses several important issues relating to the management of credit card portfolios, including: credit line management, over-limit practices, minimum payment practices and negative amortization, workout and forbearance practices, income recognition, loss allowance practices, and policy exceptions. (See Appendix A.)

On the issue of minimum payment practices and negative amortization, the guidances states, "Agencies expect lenders to require minimum payments that will amortize the current balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. Prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality raise safety and soundness concerns and are subject to examiner criticism."

While some lenders require a minimum payment (e.g., two to three percent of the outstanding balance) that is sufficient to cover interest and some amortization of principal, other lenders specifically require a minimum payment that is sufficient to cover interest and fees along with a one percent amortization of the principal balance. The latter practice ensures the amortization of principal. Thus, monthly minimum payments should cover at least a one percent principal balance reduction, as well as all assessed monthly interest and finance charges.

Management should have in place systems to monitor compliance with the *Account Management and Loss Allowance* guidance, including reports detailing any negative amortization in the portfolio. Account management practices should ensure that controls are in place so that the performing segment of the portfolio is adequately amortizing.

Also, in December 2002, OTS, together with the other banking agencies, issued an advisory to clarify the appropriate accounting treatment for banks and savings associations that securitize credit card receivables and record Accrued Interest Receivable (AIR).[2] The guidance contained in this issuance is consistent with GAAP as specified in Financial Accounting Standards Board Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), and is applicable to institutions preparing regulatory reports filed with the federal banking agencies.[3] The agencies consulted with the staff of the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) in developing this guidance. (See Appendix B.)

Collections and Workouts

The increase in bad debt and fraud losses from credit cards have been attributed to relaxed underwriting standards by some issuers (including initiating subprime credit card programs), poor or imprudent account management practices, continued mass marketing of cards in a saturated market, increased credit card and other debt by consumers, and increases in consumer bankruptcies. An increase in losses can also be attributed to collection staff, systems, and controls that have not kept pace with new account generation.

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[2] For information and guidance on the regulatory capital treatment of the AIR asset, see the "Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations," dated May 17, 2002. (See CEO Memo 160)

[3] These regulatory reports include the bank Consolidated Reports of Condition and Income (Call Report), and the Thrift Financial Report (TFR).

An effective collection process is a key component of controlling and minimizing credit losses. Savings associations must manage the process effectively at each operational level. The problems associated with an inadequately managed collection function include the following:

> An effective collection process is a key component of controlling and minimizing credit losses.

- Reduced earnings caused by increased loan losses and reduced recoveries.
- Reduced earnings caused by higher collection expenses.
- Inaccurate or untimely communications to senior management and the directorate.
- Inaccurate reporting of past due and charged-off loans leading to imprudent management decisions.
- Improper use of re-aging (changing the delinquency status of an account), fixed payment/workout programs, or other collection practices.
- Insufficient allowance for loan losses caused by weak MIS, inaccurate past due figures, and the improper use of re-aging, fixed payment programs, etc.
- Inadequate audit trail of collection and recovery activities.
- Poorly trained employees, resulting in loss of productivity, collections, and recoveries.
- Violations of law and regulations.

Collection is labor intensive and is increasingly difficult to manage properly due to the size and complexity of the credit card business. Management should use current and historical information to formulate a strategy to optimize its collection efforts. In general, such strategy should attempt to direct the department's efforts to accounts with the greatest risk of loss and the greatest potential for collection.

Close supervision of the collection staff is critical. Supervisors should regularly review each collector's performance in areas such as number of contacts made, time per contact, and promises to pay versus dollars received. Management should also determine and use the optimum number of accounts per collector, which is a crucial factor in preventing and controlling delinquencies and charge offs. Surveys of collection departments report that the average number of accounts per collector for large credit card operations is approximately 300. This number can vary widely, however, depending on the type of account (bank card or retail, prime or subprime) and the technology used. Also, front-end (early delinquency) collectors may handle more accounts, while back-end (severe delinquency) collectors typically handle fewer accounts.

Collection strategies determine which accounts collectors work on, the timing of collection activities, and the manner of the contact (for example, phone calls, collection letters, and legal letters). In many savings associations, collection strategies rely on models that track the past behavior of borrowers to predict the likelihood of collection. Some associations also use champion/challenger collection strategies.

Armed with such information, management can effectively direct collection efforts with an emphasis on the dollars at risk of default. Management must maintain close control over collection strategies because seemingly minor changes can significantly affect the dollar amount collected. You should review the collection strategy process and reports, and discuss them with management. You should also have a general understanding of the technologies employed by collection departments. In addition, you should review the collection training program. Well-managed operations should include formal training programs for new employees that can include both classroom and on-the-job training.

Account management also includes developing and managing workout practices, such as re-aging and managing fixed-payment programs, and Consumer Credit Counseling Service (CCCS) programs. How management supervises and controls these programs determines how the association should classify and report the accounts to OTS and what focus it should place on collection efforts. (See a discussion of CCCS programs later in this section.)

Re-aging

The credit card industry often uses re-aging, sometimes referred to as "curing" or "rollback." With re-aging, the bank changes the delinquency status of an account after receiving some, but not all, payments required to bring the account current. Re-aging applies to both forward and backward changes, and often occurs in both the customer service and collection areas. For example, a payment on an account subsequently returned for nonsufficient funds would result in re-aging the account into a more severe delinquency status. Conversely, the savings association may bring a delinquent account current if the borrower showed a renewed commitment to repay the account.

More institutions are adopting the practice of re-aging a delinquent account to current status, after the borrower has made partial payments. This practice serves to avoid reporting performing accounts perpetually delinquent and to help customers who demonstrate a renewed willingness and ability to repay their loans.

> An improperly managed re-aging program can lead to pools of problem receivables. It can also understate delinquency and charge-off levels, and impede accurate analysis of the ALLL.

Savings associations should establish some minimum criteria, such as a requirement that an account holder make three consecutive monthly payments, before a delinquent account is re-aged to a current status. The underlying philosophy is that three consecutive payments show the customer's capacity and willingness to pay. An improperly managed re-aging program can lead to pools of problem receivables. It can also understate delinquency and charge-off levels, as well as impede accurate analysis of the allowance for loan and lease losses (ALLL).

In June 2000, the Federal Financial Institutions Examination Council (FFIEC) published the *Revised Uniform Retail Credit Classification and Account Management Policy* (Account Management Policy). The Account Management Policy establishes criteria for all federally regulated banks and savings associations and their operating subsidiaries for classifying retail credit accounts based on delinquency status (rather than a detailed credit analysis of each account). We discuss the Account Management Policy statement more fully in Handbook Section 217, Consumer Lending, and Section 260, Classification of Assets.

Because re-aging and other workout programs affect delinquency status, the Account Management Policy establishes criteria for the number of payments the borrower must make before an institution can re-age an account. The Account Management Policy also sets limits on the number of times an institution can re-age an account within one and five-year periods. In addition, the Account Management Policy specifies that:

- Institutions that re-age open-end accounts should establish and adhere to reasonable written re-aging policies. An open-end account eligible for re-aging should exhibit the following:

  — The borrower shows a renewed willingness and ability to repay the loan.

  — The existence of the account for at least nine months before allowing a re-aging.

  — The borrower makes at least three minimum consecutive monthly payments or the equivalent lump sum before an account is re-aged. The institution may not advance funds to the borrower for this purpose.

- Institutions should not re-age accounts more than once within a twelve-month period (that is, at least twelve months must have elapsed since a prior re-aging) nor twice within a five-year period.

- Institutions may re-age an account after the borrower enters a workout program, including internal or third-party debt counseling services, but only after receipt of at least three consecutive monthly payments or the equivalent cumulative amount. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the re-aging limits described above.

- For open-end credit, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees). However, the institution may not extend new credit to the borrower until the balance falls below the designated predelinquency credit limit.

As indicated, savings associations should establish appropriate written policies and procedures to govern their re-aging practices. The re-aging policy should address:

- Approval and reporting requirements.

- Age of the account before it is eligible for re-aging.
- Delinquency levels eligible for re-aging.
- Status of the account after being re-aged, i.e., closed, blocked, or open.
- Time limitations between re-agings as well as any limitations on the number of re-agings permitted for each account.
- Consideration of the borrower's overall capacity to repay (factors such as income, length of employment, and other debts) in the re-aging decision.
- Number and amount of payments required to qualify for re-aging.

You should determine if the association's re-aging policy complies with the Account Management Policy.

Accurate reports for the re-aging program are essential. At minimum, management should review regular reports that show both the number and dollar amount of newly re-aged accounts (current month) and those re-aged within the last 12 months. Management also should monitor cumulative historical data that shows the performance of re-aged accounts over time. Without such information, management cannot effectively determine how re-aging affects the association's asset quality. For example, if the association ultimately charges off a large percentage of accounts within 12 months after re-aging, management should assess whether the results (dollars collected prior to charge off versus collection costs) justify the re-aging policy or highlight the need for a revised policy.

Fixed-Payment Programs

Another practice often used to facilitate collection is the fixed-payment program (also known as cure, zero, or reduced-interest programs). Savings associations target such workout programs to borrowers with prolonged or severe credit problems to work with the borrower, to encourage continued repayment, and to minimize loss.

> Management should institute strong controls and ongoing monitoring and perform regular analyses of the programs to determine whether they ultimately benefit the association.

While most associations offer one or more fixed-payment/workout programs, program characteristics vary greatly within the industry. Programs typically consist of a fixed-payment amount, a lower minimum payment percentage, and/or a reduced interest rate for a specified period of time (usually 12 months). As an additional incentive, institutions often re-age the accounts to current status after they receive three or more consecutive payments at the newly agreed upon rate/amount. You should determine if any such re-agings comply with the association's written policies as well as the Account Management Policy.

Loss rates associated with fixed-payment programs are generally higher than those of the total portfolio because of the borrowers' financial problems. The savings association should have policies that specify the terms and conditions of fixed payment programs, such as qualifications for entering the program and how long an account can stay in the program. Management should institute strong controls and perform ongoing monitoring and analyses of the programs to determine whether they ultimately benefit the association. Again, any re-aging or change in the delinquency status or reporting of the account should be part of an overall policy that comports with the Account Management Policy.

Consumer Credit Counseling Service

As part of their collection efforts, many financial institutions also work with the Consumer Credit Counseling Service (CCCS) or other credit counseling services. CCCS is a nonprofit organization that functions as an independent third party to help consumers work through their financial difficulties. CCCS funds its operations by retaining a percentage of each dollar collected. Properly managed, CCCS programs aid both the consumer and the credit community.

A consumer's acceptance into the CCCS program is based on a CCCS counselor's determination that his or her financial situation is salvageable. If accepted, the consumer must agree to cancel all credit cards, develop and adhere to a budget (with counselor guidance), and make debt payments as agreed. CCCS then notifies creditors that it has accepted the consumer into the program and negotiates reduced payment terms with each creditor. Terms vary by creditor, with some requiring the full payment amount and others reducing interest and principal payments significantly in an attempt to stop the account from going to loss. Consumers then make their payments directly to CCCS, which pays the creditors.

Upon receiving confirmation of a consumer's acceptance into the program, creditors will normally re-age delinquent accounts to a current status after receipt of those payments. At this point the creditor generally waives any late and over-limit fees, and ceases all collection efforts as long as the account complies with the renegotiated terms. If an account goes delinquent again for any significant period of time, it usually reverts to the original contract terms, collection efforts commence, and the creditor drops the account from the CCCS program.

Savings associations should have a policy regarding CCCS accounts and appropriate systems to properly account for related transactions with CCCS. An association typically assigns an individual to supervise and monitor its CCCS accounts. The individual should ensure that the association properly identifies all CCCS accounts to enable accurate reporting of CCCS delinquencies and charge offs. The association should incorporate CCCS information into the appropriate loan risk grades and into ALLL calculations. In addition, any re-aging or change in the delinquency status or reporting of the account should be part of an overall policy that comports with the Account Management Policy.

When loan terms, such as the number or amount of payments, principal balance or the interest rate, are modified through either fixed payment programs or CCCS programs, the value of the discounted cash flows of the restructured loan may be less than that the loan's carrying value. When material, associations should adjust the carrying value of such loans in accordance with GAAP.

Management Information Systems for Collections

The collections area typically requires many management information system (MIS) reports to track and manage loan performance, asset quality, and default risk. Regular MIS reports for each collection program are an essential part of proper portfolio supervision. Management should regularly review key MIS collection reports and be able to identify and quantify all collection program specifics, such as delinquency, the number of re-agings on an account, and the percentage of re-aged accounts that the association must ultimately charge off.

Reports should track the performance of each card issue against the performance of the credit card portfolio as a whole. In addition, where the association uses special collection efforts, such as re-agings or workout programs, including CCCS programs, it should compare collections under those programs with performance under the association's standard collection program. If a program is not working effectively, management should discontinue or modify it. You should evaluate MIS reports for pertinent information and accuracy, criticize the absence of necessary MIS reports, and ensure that the association takes steps to initiate corrective action.

One report, called the rollover, breakage, or roll-rate report, is particularly important. Through this report, management can review the number and dollar volume of accounts that move to charge off from each delinquency category. With this information management can predict the delinquency based (not bankruptcy based) charge-off rate as far as six months into the future. In addition, this report can aid management decisions regarding collection staffing levels.

Delinquency and charge-off reports serve as valuable tools in evaluating collection effectiveness. Management should review overall portfolio reports as well as reports on a program-by-program basis. Many credit card operations report delinquencies using two formats: end-of-month (EOM) and sum-of-cycle (SOC). Associations use EOM delinquencies for Thrift Financial Report purposes and to evaluate outstanding delinquencies at month-end as a percentage of outstanding receivables. SOC reports compute delinquencies for each billing cycle, and then aggregate these cycles to determine delinquency for the total portfolio. Unlike EOM reports, the SOC reports ignore the "cleaning up" of delinquencies between the end of the cycle date and the end of the month.

Because new credit card accounts often take time to become seriously delinquent, management may find reports that analyze delinquencies and charge offs on a "lagged" basis useful, especially if a portfolio has experienced significant growth. Such analyses take current delinquency and charge-off figures as a percentage of receivables that were outstanding six or 12 months ago. Also, a "block" or "status code" report provides valuable information for reviewing the composition of the portfolio; (i.e., the number and dollar amount of fixed payment, bankruptcy, fraud, deceased, and canceled accounts).

As discussed previously, a review of re-aging reports is a critical step in the evaluation of the portfolio. Other reports could include actual versus budgeted performance, changes in collection strategies, and performance of behavioral or other scoring models.

Delinquency, Classification, and Charge-Off Policies

Management should regularly assess the quality of the portfolio through a variety of means including a review of past due, charge off, and profitability reports. Management's ability to quickly identify trends in the portfolio and to react appropriately is a critical element in proper and consistent credit card management. In associations lacking a timely charge-off program, loss ratios may be meaningless for periods of less than one year. As a result, management may not become aware of downward trends until year-end or until examiners initiate charge offs. This delays recognition of problems as well as the implementation of necessary corrective action.

Management's ability to quickly identify trends in the portfolio and to react appropriately is a critical element in proper and consistent credit card management.

You should determine how management charges off contractual and noncontractual losses such as bankruptcy, fraud, and deceased accounts. Where the association charges off delinquent credit card loans in the normal course of business, under a policy consistent with OTS regulatory guidelines, you will not likely need to require additional charge offs as a result of your examination.

In accordance with the Account Management Policy, associations should:

- Classify open-end accounts that are 180 days or more delinquent as Loss.
- Classify open-end accounts that are 90 or more days past due as Substandard.
- Charge off bankruptcy, fraud, and deceased accounts in a timely manner:
  - — Associations should charge off losses from deceased open-end accounts at the earlier of when the loss is determined or no later than when the account becomes 180 days contractually delinquent.
  - — Unless the association can clearly demonstrate and document that repayment on an account is likely to occur, it should charge off accounts in bankruptcy within 60 days of receipt of notification of filing from the bankruptcy court or within 180 days, whichever is shorter. The association should take the charge off by the end of the month in which the time period lapses. In the case of fraudulent accounts, the association should place a block on the account until it can complete its fraud investigation (usually within 90 days). Once the association verifies the existence of fraud, the association should charge off the account as noted below.

Recoveries

Recoveries represent collection activities conducted after the charge off of an account. The rate of recovery depends on many factors, including:

- Charge-off policy.
- Previous collection efforts.
- Depth and experience of staff.
- Adequacy of systems and controls.
- Use of technology.

An association generally conducts recovery activities internally. Then, after it has worked the account for several months, it may outplace the account to a collection agency. When outplacing accounts, the association must maintain strict controls and appropriate systems to evaluate each agency's performance. Collection agencies receive a percentage of the dollars collected, typically between 30 percent and 60 percent. The amount varies based on whether the agency is the primary (the first agency to work the accounts), secondary, or tertiary collector. Fees are lowest for the primary agency (these are the accounts easiest to collect) and highest for the tertiary agency. The association should periodically rotate outplaced accounts among agencies to ensure the servicers actively and appropriately work the accounts.

Fraud Control

Fraud is a continuing problem associated with credit card programs. The very nature of the product, an easily obtainable unsecured line of credit that the consumer manages, makes it susceptible to fraud abuse. The bank card associations, issuers and acquirers, the U.S. Postal Service, and their vendors have been focusing on strengthening systems and controls to reduce fraudulent activities. Because of the advances in fraud detection, fraud losses, measured as a percentage of sales volume, have declined for many issuers.

> Fraud is a continuing problem associated with credit card programs--Reporting specific information on types of fraud allows an association to better identify its points of greatest risk.

Fraud can be orchestrated in many ways. Lost or stolen cards and nonreceipt of issued cards represent a large percentage of all fraud reported. The bank card associations track fraud according to type and most issuers follow this or a similar format in reporting fraud in their internal MIS reports. Reporting specific information on types of fraud allows an association to better identify its points of greatest risk. If the operation does not distinguish fraud losses by type, discuss the benefits of such reporting with association management.

Credit card issuers should review their average fraud losses to determine if the staff is identifying fraud activities in a timely manner. If the issuer has inadequate systems and controls to identify fraud, this will likely result in the frauds running longer, permitting more transactions, and resulting in higher losses.

Card issuers use some of the following techniques to reduce fraud:

- Sorting mail outside the facility where the mail was initiated.
- Instituting call-to-activate (CTA) requirements where the accountholder must call from his or her home phone to activate new and reissued cards.
- Implementing pattern recognition programs and systems to monitor unusual card usage.
- Use of sophisticated fraud detection systems.
- Extending the time in which the institution reissues cards to three years from two years to reduce the number of cards in the delivery system.
- Designating a special group to handle lost or stolen card reports.
- Increasing the level of payment review to include all checks over a certain amount, $3,000 for example, regardless of whether or not there is a payment coupon.

Most large issuers maintain dedicated staff that perform certain activities required when a cardholder notifies the issuer of a suspected fraud or when the issuer becomes aware of fraud. These activities include:

- Preparing a lost or stolen report from the cardholder and advising the cardholder to destroy additional cards. The report should include all relevant information regarding the fraudulent activity, corrective action taken, and the name of the manager signing off.
- Blocking the account and placing it on an exception file. Each issuer will have its own block codes depending upon its processor.
- Preparing a request to issue new cards to the cardholder.
- Setting up a file for investigation on fraud accounts. This includes requesting draft copies of fraudulent items and challenging the cardholder on questionable items.
- Reviewing and initiating fraud transactions for chargebacks. This includes preparing fraud notifications to bankcard interchange systems such as Visa or MasterCard, investigating and documenting fraudulent cards, and prosecuting, if possible.
- Charging off losses after the account becomes 180 days past due or within 60 days after fraud is determined, whichever is sooner. The issuer subsequently submits losses to Visa or MasterCard for reimbursement on insurance, if applicable.

Management should have adequate controls in place to ensure that association staff recognize fraudulent activities in a timely manner, and appropriately blocks the accounts to prevent further charges. The timing of the block date is important as the vast majority of fraud losses occur on or prior to the block date and those after the block date have significantly lower transaction sizes. According to industry studies, improvement in authorization and other fraud control measures has materially lowered losses from fraud after the block date.

The Account Management Policy requires associations to charge off fraudulent accounts within 90 days of the discovery of the fraud or 180 days (for open-end accounts), whichever is shorter. The association should take the charge off by the end of the month in which the time period elapses. This period provides the fraud unit with ample time to conduct its investigation.

Savings associations should not re-age fraudulent accounts (as opposed to disputed accounts) at the time of notification or identification to permit the investigation to proceed without reaching the mandatory charge-off period of 180 days contractual delinquency. OTS considers this practice unacceptable.

Allowance for Loan Losses

Methods used to determine the allowance for loan losses related to credit card portfolios will vary among financial institutions. These can range from a simple historical average of loss rates to complex migration to loss analyses. However, the methodology and resulting allowance must conform to the "Interagency Policy Statement on the Allowance For Loan and Lease Losses," dated December 21, 1993, and the "Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions," dated July 2, 2001.

As noted in those policy statements, associations should maintain the ALLL at a level adequate to absorb estimated credit losses that they will likely realize on a loan or pool of loans based upon facts and circumstances as of the evaluation date. Associations should base these estimated inherent credit losses on the historical net charge-off rates, adjusted for current economic conditions and trends, as well as changes in lending activities. The losses should meet the criteria for accrual of a loss contingency (i.e., a provision to the ALLL) set forth in GAAP. (See Handbook Section 261 for general guidance on the ALLL.)

For credit card loans, institutions generally maintain the allowance based on outstanding balances, rather than unused lines. This is because credit losses are compared with existing balances, and issuers are able to restrict new purchases and/or close the line to borrowers if credit quality declines. However, poor account management practices, or weak accountholder agreements that allow new charges on delinquent or otherwise troubled accounts, might necessitate an increase in the ALLL for exposure to committed lines. The following factors should be considered when evaluating the sufficiency of the ALLL:

- Recent and historical trends in delinquencies.
- Charge-offs for credit reasons, bankruptcies, deaths, and seasonality factors.
- Current composition of the portfolio.
- Level of recoveries.

Outstanding credit card balances for prime accounts often have a high prepayment speed or turnover rate, usually one or more times per year. This has been the basis for credit card issuers to argue for the six months or less ALLL coverage where the average balance of the portfolio turns over every four to six months. Credit card portfolios of lower credit quality or subprime accounts generally have much slower turnover rates. Portfolios that have higher concentrations of borrowers who only pay the minimum payments or portfolios with high levels of chronically delinquent accounts will have much longer average lives. Therefore, the ALLL should be sufficient to cover expected losses for loans in these higher risk portfolios. While some of these accounts may have shorter average lives due to charge-offs or restructurings, the association should calculate the average life of a segment of loans based upon specific portfolio segmentations with fully supported estimated prepayment speeds.

Keep in mind that the average charge-off rate will be lower for rapidly increasing portfolios, as most new accounts take from 12 to 24 months for serious delinquency to develop and for the association to recognize the losses. Where loss rates are low due to an increase in new accounts, it may be appropriate for the association to use industry average charge-off rates to determine the ALLL.

A rolling analysis generally segments the portfolio into various degrees of delinquency and tracks the roll rate from one delinquency "bucket" to the next over time. Typically, as accounts age, the percentage of accounts that roll to the next bucket e.g., the roll rate, increases significantly. By applying the average roll rates from current account balances to various delinquency buckets, an association can better estimate losses resulting from delinquency in the existing portfolio. In some cases, it may be appropriate to further segment the portfolio, particularly if significant portfolio segments demonstrate materially different loss characteristics.

Diversified lenders might segment the portfolio by major product types, such as gold cards, classic cards, affinity cards, corporate accounts, subprime, and/or secured cards. Financial institutions might also segment portfolios by date of origin ("vintage"), by solicitation, by risk classification, or by geography. Roll rates applicable to each segment would then be applied to balances in the various delinquency buckets in order to estimate losses for each segment. While this roll rate analysis can be useful in predicting losses due to delinquency, associations must also assess the adequacy of the ALLL for losses due to bankruptcy, death, or other reasons that can occur at any level of delinquency.

Whether an association uses a migration analysis or a historical loss rate, it should base its ALLL methodology on the actual loss experience of its portfolio. Associations should analyze losses over a period of two or three years to consider the seasonal nature of the credit card market.

> Whether an association uses a migration analysis or a historical loss rate, it should base its ALLL methodology on the actual loss experience of its redundant portfolio.

Management should adjust historical loss experience to reflect current conditions that may affect the current portfolio such as:

- Changes in lending policies and procedures.
- Trends in relevant national or local economies.

- Changes in the nature or volume of the portfolio.
- Material changes in management or staffing.
- Changes in the volume or severity of past due and classified loans.

In reviewing the reasonableness of an association's ALLL methodology for credit cards, make sure that re-agings have not caused an inappropriate delay in reporting delinquencies or charge offs. In addition, determine whether or not the association "purifies" its losses before charging them to the allowance, that is, reversing capitalized interest and fees considered uncollectible against appropriate income accounts, so that charge offs are only for principal balances (purchases and cash advances). Reported charge-offs would therefore exclude accrued and unpaid finance charges and fees. The resulting ALLL would be based upon principal charge offs that do not properly capture these capitalized charges. While this is common practice in the industry, it necessitates the creation of a separate reserve or other methodology to properly reflect uncollectible finance charges and fees. Regardless of accounting practice, ALLL methodology should ensure allowances or reserves cover all estimated uncollectible amounts (principal, fees, interest, etc.).

Profitability Analysis

Credit card accounts generate income in a variety of ways, including interest, annual fees, interchange fees (a percentage of credit card sales paid by the merchant for access to the interchange system), late charges, cash advance fees, and over-limit fees. Some credit card operations also receive servicing fees and residual income from securitized portfolios. Interest rates are generally higher than other loans, but can vary significantly depending upon product type, borrower risk profiles, competition, and state usury laws. Overall, credit cards are among the highest gross yielding assets held by financial institutions. However, they also generate higher charge offs than other loan types.

Overhead expenses are also higher for credit card operations than many other lines of business due to small relative loan balances and a higher number of transactions per account. Credit card operations involve significant expenditures for marketing/account acquisition, data processing, servicing, collections, and facilities and equipment. Therefore, it is important that management perform profitability analyses of the credit card operations separate from the association's other lines of business. Where appropriate, management should separately analyze profitability of different segments of the credit card portfolio.

Good management information systems, including timely and accurate reports, are crucial to ensuring that the association adequately assesses profitability.

Rewards/Rebate Programs

As a result of increased competition, many issuers offer some type of reward or rebate program to cardholders. Rewards/Rebates include cash, free gasoline, free phone time, free airline tickets, discounts on car purchases, and numerous other offers. Associations offering such programs, or participating with a partner in a program, must evaluate the liability represented by the rebate or reward redemption amount. Associations must establish a liability account, or reserve, in accordance with GAAP based upon management's estimates. Associations should adjust the liability associated with these marketing programs on a regular basis due to changes in program assumptions, including number of cardholders in the program, general economic conditions, actual contract costs, current number of rewards/rebates earned or redeemed, and program changes. You should review the association's reserve methodology for adequacy.

SECURITIZATION

The issuance of asset-backed securities (ABS) provides a major source of funding for larger credit card issuers. (A more detailed discussion on Securitizations is in Handbook Section 221, Securitizations.) Issuing ABS certificates with rates correlated to the accounts in the trust allows management to manage interest rate risk. Credit card operations can generate substantially higher returns on assets than traditional thrift assets. The returns appear even higher for associations that remove credit card balances from the books through securitization since they continue to receive the residual income as seller/servicer.

However, do not rely on a return on book assets analysis for such associations. The components of this residual net income for balances sold are essentially the same as accounts on the association's books, less the interest paid to the investors. Therefore, profitability analyses of credit card operations are performed on a managed assets basis rather than an on-balance-sheet basis. This allows more accurate analyses of profitability, cost allocation, collections efficiency, delinquency and loss trends, interest rate risk, and other performance factors affecting the credit card operation. It is expected, however, that the MIS track both on-balance sheet and managed asset portfolio.

Such profitability analysis also allows proper comparison to other issuers. Market data for comparison can be obtained by reviewing credit card trust prospectuses from other issuers who securitize. In addition, Visa and MasterCard publish a variety of statistics for participating issuers on a monthly basis.

Trust Structure

Basic credit card securitization involves the transfer of a number of loan receivables to third-party investors through the issuance of asset-backed securities. If the securitization is accounted for as a sale in accordance with Statement of Financial Accounting Standards No. 140 "*Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*," the credit card receivables are removed from the balance sheet. Historically, financial institutions established credit card securitizations in a "stand-alone" trust structure, meaning that receivables from specified accounts were assigned for the entire life of a trust. In 1988, large issuers began using a "master trust structure," which allows issuers to add receivables from new accounts periodically and to issue multiple series from a common pool of receivables. In addition to adding receivables to issue new series, the master trust structure allows the issuer to add receivables to replace balances lost by cardholder attrition and/or to maintain the characteristics of the existing pool.

To protect investors, most credit card securitizations have specified "trigger" events that can cause early amortization of the trust. Early amortization begins if the receivables fail specified performance or loss measures. Each series in a master trust may have different trigger events that may or may not cause early amortization in other series.

Since early amortization requires the issuing institution to repay investors earlier than anticipated and can take one year or less, it can cause serious liquidity problems. It can also damage the issuer's reputation in the investment community, limiting further credit card securitizations. It is therefore very important for management and the directorate to be aware of triggers and have reporting procedures in place to monitor the performance of each series issued. You should review these reports and assess the adequacy of the association's monitoring procedures.

Management must obtain sound legal, accounting, and tax advice in planning a credit card securitization program. When properly structured and operated, associations may treat credit card securitizations as sales, allowing removal of assets from the balance sheet and improving capital and performance ratios. Under sale accounting, the association recognizes monthly profit from these accounts as servicing/other income. With the implementation of SFAS No. 140, the association recognizes estimated net profits over the life of these receivables at the time of transfer.

When properly structured and operated, associations may treat credit card securitizations as sales, allowing removal of assets from the balance sheet and improving capital and performance ratios.

If it intends to obtain sale treatment under GAAP, the association must carefully structure the trust in accordance with applicable GAAP guidance. In addition, the association should base profits from the sale of ABS on realistic and supported assumptions for delinquencies, operating expenses, prepayments, and losses. Management should reevaluate these assumptions at least quarterly and revise the carrying value of the underlying assets when material changes occur.

Since credit cards are revolving lines of credit, savings associations structure securities backed by credit cards differently than those secured by traditional association assets, such as mortgages. Securitizing associations place credit card accounts into a trust and typically sell up to 96 percent of the outstanding receivables to investors as an ABS. Under the ABS agreement, the issuer typically must retain at least four percent participation.

The association sells only the outstanding receivables, not the accounts, to the investors. There is typically a "revolving" period, during which the investor receives only interest, and an "amortization" period, when investors receive both principal and interest.

During the revolving period, the investors' principal amount is held constant since the issuer uses principal repayments and a portion of interest payments by the cardholders to purchase new receivables (new cardholder purchases) generated by the accounts in the trust. The issuer's ownership interest in the receivables is generally not subordinated, existing to absorb fluctuations in the total balances so that they do not fall below the investor amount. The revolving period typically lasts two to seven years, and is necessary since average cardholder payments and losses could normally reduce outstanding receivables to zero in one year or less, making the securities less attractive to investors and increasing securitization costs to the issuer.

During the amortization period, the trust allocates principal payments and losses to the investor and issuer based upon their pro-rata share of the outstanding balances. Some credit card securitizations have bullet amortization features, which make a single payment on the maturity date. Consequently, a credit card ABS results in amortization of outstanding balances back onto the issuer's books, which can occur in one year or less after amortization begins. However, issuers often repackage the receivables at maturity or during amortization into a new ABS. Management must carefully plan the association's securitizations to manage their effect on liquidity needs, asset size, and capital requirements as well as profitability.

Credit Enhancements

To attract investors, credit card ABS generally must obtain high investment quality ratings at origination. Therefore, issuers generally must include substantial credit enhancements with the ABS that will protect investors if the accounts fail to generate sufficient cash flows. Such enhancements include spread accounts[4], letters of credit, cash collateral accounts, and subordination agreements. The level of credit enhancement an association requires to obtain a "AAA" rating compared with other issuers can provide insight as to the market's perception of the association's credit card operations and the riskiness of its portfolio. The credit enhancement provided by the association may constitute recourse to the association for regulatory capital purposes. (See Appendix B for interagency guidance relating to accrued interest receivable.) Management should continuously assess the performance of all transferred assets and evaluate the impact on retained interests through the ongoing estimate of future cash flows.

Recourse

Although the association removes sold receivables from its books for both financial and regulatory reporting purposes, it may still have to hold risk-based capital against amounts considered to reflect recourse to the seller. For securitizations, recourse typically involves the risk of loss that the seller retains in connection with the sale of the securitized loans to investors. The general rule is that for sales that qualify as sales under GAAP, the assets sold are not subject to risk-based capital requirements, provided the association meets both of the following conditions:

- Retains no risk of loss from the asset transferred.

[4] A form of cash collateral account established from the monthly finance charges received from the underlying pool of receivables available to cover losses in any given month. If not needed, this excess spread generally reverts to the seller/servicer. Many trust agreements provide that if portfolio yield declines or losses increase, the monthly excess spread is captured in a spread account to provide future credit enhancement.

- Has no obligation to any party for the payment of principal or interest on the assets resulting from default, changes in market value after transfer, or any contractual relationship that could continue after final payment, default, or other termination of the assets transferred.

If a savings association retains recourse in a securitization, it must hold risk-based capital equal to the lesser of (a) the amount of recourse (if a low-level recourse option is appropriate), or (b) the risk-weighted capital requirement for the receivables as if they were still on the books. The amount of recourse for securitizations is generally measured by subordinations, guarantees, pledged collateral, spread accounts, or other association assets (including residual or other interest-only strips created under SFAS No. 140) that absorb losses prior to their recognition by the investors.

In addition, OTS restricts the amount of such residuals that may be includable in regulatory capital. You can find guidance for regulatory capital treatment of credit card securitizations in 12 CFR § 567.12.

Implicit Recourse

Recourse may exist without explicit contractual agreement, or if there is a contractual limit, where the association assumes risk of loss in amounts exceeding the limit. Implicit recourse is usually demonstrated by an association's actions subsequent to the sale. The following actions may be considered evidence of implicit recourse[5]:

> Implicit recourse is usually demonstrated by an association's actions subsequent to the sale.

- Providing voluntary support for securitization by selling assets into a trust at a discount from book value.
- Exchanging performing assets for nonperforming assets.
- Infusing additional cash into a spread account or other collateral account.
- Other actions to support an asset sale that result in an impairment of the association's capital.

Such actions by the issuing savings association may represent recourse, even if such actions are not required of the issuer (and/or servicer) by trust documents. By taking these actions, OTS may require that other sales of receivables in a particular trust be fully risk weighted in calculating the association's regulatory capital requirement.

Other Considerations

In addition to the required regulatory risk-based capital treatment for recourse assets, be alert to the level and growth of spread accounts and other forms of recourse in relation to core and equity capital. This should include growth of recourse on existing securitizations, since spread account requirements

[5] The above examples are illustrative and are not meant to be all-inclusive. Implicit recourse should be evaluated on a case-by-case basis.

for existing trusts will often increase when the performance of a trust declines. An unsafe condition can exist if the issuer has allocated an excessive amount of equity capital to recourse assets, and/or has large levels of unfunded spread account commitments outstanding during periods of weakening spreads. In addition, you should take into account the risk of loss relative to recourse arrangements when evaluating the adequacy of the ALLL.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(c)(1)(T)	Credit Cards
§ 1464(c)(2)(D)	Consumer Loans

Code of Federal Regulations (12 CFR)

Federal Reserve System

Part 205	Electronic Funds Transfers Subject to Regulation E
Part 226	Truth in Lending

Office of Thrift Supervision Regulations

§ 560.1	General
§ 560.3	Definitions
§ 560.30	Lending and Investment Powers Chart
§ 560.93	Lending Limitation
§ 560.170	Records for Lending
§ 563.170(e)	Use of Data Processing Services
Part 567	Capital

OTS Bulletins and CEO Memos

Regulatory and Thrift Bulletins

TB 51	Interagency Policy Statement on Prescreening

CEO Memos

No. 128	Revised Uniform Retail Credit and Account Management Policy (7/2000)
No. 104	Interagency Guidelines on Subprime Lending (3/1999)
No. 137	Expanded Guidance for Subprime Lending Programs (2/2001)

Interagency Guidance and Policy Statements

Account Management and Loss Allowance Guidance (January 2003) (See Appendix A)

Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations (December 2002) (See Appendix B)

Interagency Advisory on Credit Card-Related Merchant Activities (November 1993)

Uniform Retail Credit Classification and Account Management Policy (June 2000)

Interagency Policy Statement on Securitizations (December 1999)

Interagency Guidance on Subprime Lending (March 1999)

Interagency Policy Statement on Allowance for Loan and Lease Losses (December 1993)

Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (July 2001)

Financial Accounting Standards Board

Statement of Financial Accounting Standards (SFAS)

No. 140	Accounting for Transfers and Servicing of Financial Assets & Extinguishments of Liabilities - a replacement of Statement No. 12

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Credit Card Lending Program

EXAMINATION OBJECTIVES

To determine if the policies, procedures, and controls regarding credit cards adequately ensure safety and soundness 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 is in conformance 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 and overall risk.

To determine if any recourse, either contractual or implicit, exists for any sold or securitized accounts.

To initiate corrective action when deficiencies exist that could affect safety and soundness, or when you note violations of laws or regulations.

EXAMINATION PROCEDURES

Perform the following procedures as appropriate depending on the size, complexity, and risk profile of the association's credit card operations. Not all procedures are necessary for each examination. You should determine which procedures are necessary during the scoping process.

Execute the following examination procedures in conjunction with Handbook Section 201, Lending Overview, review. When an association has multiple loan departments (e.g., segregated by lending type(s)), you should arrive at a conclusion about the individual lending operations and an overall evaluation of the lending function and the quality of the loan portfolio. The Examiner-in-Charge (EIC) or assisting examiner responsible for Asset Quality should avoid duplication of effort by ensuring an exchange of information and results from examiners responsible for the different Asset Quality sections.

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Credit Card Lending

Program

WKP. REF.

LEVEL I

WKP. REF.

This section expands on the general lending policies described in Handbook Section 201 Overview, and Section 217, Consumer Lending to include additional guidelines for Credit Card Lending and the use of Credit Scoring Models.

1. Participate in the Level I reviews of Sections 201 and 217, or discuss the findings with the EIC. The review should focus on whether the association's loan policies and procedures address the different types of credit cards offered and how they are solicited. It should also assess whether the underwriting guidelines, including lending limits and documentation requirements, are appropriate.

2. Review the PERK information and the scoping material related to this area including the PERK credit card operation alert letter, if applicable.

3. Determine whether the association has corrected deficiencies mentioned in prior examination reports and audit reports.

4. In conjunction with the EIC or examiner(s) performing the board and management report reviews under Sections 260, 310, and 330, ascertain if any problems or concerns regarding credit card lending were noted.

5. Review management information systems (MIS) delinquency and performance reports as well as board reports relating to credit card operations. This may have already been performed in connection with Handbook Section 201. If so, coordinate with the examiner who performed that work. Determine if MIS and board reports are adequate and accurate. Use performance information to focus your review on higher risk or problem areas.

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6. Using an appropriate sampling technique, select accounts for review. (See Handbook Section 209, Sampling.) For associations relying on automated credit decisions, the review should include a check for compliance with underwriting policies by focusing on exception reports (accounts approved by individuals after rejection by the automated process).

7. Determine whether the association is adhering to the *Interagency Account Management and Loss Allowance Guidance* with respect to credit line management, over-limit practices, workout and forbearance practices, income recognition, loss allowance practices, and policy exceptions. Determine whether the credit card portfolio is experiencing any overall negative amortization. (See Appendix A.)

8. Ensure that the required monthly minimum payment amount is sufficient to ensure at least a one percent principal balance reduction.

9. Determine if the association is properly classifying its credit card accounts in accordance with the *Uniform Retail Credit Classification and Account Management Policy.*

10. Assess the adequacy of any re-aging programs.

11. Complete the Credit Card Lending Questionnaire or, if completed by management, verify for accuracy.

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12. Determine whether the association has established adequate allowance for loan and lease losses for the credit card portfolio.

13. Coordinate with the examiner reviewing the compliance management function to ensure that the credit card lending area is adequately covered within the scope of compliance management oversight, and that there are no material violations of consumer lending laws that could impact the risk profile of the credit card portfolio.

14. If you find problems, deficiencies, or excessive risk in the performance of the aforementioned procedures, discuss the preliminary findings with the EIC or examiner(s) assigned to the asset quality area and expand the scope accordingly. Expanded procedures need to be sufficient to both verify and support the preliminary findings or indicate that the findings do not appear to be an area of concern.

15. Reconcile the credit card portfolios to the trial balance and Thrift Financial Report.

16. Review the validity of the accounting for residual interests in the securitization of credit card receivables and the effect of any recourse on the thrift.

17. Verify level of concentration risk and the effect on capital.

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18. Determine the overall level of credit risk in the portfolio by reviewing the association's internal or external credit score.

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

LEVEL II

1. Expand sample of loans in portfolios where you note significant risks and/or deficiencies. Place specific emphasis on re-aged accounts, over-limit approvals, and declinations or approval of applicants per override.

2. Expand the analysis of the internal loan review process.

3. Expand the review of the scope and depth of work performed by internal and external auditors.

4. Expand the review of the internal rating system and allowances for loan losses.

5. Expand the analysis of the account acquisition and underwriting process.

6. Review the organizational structure of the credit card area, including MIS, and the qualifications, capabilities, and expertise of its principal officers.

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7. Summarize findings (including the reasons for expansion of scope), obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations.

8. Ensure that your review meets the Objectives of this Handbook Section and Section 201. 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
If the savings association acts only as the agent (refer to Handbook Section 218) for a credit grantor, it is not necessary to use the questionnaire.		

Credit Card Policies and Procedures

	Yes	No
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?	☐	☐
• Detailed procedures for reviewing credit card applications?	☐	☐
• Standards for determining credit lines?	☐	☐
• Minimum standards for documentation?	☐	☐
• Collection procedures?	☐	☐
2. Do the board and management review credit card policies at least annually?	☐	☐

Underwriting Standards

	Yes	No
1. Do audit and/or internal loan review staff test compliance with underwriting standards?	☐	☐
2. Are underwriting standards periodically reviewed and revised?	☐	☐
3. Are data from applications tested for input accuracy to the account processing system? If so, what is the sample size and frequency of the test?	☐	☐
[Click&type]		
4. Does an independent person periodically review line of credit increases to determine compliance with the association's policies and procedures?	☐	☐
5. Does an independent person periodically review credit lines for appropriateness of amount?	☐	☐

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		Yes	No
6.	Are procedures in effect to review credit lines when the association becomes aware of a change in financial status or creditworthiness of a cardholder?	☐	☐
7.	Does the association have procedures covering the establishment and periodic review of employee accounts?	☐	☐
8.	Is the information on fraud claims reviewed to determine whether: an employee was involved; a breakdown in the savings association's control of issued cards occurred; or the card may have been taken before it left the association?	☐	☐
9.	Is an officer required to sign off on the conclusion of a fraud investigation?	☐	☐
10.	Does the credit card operation prepare a budget by: function (e.g., collections, application processing), program (e.g., secured card, private label), and overall operations?	☐	☐
11.	Are actual results compared to budget at least quarterly?	☐	☐
12.	Are significant trends and deviations adequately explained in the financial review process?	☐	☐
13.	If assets are securitized, do asset securitizations receive appropriate approval?	☐	☐
14.	Does the association have appropriate collection programs for securitized loans?	☐	☐
15.	Does management have a plan to ensure adequate funding for maturing securitizations and in the event of early amortization?	☐	☐

Credit Card Records

1.	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?	☐	☐
2.	Are subsidiary credit card records reconciled daily to appropriate general ledger accounts?	☐	☐

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		Yes	No
3.	Are reconciling items investigated by persons who do not also originate entries or handle cash and checks?	☐	☐
4.	Are delinquent account past-due notices handled only by persons who do not also handle cash and checks?	☐	☐
5.	Are inquiries about loan balance received and investigated by persons who do not also handle cash and checks?	☐	☐
6.	Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not handle cash and checks?	☐	☐
7.	Does the association maintain a daily record summarizing transaction details, such as charges, cash advances, payments received, and interest and fees collected to support applicable general ledger account entries?	☐	☐
8.	Are two authorized signatures required to effect a status change regarding individual customer accounts?	☐	☐
9.	Are file maintenance changes reviewed and compared with approved change requests?	☐	☐
10.	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?	☐	☐
11.	Is an overdue accounts report generated for each billing cycle?	☐	☐

Loan Interest and Merchant Discount

		Yes	No
1.	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?	☐	☐
2.	Are sales drafts posted promptly to customer account?	☐	☐

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		Yes	No
3.	Are merchants carefully screened with credit underwriting criteria?	☐	☐
4.	Are items missing from a merchant's remittance of sales charged back to the merchant, or otherwise adjusted satisfactorily?	☐	☐
5.	Are merchants' accounts monitored for number and frequency of missing, rejected, or otherwise unsatisfactory items?	☐	☐
6.	Are merchants' accounts subject to holding for collected balances?	☐	☐
7.	Are all holdover items cleared daily?	☐	☐
8.	Are merchants' accounts monitored for unusual volume fluctuations?	☐	☐
9.	Are all rejected items cleared the following day?	☐	☐
10.	Is a review of rejected drafts and payments made by someone independent of the processing clerks?	☐	☐
11.	Is incoming mail maintained under dual control?	☐	☐
12.	Are service charge policies universally applied to accounts?	☐	☐
13.	Does an officer review and approve all internally prepared entries affecting customer account records?	☐	☐
14.	Are records of those entries maintained and reviewed?	☐	☐
15.	Is there a separate control account for accounting for merchants' accounts payable?	☐	☐
16.	Are the merchants' accounts paid on a regular basis?	☐	☐
17.	Does someone other than the person who made the original computations or who prepared the original input data periodically check merchants' discount computations?	☐	☐

Yes No

Card Issuance and Control

1. Does the association balance daily the records of issued cards to the electronic data processing report total of new and reissued cards? ☐ ☐

2. Does someone independent of the embossing unit reconcile the daily record of issued, spoiled, and on-hand cards at the embossing unit? ☐ ☐

3. Is the association certain that the card manufacturer is financially responsible and reputable? ☐ ☐

4. Is the card manufacturer required to provide adequate security controls over cards during all phases of processing and shipping? ☐ ☐

5. 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? ☐ ☐

6. Are unissued cards kept under effective dual control and accounted for in each of the various steps in encoding, embossing, stuffing, and mailing? ☐ ☐

7. Are cards embossed for issuance only upon receipt of properly authorized written instructions? ☐ ☐

8. Are adequate controls maintained over any cards that were embossed and not issued to customers? ☐ ☐

9. Is the embossing area restricted to prevent unauthorized access? ☐ ☐

10. Does the embossing machine have a key controlled counter? ☐ ☐

11. If so, is it locked when not in use? ☐ ☐

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		Yes	No
12.	Are there adequate controls over the use of encoding equipment?	☐	☐
13.	Is locked storage space provided for cards during employee meals and coffee breaks?	☐	☐
14.	Are cards spoiled during the embossing process destroyed under dual control?	☐	☐
15.	Are both employees present during destruction required to sign the destruction register?	☐	☐
16.	Are at least two persons present while cards are being processed?	☐	☐
17.	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?	☐	☐
18.	Is certification of blank cards made at least monthly by someone who is not involved in card handling?	☐	☐
19.	Is the reserve supply of blank cards under dual custody?	☐	☐
20.	Are cards placed in envelopes for mailing under joint custody and checked to the issuance register at the same time?	☐	☐
21.	Are cards maintained in joint custody before, during, and after mail processing until they have been delivered to the U.S. Post Office?	☐	☐
22.	Are cards sent by no forwarding mail?	☐	☐
23.	Is control established over cards returned from the Post Office as undeliverable so that:		
	• The mail is opened under joint custody?	☐	☐

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		Yes	No
	• 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?	☐	☐
24.	Are test or demonstration cards adequately controlled?	☐	☐
25.	If the association issues cards at more than one location (such as at branches), does it have card control procedures for these locations?	☐	☐
26.	If vendors produce the cards, does legal counsel review the contracts for services?	☐	☐
27.	Are cards mailed to customers in envelopes with a return address that does not identify the association's name or usual place or business?	☐	☐
28.	Are returned cards controlled and accounted for by individuals other than those with card issuer or system operations responsibilities?	☐	☐
29.	Is it against policy for the association to mail unsolicited cards?	☐	☐
30.	Are cards that were left inadvertently or captured at Remote Service Unit (RSU) locations properly controlled?	☐	☐
31.	Are plastic card and personal identification numbers (PINs) always mailed separately and on different dates?	☐	☐
32.	After the card is issued, is there a follow-up mailing to inquire if the customer received the card and the PIN?	☐	☐

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		Yes	No
33.	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)

		Yes	No
1.	Are PSIs or Personal Identification Number (PINs) controlled with system-access controls and printed only in line envelopes?	☐	☐
2.	In the event a customer’s PIN is lost or forgotten:		
	• Are there adequate control procedures for old PIN cancellation and new PIN issuance?	☐	☐
	• Is there accountability on the persons initiating such transactions?	☐	☐
3.	Is the PIN encrypted or disguised when:		
	• Transmitted over public access telephone lines?	☐	☐
	• Stored in computer files?	☐	☐
4.	Is all documentation relating to encryption, decryption, and PIN generation properly secured?	☐	☐
5.	In the unlikely event that management insists on having access to both customer account numbers and PINs, have adequate compensating controls been implemented?	☐	☐
6.	If PINs corresponding account numbers appear in a format where they could be matched, are controls maintained to prevent compromising situations?	☐	☐

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Yes No

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 of Terminal Sharing

1. If terminals are shared, does the written agreement among associations clearly identify the rights and responsibilities of all parties, including installation, maintenance, and training of employees and customers? ☐ ☐

2. Does the agreement cover responsibilities in the event of equipment failure? ☐ ☐

3. Has the association established data storage and forward procedures to update records after a system pause in operations? ☐ ☐

4. Can the association identify the terminal or communications device from which data are entering? ☐ ☐

5. Is there a daily settlement procedure for each shared device? ☐ ☐

Operational Controls

1. Are transactions promptly posted to customer accounts? ☐ ☐

2. Are “hot” card and suspect lists properly updated and distributed? ☐ ☐

3. Do exception reports meet the needs of management, user, and audit departments? ☐ ☐

4. Do exception reports receive appropriate daily review? ☐ ☐

5. Are customer names and addresses protected from unauthorized changes? ☐ ☐

6. Are procedures manuals adequate to ensure continuity in the maintenance of control procedures? ☐ ☐

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Comments

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

Subject. ***Credit Card Lending*** *Description:* ***Account Management and Loss Allowance Guidance***
Date: ***January 8, 2003***

Purpose

Recent examinations of institutions engaging in credit card lending have disclosed a wide variety of account management, risk management, and loss allowance practices, a number of which were deemed inappropriate. This interagency guidance communicates the Agencies' expectations for prudent practices in these areas.

The Agencies recognize that some institutions may require time to implement changes in policies, practices, and systems in order to achieve full consistency with the guidance on credit card account management. Such institutions should work with their primary federal regulator to ensure implementation of needed changes as promptly as possible.

With respect to income recognition and loss allowance practices for credit card lending, the guidance reflects generally accepted accounting principles (GAAP), existing interagency policies on loss allowances, and current Call Report and Thrift Financial Report instructions.[1] The Agencies expect continued and ongoing compliance with GAAP and these reporting instructions.

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[1] Relevant GAAP guidance is provided in Financial Accounting Standards Board Statement No. *5, Accounting for Contingencies,* which provides the basic guidance on accounting for loss allowances for the collectibility of receivables. Additional GAAP guidance is within Chapter 7 of the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide *Banks and Savings Institutions.* Banking and thrift regulatory guidance is included in the Call Report and Thrift Financial Report instructions as well as in the July 6, 2001 Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions and the December 21, 1993 Interagency Policy Statement on the Allowance for Loan and Lease Losses.

Applicability of Guidance

The account management and loss allowance principles described herein are generally applicable to all institutions under the Agencies' supervision that offer credit card programs. The risk profile of the institution, the strength of internal controls (including internal audit and risk management), the quality of management reporting, and the adequacy of charge-off policies and loss allowance methodologies will be factored into the Agencies' assessment of the overall adequacy of these account management practices. Regulatory scrutiny and risk management expectations for certain practices, such as negative amortization of over-limit accounts, will be greater for higher risk portfolios and portfolio segments, including those that are subprime.

Wherever such practices are deemed inadequate or imprudent, regulators will require immediate corrective action.

Account Management, Risk Management, and Loss Allowance Practices

The Agencies expect institutions to fully test, analyze, and support their account management practices, including credit line management and pricing criteria, for prudence prior to broad implementation of those practices. Credit card lenders should review their practices and initiate changes where appropriate.

Credit Line Management

When assigning initial credit lines and/or significantly increasing existing credit lines, lenders should carefully consider the repayment capacity of borrowers. When inadequately analyzed and managed, practices such as multiple card strategies and liberal line-increase programs can increase the risk profile of a borrower quickly and result in rapid and significant portfolio deterioration.

Credit line assignments should be managed conservatively using proven credit criteria. The Agencies expect institutions to test, analyze, and document line-assignment and line-increase criteria prior to broad implementation. Support for credit line management should include documentation and analysis of decision factors such as repayment history, risk scores, behavior scores, or other relevant criteria.

Institutions can significantly increase credit exposure by offering customers additional cards, including store-specific private label cards and affinity relationship cards, without considering the entire relationship. In extreme cases, some institutions have granted additional cards to borrowers already experiencing payment problems on existing cards. The Agencies expect institutions that offer multiple credit lines to have sufficient internal controls and management information systems (MIS) to aggregate related exposures and analyze performance prior to offering additional credit lines.

Over-limit Practices

Account management practices that do not adequately control authorization and provide for timely repayment of over-limit amounts may significantly increase the credit risk profile of the portfolio. While prudent over-limit practices are important for all credit card accounts, they are especially important for subprime accounts, where liberal over-limit tolerances and inadequate repayment requirements can magnify the high risk exposure to the lending institution, and deficient reporting and loss allowance methodologies can understate the credit risk.

Over-limit practices at all institutions should be carefully managed and should focus on reasonable control and timely repayment of amounts that exceed established credit limits. Management information systems for all institutions should be sufficient to enable management to identify, measure, manage, and control the unique risks associated with over-limit accounts. Over-limit authorization on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls. The objective should be to ensure that the borrower remains within prudent established credit limits that increase the likelihood of responsible credit management.

Minimum Payment and Negative Amortization

Competitive pressures and a desire to preserve outstanding balances have led to a general easing of minimum payment requirements in recent years. New formulas that have the effect of further delaying principal repayment are gaining popularity in the industry. In many instances, the result has been liberal repayment programs that increase credit risk and mask portfolio quality. These problems are exacerbated when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and the outstanding balance continues to build ("negative amortization"). In these cases, the lender is recording uncollected income by capitalizing the unpaid finance charges and fees into the account balance owed by the customer. The pitfalls of negative amortization are magnified when subprime accounts are involved, and even more so when the condition is prolonged by programmatic, recurring over-limit fees and other charges that are primarily intended to increase recorded income for the lender rather than enhance the borrowers' performance or their access to credit.

The Agencies expect lenders to require minimum payments that will amortize the current balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. Prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality raise safety and soundness concerns and are subject to examiner criticism.

Workout and Forbearance Practices

Institutions should properly manage workout[2] programs. Areas of concern involve liberal repayment terms with extended amortizations, high charge-off rates, moving accounts from one workout program to another, multiple re-agings, and poor MIS to monitor program performance. Where workout programs are not managed properly, the Agencies will criticize management and require appropriate corrective action. Such actions may include adversely classifying entire segments of portfolios, placing loans on nonaccrual, increasing loss allowances to adequate levels, and accelerating charge-offs to appropriate time frames.

Temporary hardship programs that help borrowers overcome temporary financial difficulties are not considered workout programs for this guidance. Temporary hardship programs longer than a 12-month duration, including renewals, are considered workout programs.

[2] For purposes of this guidance, a workout is a former open-end credit card account upon which credit availability is closed, and the balance owed is placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization/liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with its original terms, but shows the willingness and ability to repay the loan in accordance with its modified terms and conditions.

Repayment Period - Repayment terms for accounts in workout programs vary widely among credit card issuers, Practices range from programs designed to maximize collection of balances owed to programs apparently designed to maximize income recognition and defer losses. Some institutions' programs have not reduced interest rates sufficiently to facilitate timely repayment and assist borrowers in extinguishing indebtedness. In many cases, reduced minimum payment requirements in combination with continued charging of fees and finance charges have extended repayment periods well beyond reasonable time frames.

Workout programs should be designed to maximize principal reduction. Workout programs should generally strive to have borrowers repay credit card debt within 60 months. Repayment terms for workout programs should be consistent with these time frames, with exceptions clearly documented and supported by compelling evidence that less conservative terms and conditions are warranted. To meet these time frames, institutions may need to substantially reduce or eliminate interest rates and fees so that more of the payment is applied to reduce principal.

Settlements - Institutions sometimes negotiate settlement agreements with borrowers who are unable to service their unsecured open-end credit. In a settlement arrangement, the institution forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over a several month period. Institutions' charge-off practices vary widely with regard to settlements.

Institutions should ensure that they establish and maintain adequate loss allowances for credit card accounts subject to settlement arrangements. In addition, the FFIEC Uniform Retail Credit Classification and Account Management Policy states that "actual credit losses on individual retail loans should be recorded when the institution becomes aware of the loss." In general, the amount of debt forgiven in a settlement arrangement should be classified loss and charged off immediately. However, a number of issues may make immediate charge-off impractical. In such cases, institutions may treat amounts forgiven in settlement arrangements as specific allowances. [3] Upon receipt of the final settlement payment, deficiency balances should be charged off within 30 days.

Income Recognition and Loss Allowance Practices

Most institutions use historical net charge-off rates, based on migration analysis of the roll rates[4] to charge-off, as the starting point for determining appropriate loss allowances. Institutions then typically adjust the historical charge-offs for current trends and conditions and other factors. Recent examinations of credit card lenders have revealed a variety of income recognition and loss allowance practices. Such practices have resulted in inconsistent estimates of incurred losses and, accordingly, the inconsistent reporting of loss allowances.

[3] For regulatory reporting purposes, banks should report the creation of a specific allowance as a charge-off in Schedule RI-B of the Reports of Condition and Income (Call Report). Savings associations should report these specific allowances, along with other specific allowances, on Schedule VA in the Thrift Financial Report (TFR). Loans to which specific allowances apply should be reported net of specific allowances in the Call Report and TFR.

[4] Roll rate is the percentage of balances, or accounts, that move from one delinquency stage to the next delinquency stage.

Accrued Interest and Fees[5] **-** Institutions should evaluate the collectibility of accrued interest and fees on credit card accounts because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual based on delinquency status, the Agencies expect all institutions to employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. Institutions must account for the owned portion of accrued interest and fees, including related estimated losses, separately from the retained interest in accrued interest and fees from credit card receivables that have been securitized.

Loan Loss Allowances - The allowance for loan and lease losses (ALLL) should be adequate to absorb credit losses that are probable and estimable on all loans. While some institutions provide for an ALLL on all loans, others only provide for an ALLL on loans that are delinquent. Typically, this practice results in an inadequate ALLL. Institutions should ensure that their loan impairment analysis and ALLL methodology, including the analysis of roll rates, consider the loss inherent in both delinquent and non-delinquent loans.

Allowances for Over-limit Accounts - Institutions' allowance methodologies do not always fully recognize the loss inherent in over-limit portfolio segments. For example, if borrowers were required to pay over-limit and other fees, in addition to the minimum monthly payment amount each month, roll rates and estimated losses may be higher than indicated in the overall portfolio migration analysis. Accordingly, institutions should ensure that their allowance methodology addresses the incremental losses that may be inherent on over-limit accounts.

Allowances for Workout Programs - Some institutions' allowances do not appropriately provide for the inherent probable loss in workout programs, particularly where repayment periods are liberal with little progress on reducing principal. The success of workout programs varies widely by program and among institutions.

Accounts in workout programs should be segregated for performance measurement, impairment analysis, and monitoring purposes. Where multiple workout programs with different performance characteristics exist, each program should be tracked separately. Adequate allowances should be established and maintained for each program. Generally, the allowance allocation should equal the estimated loss in each program based on historical experience as adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, volume and mix, terms and conditions of each program, and collections.

Recovery Practices - After a loan is charged off, institutions must properly report any subsequent collections on the loan.[6] Typically, some or all of such collections are reported as recoveries to the allowance for loan and lease losses. Recent examinations have revealed that, in some instances, the total amount credited to the ALLL as recoveries on an individual loan (which may have included principal, interest, and fees) exceeded the amount previously charged off against the ALLL on that loan (which may have been limited to principal). Such a practice understates an institution's net charge-off experience, which is an important indicator of the credit quality and performance of an institution's portfolio.

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[5] AICPA Statement of Position 01-6 *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others* provides guidance on accounting for delinquency fees.

[6] AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

Consistent with regulatory reporting instructions and prevalent industry practice, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

Policy Exceptions

The Agencies recognize that in well-managed programs limited exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy may be warranted. The basis for granting exceptions to the Policy should be identified and described in the institution’s policies and procedures. Such policies and procedures should address the types of exceptions allowed and the circumstances for permitting them. The volume of accounts granted exceptions should be small and well controlled, and the performance of accounts granted exceptions should be closely monitored. Examiners will evaluate whether an institution uses exceptions prudently. When exceptions are not used prudently, are not well managed, result in improper reporting, or mask delinquencies and losses, management will be criticized and corrective action will be required.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision

December 4, 2002

Interagency Advisory on the Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (collectively, the agencies) are issuing this advisory to clarify the appropriate accounting treatment for banks and thrift institutions (institutions) that securitize credit card receivables and record an asset commonly referred to as Accrued Interest Receivable (AIR).[1] The guidance contained in this issuance is consistent with generally accepted accounting principles (GAAP) as specified in Financial Accounting Standards Board Statement No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 140), and is applicable to institutions preparing regulatory reports filed with the federal banking agencies.[2] The agencies consulted with the staffs of the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) in developing this guidance.

The AIR asset represents the transferor's (seller's) subordinated retained interest in cash flows that are initially allocated to the investors' portion of a credit card securitization. Prior to the securitization transaction, the transferor directly owns a pool of credit card receivables, including the right to receive all of the accrued fees and finance charges on those receivables. However, through the securitization process, the seller's right to the cash flows from the collection of the accrued fees and finance charges generally is subordinated to the rights of the other beneficial interest holders.

This guidance clarifies that, when the seller's right to the AIR cash flows is subordinated as a result of a credit card securitization, the seller generally should include the AIR as one of the financial components in the initial accounting for the sale of credit card receivables in a securitization and in computing the gain or loss on sale. As a result, after a securitization, the allocated carrying amount of the AIR will typically be lower than its face amount. Consistent with the agencies' May 17, 2002, regulatory capital guidance, the seller should treat this asset as a subordinated retained interest (beneficial interest). In addition, an institution

[1] For information and guidance on the regulatory capital treatment of the AIR asset, see the "Interagency Advisory on the Regulatory Capital Treatment of Accrued Interest Receivable Related to Credit Card Securitizations," dated May 17, 2002.

[2] These regulatory reports include the bank Consolidated Reports of Condition and Income (Call Report), and the Thrift Financial Report (TFR).

should account for the AIR separately from loans, and report it in "Other Assets" in the institution's regulatory reports.

Institutions should ensure that they are following the accounting guidance described in this advisory. If an institution has not followed this accounting approach in the past, it should adopt it in the next regulatory report that it files and in all subsequent reports. Institutions that have been properly accounting for the AIR are expected to continue to do so.

Background

Creation of the Accrued Interest Receivable Asset

In a typical credit card securitization, an institution transfers a pool of receivables and the right to receive the future collections of principal, finance charges, and fees on the receivables to a trust. If a securitization transaction qualifies as a sale under FAS 140, the selling institution removes the receivables that were sold from its reported assets and continues to carry any retained interests in the transferred receivables on its balance sheet.

Many credit card securitizers recognize accrued fee and finance charge income on the investors' portion of the transferred credit card receivables (the AIR) as a receivable due from customers, even though the right to receive this income, if and when collected, has been transferred to the trust. An AIR asset reflecting the amount due from the trust is typically reported throughout the life of the securitization because the seller continually transfers new receivables to the trust to replace receivables held by the trust that have been repaid or written off.

Subordination of the Accrued Interest Receivable Asset

The accounting for the securitization of credit card receivables depends upon the terms and requirements of the specific securitization structure. Although some terms and requirements of individual structures vary, most credit card securitizations provide similar credit enhancements to investors and should be accounted for in a similar manner.[3] Typically, the seller transfers receivables to the trust consisting of loan principal (credit card purchases and cash advances) as well as accrued fees and finance charges. The AIR typically consists of the seller's retained interest in the investor's portion of (1) the accrued fees and finance charges that have been billed to customer accounts, but have not yet been collected ("billed but uncollected"), and (2) the right

[3] The legal documentation and structure of the securitization transaction set forth the specific rights to trust assets and cash flows purchased by the investor and retained by the transferor. In some securitizations, the investor maintains a pro rata share of all trust assets, whether principal, finance charges or fees. In other securitizations, the transferor does not legally sell the accrued fees and finance charges to the trust, but is obligated to remit cash collections of these fees and finance charges to the trust. In either case, the trust will generally have a senior claim on the accrued interest receivable. However, the structure of the transaction may affect how the retained interests (including subordinated retained interests) are measured for accounting (and regulatory capital) purposes. Accordingly, the legal opinion that an institution obtains in connection with recording the securitization as a sale should also address whether the rights to the AIR cash flows have been legally isolated from the transferor, even in the event of the transferor's bankruptcy or other receivership.

An institution with a securitization structure that differs from the fact pattern described in this guidance should ensure its accounting approach is consistent with GAAP. Such institutions may contact their appropriate federal banking agency for further guidance, if appropriate.

to finance charges that have been accrued on cardholder accounts, but have not yet been billed ("accrued but unbilled").

While the selling institution retains a right to the excess cash flows generated from the fees and finance charges collected on the transferred receivables, the transferor generally subordinates its right to these cash flows to the investors in the securitization. The seller's right to the excess cash flows related to the AIR asset is similar to other subordinated residual interests in securitized assets in that the AIR serves as a credit enhancement to protect third-party investors in the securitization from credit losses.[4] If and when cash payments on the accrued fees and finance charges are collected, they flow through the trust, where they are available to satisfy more senior obligations before any excess amount is remitted to the seller. Only after trust expenses (such as servicing fees, investor certificate interest, and investor principal charge-offs) have been paid will the trustee distribute any excess fee and finance charge cash flow back to the seller. Since investors are paid from these cash collections before the selling institution receives the amount of AIR that is due, the seller may or may not realize the full amount of its AIR asset.

Appropriate Accounting Treatment for Accrued Interest Receivable

<u>Accounting at Inception of the Securitization Transaction</u>

Generally, if a securitization transaction meets the criteria for sale treatment and the AIR is subordinated either because the asset has been isolated from the transferor (see paragraph 9(a) of FAS 140) or because of the operation of the cash flow distribution (or "waterfall") through the securitization trust, the total AIR (both the "billed and uncollected" and "accrued and unbilled") should be considered to be one of the components of the sale transaction. Thus, when accounting for a credit card securitization, institutions should allocate the previous carrying amount of the AIR (net of any related allowance for uncollectible amounts) and the other transferred assets between the assets that are sold and the retained interests, based on their relative fair values at the date of transfer. As a result, after a securitization, the allocated carrying amount of the AIR will typically be lower than its face amount.

<u>Subsequent Accounting</u>

After securitization, the AIR asset should be accounted for at its allocated cost basis (as discussed above). In addition, institutions should treat the AIR as a retained (subordinated) beneficial interest. Accordingly, it should be reported in "Other Assets" in regulatory reports[5] and not as a loan receivable.[6]

In addition, because the AIR is a retained beneficial interest, institutions should follow the guidance provided in FASB Emerging Issues Task Force Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets" (EITF 99-20), in subsequent

[4] Examples of other retained interests in securitized assets include an Interest-Only Strip and a Cash Collateral or "Spread" account.

[5] In the Call Report, the carrying value of the AIR asset should be reported in Schedule RC-F, item 5, and in Schedule RC-S, item 2.b, column C (if reported as a stand-alone asset). In the TFR, the AIR should be reported in Schedule SC, line SC 690, and Schedule SI, line SI 404.

[6] In addition to the regulatory reporting requirements described in the above footnote, the agencies note that for financial statements prepared in accordance with GAAP, the AIR asset would be subject to the disclosure requirements pertaining to retained interests in securitized financial assets that are specified in paragraphs 17(f) and 17(g) of FAS 140.

accounting. EITF 99-20 specifies the accounting approach that an institution should follow to evaluate a retained beneficial interest for impairment and how to account for any impairment that occurs.

Relationship Between the Accrued Interest Receivable and the Interest-Only Strip Asset

In assessing whether the AIR is appropriately measured for regulatory reporting purposes, institutions should carefully consider the accounting treatment for the Interest-Only Strip asset. The Interest-Only Strip and the AIR are closely related. Both represent the seller's subordinated beneficial interest in excess cash flows from the trust. Despite their close relationship, these cash flows have different risk characteristics. The AIR represents the right to receive the cash flows from fees and finance charges that have already accrued on cardholders' accounts. The Interest-Only Strip, on the other hand, represents an estimate of cash flows from fees and finance charges that will accrue on cardholders' accounts in the future. Because the Interest-Only Strip cash flows can be contractually prepaid or settled in such a way that the seller would not recover substantially all of its investment, the Interest-Only Strip must be accounted for at fair value like a trading or available-for-sale security in accordance with paragraph 14 of FAS 140. In contrast, the AIR cannot be contractually prepaid or otherwise settled in such a way that the owner would not recover substantially all of its recorded investment.

Institutions should consider the close relationship between these assets and ensure that the amount of assets recognized for the right to receive excess cash flows from securitizations, in total, is not overstated. In addition, institutions should describe the accounting treatment for the AIR and the Interest-Only Strip in their accounting policies and related disclosures and be able to demonstrate that their accounting approach is consistent with GAAP. Examiners will review this documentation when evaluating an institution's accounting for securitization activities.

Additional Information

For further information on the appropriate risk-based capital treatment for the AIR asset, please contact Thomas G. Rees, Deputy Chief Accountant at the OCC, at (202) 874-5411; Robert F. Storch, Accounting Section Chief at the FDIC, at (202) 898-8906; Charles H. Holm, Assistant Director, at the Board, at (202) 452-3502; Timothy J. Stier, Chief Accountant, at the OTS, at (202) 906-5699.

Leasing Activities

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.

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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 property 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 collateralization 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 Examination 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

[1] The accounting definition of capital leases is very similar to OTS's financing leases.

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.

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

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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

<u>WKP. REF.</u>

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.

3. Review management reports, especially exception reports, related to this area. Assess the adequacy and accuracy of the reported information.

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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

1. Review the reconcilement of the subsidiary ledgers for leasing to the general ledger. Investigate any large reconciling items.

2. Select leases for review using an appropriate sampling technique. (For details on sampling, refer to Section 209 of the Examination 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.
   - Lease accounts of officers and directors of other institutions.

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- Lease accounts related to significant borrowers.
- Lease accounts in excess of their credit limits.

3. Analyze a sample of credit files for lessors for credit quality (earnings, indebtedness, credit history, collateral, loan modifications) and compliance with the credit policy.

4. 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.

5. 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.

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Leasing Activities

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LEVEL III

1. 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.

2. Determine if the institution has adequate inventory controls over property held for leasing.

3. Inspect large lease properties for which the leases are past due.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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Leasing Activities

Questionnaire

	Yes	No

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?	☐	☐
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?	☐	☐

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		Yes	No
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?	☐	☐
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?	☐	☐
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?	☐	☐

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Yes No

COMMENTS

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Asset-Backed Securitization

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.

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Appendix C

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.

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[1] See "Interagency Advisory on the Unsafe and Unsound Use of Covenants Tied to Supervisory Actions in Securitization Documents," May 23, 2002.

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 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.

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[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.

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.

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 re-written 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 volume-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 difficult 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.

<u>Prudent Risk Management Practices</u>

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, agreements 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 provide 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.

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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.

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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.

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

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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.

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- 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.
  - 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.

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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.

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.

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- — 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.
- — 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.

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- Determine who is responsible for major decisions and how final decisions are executed.

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.

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- Determine how management monitors and controls these risks.

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:

   - A review of the number and dollar volume of existing past-due loans, early payment defaults, and repurchased loans from securitized asset pools. The

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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.

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.

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- 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.

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.

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- 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).
    - ✓ 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.

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— 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.
- 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.

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- 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.
- 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").

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- 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.

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.

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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 originates or retains. Also, determine whether the allowance for loan

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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.
- Specify procedures for valuing retained servicing rights.

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- 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.
- Adequacy of management information systems.
- Propriety of accounting systems and regulatory reporting.

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- 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.

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.

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,

[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.

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 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

[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.

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

[4] Safety and Soundness Standards 12 CFR Part 3 (OCC), 12 CFR Part 570 (OTS).

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 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.

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

[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.

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.

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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:
    1. Long Term: At least one category below investment grade.
    2. Short Term: Investment Grade.
    3. Rating must be publicly available.
    4. 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.

Equity Investments

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.

LINKS
Program
Questionnaire

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 organization. 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, One- to Four-Family Residential Real Estate 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 nonincludable 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

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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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WKP. REF.

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

1. 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.

2. If weaknesses exist within internal accounting procedures, reconcile the savings association's current reported equity investments to an audited financial statement.

3. If REI are material, perform any appropriate and relevant procedures detailed in Handbook Section 740, Real Estate Development.

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4. 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

		Yes	No
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?	☐	☐
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?	☐	☐

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		Yes	No
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?	☐	☐
	— 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?	☐	☐

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		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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Troubled Debt Restructurings

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.

LINKS

Program

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 Examination 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

Examination 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. Examination 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-depend- ent 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, represents 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 Non-accrual Loans to Accrual Status (June 10, 1993)

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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

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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.

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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.

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

LEVEL II

1. 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.

2. 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 and Liabilities

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.

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Program

- 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

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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

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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.

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Other Assets and Liabilities

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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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Other Assets and Liabilities Program

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LEVEL II

1. 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.

2. 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.

3. 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.

4. 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.

5. 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.

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6. Determine if the other assets accounts include a significant investment in cash value life insurance. If so, determine the following:

- 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.)

7. Review the adequacy of the Board's documentation justifying the amount of cash value life insurance.

8. Review whether the insurance arrangement complies with Federal Reserve Regulation O, as applicable.

9. Determine whether the insurance policy adequately protects the savings association's interests.

10. 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.

11. 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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12. 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.

13. 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.

14. 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.

15. 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.

16. 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.)

17. 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

1. 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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Real Estate Owned and Repossessed Assets

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.

LINKS
Program
Questionnaire

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.

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[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.

- 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.

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 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 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.

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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.

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

1. 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.

2. 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:

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- 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.
- The costs of managing and maintaining REO.

3. 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.

4. Review a list of all loans to facilitate the sale of REO or significant other repossessed assets.

5. 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.

6. 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.

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- 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.

7. 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.

8. From a selected sample, determine whether the savings association holds a valid title for REO and other repossessed assets.

9. Determine that the savings association paid any taxes due on REO parcels as required by local law.

10. Determine if the savings association obtained adequate hazard and public liability insurance for REO selected for review.

11. 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.

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12. 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.
- Work papers from the previous examination.

13. 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.

14. 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.

15. 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:

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- 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.
- 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.

16. 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

1. 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.

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— Whether OTS should require independent appraisals.

2. In the event the independent auditor's work papers are not available, you should take the following actions:

- 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 Repossessed Assets

Questionnaire

	Yes	No

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?	☐	☐
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?	☐	☐

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Yes No

COMMENTS

Fixed Assets

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.

LINKS
Program
Questionnaire

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 significant 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 Examination 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 Leasebacks
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

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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

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- Nature and volume of operations
- 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

1. 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.

2. For major purchases, determine if the association obtained independent appraisals, or competitive bids, and whether the transactions meet regulatory requirements.

3. Determine whether accounting treatment and reporting of fixed assets are correct.

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4. 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.

5. 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.

6. Determine whether association personnel are improperly using the association's fixed assets for their own benefit.

7. 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.

8. 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 Examination 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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9. 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.

10. Determine if the association accounts for any real estate they no longer intend to develop for their own use as REO.

11. 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.

12. 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

1. For sales judged to be below fair market value, determine need for reappraisals.

2. 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 (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.

3. Relate any funding commitments under lease agreements and fixed asset expenditures, if significant, to the review of liquidity.

4. 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? ☐ ☐

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	Yes	No
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)

	Yes	No
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)

	Yes	No
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?	☐	☐
15. Do the association's operating procedures for capital leases provide for the review of the amount recorded for accuracy?	☐	☐

Shared Facilities

	Yes	No
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?	☐	☐

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	Yes	No
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?	☐	☐
• 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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Yes No

COMMENTS

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Classification of Assets

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.

LINKS
Program
Appendix A

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 Examination Handbook Section 261, Adequacy of Valuation Allowances.)

Asset Quality Ratings

As fully developed in Examination 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 performance, 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 Examination 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 Examination Handbook 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 Examination 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.

[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.

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 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]

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[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.)

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.

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 Handbook Section 540, Investment Securities, for ratings 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 Examination 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 developer. 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 Examination 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 classiable 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 principal 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.

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[3] The association or regulator might just as appropriately charge off the loan at this point, depending on the perceived likelihood of repayment.

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 Examination 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 obligation 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 Examination 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

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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.

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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 Examination 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.

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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

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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

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Adequacy of Valuation Allowances

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.

LINKS
Program
Questionnaire
Appendix A
Appendix B

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,

[1] Examination Handbook Section 260, Classification of Assets, presents a discussion on asset classification.

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.

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 Examination 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.

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[2] The ALLL must not include the portion of loans and leases classified Loss regardless of whether the Loss amount was measured in an aggregate analysis or on an individual loan basis.

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. Instead, 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. Examination 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 Examination 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.

[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.

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 Examination Handbook

Section 240	Troubled Debt Restructuring
Section 251	Real Estate Owned and Repossessed Assets
Section 260	Classification of Assets

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 Re-structuring
No. 114	Accounting by Creditors for Impairment of a Loan

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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.

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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 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

1. Review the following reports submitted to the board of directors:

- delinquent and classified assets,
- charge-offs, and
- valuation allowance adequacy.

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- Comment on a lack of or inaccurate reporting.

2. 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.

3. 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.

4. 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.

5. Considering all pertinent factors, determine the adequacy of the institution's ALLL.

6. 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.

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7. 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.

8. 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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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? ☐ ☐

   - 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? ☐ ☐

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		Yes	No
	— 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?	☐	☐
	• 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?	☐	☐

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		Yes	No
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?	☐	☐
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

		Yes	No
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?	☐	☐
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?	☐	☐

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	Yes	No
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

Exam Date: ____________
Prepared By: ____________
Reviewed By: ____________
Docket #: ____________

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 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.

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[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.

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 purposes 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.

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[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 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.

(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]

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.

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[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.

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 nonclassified 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.

- 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.

[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.)

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]

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

[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.* 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."

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 objectives 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.

[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.

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:

- 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 in-

[13] The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

ternal policies, practices and procedures, and compliance with laws and regulations so that any noted deficiencies can be remedied in a timely manner.

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.

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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.

Qualified Thrift Lending Test

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.

LINKS
Program
Appendix A
Appendix B
Appendix C

Qualified Thrift Lending 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.

Assets that are includable as QTI without limit:

- 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).

Assets that are includable as QTI up to 20 percent of portfolio assets:

- 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 an 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 Test 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

LEVEL I

WKP.REF.

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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Reviewed By:	
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WKP. REF.

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

1. When the institution has failed the QTL or DBLA test, determine if the failure is the first one.

2. Determine how long the failure has lasted and if the institution has complied with the appropriate penalties.

3. 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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4. Determine management's plan for maintaining QTL or DBLA status once regained, stressing the consequences of a second failure.

5. 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.

6. 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 #:	

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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]

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Office of Thrift Supervision
Qualified Thrift Lender Test
QTL Calculator

QTL Worksheet for the Month of

(For Instructions, click here or on Line number. Shaded cells are automatically calculated.)

PART 1 - PORTFOLIO ASSETS:	Line	% Assets	$ Bil, Mil, Thou
Total Assets	1	100.0	0
20% of Total Assets *(Line 1 x 20%)*	2	20.0	0
Office Building	3		
Liquidity (Cash and Marketable Securities) - Cannot Exceed Line 2	4		
Goodwill and Other Intangibles	5		
Deductions from Total Assets *(Sum of Lines 3, 4, and 5)*	6	0.0	0
PORTFOLIO ASSETS *(Line 1 Minus Line 6)*	7	100.0	0
20% OF PORTFOLIO ASSETS *(Line 7 x 20%)*	8	20.0	0

PART 2 - QUALIFIED THRIFT INVESTMENTS (QTI):
ASSETS INCLUDABLE WITHOUT LIMIT:

	Line	% Assets	$ Bil, Mil, Thou
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 Issued (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	0.0	0

ASSETS INCLUDABLE UP TO 20% OF PORTFOLIO ASSETS:

	Line	% Assets	$ Bil, Mil, Thou
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		
FannieMae or FreddieMac Stock	26		

PUERTO RICAN AND VIRGIN ISLAND INSTITUTIONS ONLY (ALL OTHER INSTITUTIONS GO TO LINE 30):

	Line	% Assets	$ Bil, Mil, Thou
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 *(Lesser of the Sum of Lines 20 through 26 or Line 8)*	30	0.0	0.0
PART 3: **TOTAL QUALIFIED THRIFT INVESTMENTS** *(Sum of Lines 19 and 30)*	31	0.0	0.0
ACTUAL THRIFT INVESTMENT PERCENTAGE (ATIP) *(Line 31 Divided by Line 7)*	32	0.0	#DIV/0!

(January 2007)

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 calculatior 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 investm 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 servicin rights). While OTS does not consider servicing assets intangibles for regulatory capital purposes, our poli is to deduct mortgage servicing assets for QTL.

Line 6 – Deductions from Total Assets

Enter the sum of Lines 3, 4, and 5.

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 disc

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 domesti 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 repa
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.
Appendix C: Qualified Thrift Lender Test Section 270
270C.4 Examination Handbook June 2002 Office of Thrift Supervision

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 previous 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.

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 rollin 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 corpora 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 record 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 businesse 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 through 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.

Margin Securities (Regulation U)

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.

LINKS
Program
Appendix A
Appendix B
Appendix C
Appendix D
Appendix E

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.

[1] OMB granted the FRB an extension of time to use this form beyond the printed expiration date.

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

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.

Exam Date:	
Prepared By:	
Reviewed By:	
Docket #:	

Margin Securities (Regulation U) Program

WKP. REF.

LEVEL II

1. If the savings association recently deregistered, verify that the savings association was eligible to deregister.

2. Ascertain the accuracy of the two most recent annual reports (FR-G4).

3. Determine whether the savings association corrected previous violations.

4. 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).

5. 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

1. 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.

[1] For purposes of Regulation U, the Federal Reserve Board classifies savings associations as nonbank lenders.

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 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.

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Background Information

1. Principal lines of business:

2. Registrant is: (check one)

   ☐ Sole proprietorship
   ☐ Partnership
   ☐ Corporation
   ☐ Private investor
   ☐ Other (specify)

   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

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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.

FR G-1
Page 4 of 4

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)

____

____
Date

____
Print or type name(s) and title(s)

____

____
Name of firm

____
Telephone number (including area code)

*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:	Signed:
______________________________	______________________________
Borrower's signature Date	Borrower's signature Date
______________________________	______________________________
Print or type name	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".

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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.

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Page 2 of 4

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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Page 3 of 4

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)