INTRODUCTION

Section 39 of the Federal Deposit Insurance Act, *Standards for Safety and Soundness,* requires each federal banking agency to establish safety and soundness standards for all insured depository institutions. Appendix A to Part 364 of the FDIC Rules and Regulations, *Interagency Guidelines Establishing Standards for Safety and Soundness,* sets out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. Operational and managerial safety and soundness standards pertaining to an institution's loan portfolio address areas such as asset quality, internal controls, credit underwriting, and loan documentation.

The examiner's evaluation of an institution's lending policies, credit administration, and the quality of the loan portfolio is among the most important aspects of the examination process. To a great extent, the quality of an institution's loan portfolio determines the risk to depositors and to the FDIC's insurance fund. Conclusions regarding the institution's condition and the quality of its management are weighted heavily by the examiner's findings with regard to lending practices. Emphasis on review and evaluation of the loan portfolio and its administration by institution management during examinations recognizes that loans comprise a major portion of most institutions' assets; and, that it is the asset category which ordinarily presents the greatest credit risk and potential loss exposure to banks. Moreover, pressure for increased profitability, liquidity considerations, and a more complex society produce great innovations in credit instruments and approaches to lending. Loans have consequently become more complex. Examiners therefore find it necessary to devote a large portion of time and attention to loan portfolio examination.

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LOAN ADMINISTRATION

Lending Policies

The examiner's evaluation of the loan portfolio involves much more than merely appraising individual loans. Prudent management and administration of the overall loan account, including establishment of sound lending and collection policies, are of vital importance if the institution is to be continuously operated in an acceptable manner.

Lending policies should be clearly defined and set forth in such a manner as to provide effective supervision by the directors and senior officers. The board of directors of every institution is responsible for formulating lending policies and to supervise their implementation. Therefore examiners should encourage establishment and maintenance of written, up-to-date lending policies which have been approved by the board of directors. A lending policy should not be a static document, but must be reviewed periodically and revised in light of changing circumstances surrounding the borrowing needs of the institution's customers as well as changes that may occur within the institution itself. To a large extent, the economy of the community served by the institution dictates the composition of the loan portfolio. The widely divergent circumstances of regional economies and the considerable variance in characteristics of individual loans preclude establishment of standard or universal lending policies. There are, however, certain broad areas of consideration and concern that are typically addressed in the lending policies of all banks regardless of size or location. These include the following:

- General fields of lending in which the institution will engage and the kinds or types of loans within each general field;
- Lending authority of each loan officer;
- Lending authority of a loan or executive committee, if any;
- Responsibility of the board of directors in reviewing, ratifying, or approving loans;
- Guidelines under which unsecured loans will be granted;
- Guidelines for rates of interest and the terms of repayment for secured and unsecured loans;
- Limitations on the amount advanced in relation to the value of the collateral and the documentation required by the institution for each type of secured loan;
- Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals, when needed;
- Maintenance and review of complete and current credit files on each borrower;
- Appropriate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments;
- Limitations on the maximum volume of loans in relation to total assets;
- Limitations on the extension of credit through overdrafts;
- Description of the institution's normal trade area and circumstances under which the institution may extend credit outside of such area;
- Guidelines that address the goals for portfolio mix and risk diversification and cover the institution's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist;
- Guidelines addressing the institution's loan review and grading system ("Watch list");

- Guidelines addressing the institution's review of the Allowance for Loan and Lease Losses (ALLL) or ACL for loans and leases, as appropriate; and
- Guidelines for adequate safeguards to minimize potential environmental liability.

Note: The allowance for credit losses on loans and leases or ACL for loans and leases is the term used for those banks that adopted ASU 2016-13, which implements ASC Topic 326, Financial Instruments – Credit Losses replacing the allowance for loan losses used under the incurred loss methodology.

The above are only guidelines for areas that should be considered during the loan policy evaluation. Examiners should also encourage management to develop specific guidelines for each lending department or function. As with overall lending policies, it is not the FDIC's intent to suggest universal or standard loan policies for specific types of credit. The establishment of these policies is the responsibility of each institution's Board and management. Therefore, the following discussion of basic principles applicable to various types of credit will not include or allude to acceptable ratios, levels, comparisons or terms. These matters should, however, be addressed in each institution's lending policy, and it will be the examiner's responsibility to determine whether the policies are realistic and being followed.

Much of the rest of this section of the Manual discusses areas that should be considered in the institution's lending policies. Guidelines for their consideration are discussed under the appropriate areas.

Loan Review Systems

The terms *loan review system* or *credit risk review system* refer to the responsibilities assigned to various areas such as credit underwriting, loan administration, problem loan workout, or other areas. Responsibilities may include assigning initial credit grades, ensuring grade changes are made when needed, or compiling information necessary to assess the appropriateness of the ALLL or ACL for loans and leases.

The complexity and scope of a loan review system will vary based upon an institution's size, type of operations, and management practices. Systems may include components that are independent of the lending function, or may place some reliance on loan officers. Although smaller institutions are not expected to maintain separate loan review departments, it is essential that all institutions have an effective loan review system. Regardless of its complexity, an effective loan review system is generally designed to address the following objectives:

- To promptly identify loans with well-defined credit weaknesses so that timely action can be taken to minimize credit loss;
- To provide essential information for determining the appropriateness of the ALLL or ACL for loans and leases;
- To identify relevant trends affecting the collectibility of the loan portfolio and isolate potential problem areas;
- To evaluate the activities of lending personnel;
- To assess the adequacy of, and adherence to, loan policies and procedures, and to monitor compliance with relevant laws and regulations;
- To provide the board of directors and senior management with an objective assessment of the overall portfolio quality; and
- To provide management with information related to credit quality that can be used for financial and regulatory reporting purposes.

Credit Risk Rating or Grading Systems

Accurate and timely credit grading is a primary component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. An effective system provides information for use in establishing an allowance when evaluating specific credits and for the determination of an overall ALLL or ACL for loans and leases, as appropriate.

Credit grading systems often place primary reliance on loan officers for identifying emerging credit problems. However, given the importance and subjective nature of credit grading, a loan officer's judgement regarding the assignment of a particular credit grade should generally be subject to review. Reviews may be performed by peers, superiors, loan committee(s), or other internal or external credit review specialists. Credit grading reviews performed by individuals independent of the lending function are preferred because they can often provide a more objective assessment of credit quality. A loan review system typically includes the following:

- A formal credit grading system that can be reconciled with the framework used by federal regulatory agencies;
- An identification of loans or loan pools that warrant special attention;
- A mechanism for reporting identified loans, and any corrective action taken, to senior management and the board of directors; and
- Documentation of an institution's credit loss experience for various components of the loan and lease portfolio.

Loan Review System Elements

Loan review policies are typically reviewed and approved at least annually by the board of directors. Policy guidelines include a written description of the overall credit grading process, and establish responsibilities for the various loan review functions. The policy generally addresses the following items:

- 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.

Qualifications of Loan Review Personnel

Personnel to involve in the loan review function are qualified based on level of education, experience, and extent of formal training. They are knowledgeable of both sound lending practices and their own institution's specific lending guidelines. In addition, they are knowledgeable of pertinent laws and regulations that affect lending activities.

Loan Review Personnel Independence

Loan officers are generally responsible for ongoing credit analysis and the prompt identification of emerging problems. 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. To avoid conflicts of interest, management typically ensures that, when feasible, all significant loans are reviewed by individuals that are not part of, or influenced by anyone associated with, the loan approval process.

Larger institutions typically establish separate loan review departments staffed by independent credit analysts. Cost and volume considerations may not justify such a system in smaller institutions. Often, members of senior management that are independent of the credit administration process, a committee of outside directors, or an outside loan review consultant fill this role. Regardless of the method used, loan review personnel should report their findings directly to the board of directors or a board committee.

Frequency of Reviews

The loan review function provides feedback on the effectiveness of the lending process in identifying emerging problems. Reviews of significant credits are generally performed annually, upon renewal, or more frequently when factors indicate a potential for deteriorating credit quality. A system of periodic reviews is particularly important to the process of determining the ALLL or the ACL for loans and leases, as appropriate.

Scope of Reviews

Reviews typically cover all loans that are considered significant. In addition to loans over a predetermined size, management will normally review smaller loans that present elevated risk characteristics such as credits that are delinquent, on nonaccrual status, restructured as a troubled debt, previously classified, or designated as Special Mention. Additionally, management may wish to periodically review insider loans, recently renewed credits, or loans affected by common repayment factors. The percentage of the portfolio selected for review should provide reasonable assurance that all major credit risks have been identified.

Depth of Reviews

Loan reviews typically analyze a number of important credit factors, including:

- Credit quality;
- Sufficiency of credit and collateral documentation;
- Proper lien perfection;
- Proper loan approval;
- Adherence to loan covenants;
- Compliance with internal policies and procedures, and applicable laws and regulations; and
- The accuracy and timeliness of credit grades assigned by loan officers.

Review of Findings and Follow-up

Loan review findings should be reviewed with appropriate loan officers, department managers, and members of senior management. Typically, any existing or planned corrective action (including estimated timeframes) is obtained for all noted deficiencies, with those deficiencies that remain unresolved reported to senior management and the board of directors.

Workpaper and Report Distribution

A list of the loans reviewed, including the review date, and documentation supporting assigned ratings is commonly prepared. A report that summarizes the results of the review is typically submitted to the board at least quarterly. Findings usually address adherence to internal policies and procedures, and applicable laws and regulations, so that deficiencies can be remedied in a timely manner.

Examiners should review the written response from management in response to any substantive criticisms or recommendations and assess corrective actions taken.

Current Expected Credit Losses (CECL)

The Current Expected Credit Losses (CECL) methodology as implemented by FASB Accounting Standards Codification (ASC) Subtopic 326-20, Financial Instruments – Credit Losses – Measured at Amortized Cost applies to financial assets measured at amortized cost, net investments in leases, and off-balance-sheet credit exposures (collectively, financial assets). For institutions that are SEC filers, excluding those that are "smaller reporting companies" as defined in the SEC's rules, the CECL methodology is effective for fiscal years beginning January 1, 2020, for institutions with calendar year fiscal years. For all other institutions, (i.e., non-public institutions), including those SEC filers that are smaller reporting companies, CECL will take effect for institutions with calendar year fiscal years beginning after December 15, 2022, (i.e., January 1, 2023).

The CECL methodology does not apply to financial assets measured at fair value through net income, including those assets for which the fair value option has been elected; loans held-for-sale; policy loan receivables of an insurance entity; loans and receivables between entities under common control; and receivables arising from operating leases. Available-for-sale debt securities are not covered under the CECL methodology but are covered by ASC Subtopic 326-30, Financial Instruments – Credit Losses – Available-for-Sale Debt Securities for institutions that have adopted ASC Topic 326.

The allowance for credit losses or ACL for loans and leases is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term of the assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL for loans and leases unless there is a reasonable expectation of executing a troubled debt restructuring or the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution.

In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets. Under the CECL methodology, inputs will need to change in order to achieve an appropriate estimate of expected credit losses. For example, inputs to a loss rate method would need to reflect expected losses over the contractual term, rather than the annual loss rates commonly used under the existing incurred loss methodology. To properly apply an acceptable estimation method, an institution's credit loss estimates must be well supported.

Similar to the ALLL, the ACL for loans and leases is evaluated as of the end of each reporting period and reported in the Consolidated Reports of Condition and Income (Call Report). The methods used to determine ACLs generally should be applied consistently over time and reflect management's current expectations of credit losses. Changes to ACL for loans and leases resulting from these periodic evaluations are recorded through increases or decreases to the related provisions for credit losses (PCLs).

Throughout this Section 3.2, Loans, references pertaining to the ALLL describe the incurred methodology and apply only to institutions that have <u>not</u> yet adopted ASC Topic 326. As such, the methodology for impairment contained in ASC Subtopic 310-10, Receivables - Overall and collective loan impairment contained in ASC Subtopic 450-20, Contingencies – Loss Contingencies has been superseded and is not applicable for institutions that have adopted ASC Topic 326 (CECL). Therefore, for those institutions that have adopted CECL, examiners should refer to the Call Report Glossary entry for "allowance for credit losses" and the, "Interagency Policy Statement on Credit Losses," issued May 8, 2020, via FIL 54-2020, for additional information on the CECL methodology.

Allowance for Loan and Lease Losses (ALLL)

Each institution must maintain an ALLL that is appropriate to absorb estimated credit losses associated with the held for investment loan and lease portfolio, i.e., loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff. Each institution should also maintain, as a separate liability account, an allowance sufficient to absorb estimated credit losses associated with off-balance sheet credit instruments such as loan commitments, standby letters of credit, and guarantees. This separate liability account for estimated credit losses on off-balance sheet credit exposures should not be reported as part of the ALLL on an institution's balance sheet. Loans and leases held for sale are carried on the balance sheet at the lower of cost or fair value, with a separate valuation allowance. This separate valuation allowance should not be included as part of the ALLL and accordingly regulatory capital.

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. The 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 (U.S. 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.

Estimated credit losses should reflect consideration of all significant factors that affect repayment as of the evaluation date. Estimated losses on loan pools should reflect historical net charge-off levels for similar loans, adjusted for changes in current conditions or other relevant factors. Calculation of historical charge-off rates can range from a simple average of net charge-offs over a relevant period, to more complex techniques, such as migration analysis.

Portions of the ALLL can be attributed to, or based upon the risks associated with, individual loans or groups of loans. However, the ALLL is available to absorb credit losses that arise from the entire portfolio. It is not segregated for any particular loan, or group of loans.

Responsibility of the Board and Management

It is the responsibility of the board of directors and management to maintain the ALLL at an appropriate level. The allowance should be evaluated, and appropriate provisions made, at least quarterly. In carrying out their responsibilities, the board and management are expected to:

- Establish and maintain a loan review system that identifies, monitors, and addresses asset quality problems in a timely manner.
- Ensure the prompt charge-off of loans, or portions of loans, deemed uncollectible.
- Ensure that the process for determining an appropriate allowance level is based on comprehensive, adequately documented, and consistently applied analysis.

For purposes of Reports of Condition and Income (Call Reports) an appropriate ALLL for loans held for investment should consist of the following items:

- The amount of allowance related to loans individually evaluated and determined to be impaired under ASC (Accounting Standards Codification) Subtopic 310-10, *Receivables - Overall*.
- The amount of allowance related to loans that were individually evaluated for impairment and determined not to be impaired, as well as other loans collectively evaluated under ASC Subtopic 450-20, *Contingencies – Loss Contingencies*.
- The amount of allowance related to loans evaluated under ASC Subtopic 310-30, *Receivables –Loans and Debt Securities Acquired with Deteriorated Credit Quality*.
- The amount of allowance related to international transfer risk associated with its cross-border lending exposure.

Furthermore, management's analysis of an appropriate allowance level requires significant judgement in determining estimates of credit losses. An institution may support its estimate through qualitative factors that adjust historical loss rates or an unallocated portion that can be supported through a similar analysis.

When determining an appropriate allowance, primary reliance should normally be placed on analysis of the various components of a portfolio, including all significant credits reviewed on an individual basis. Examiners should refer to ASC Subtopic 310-10 for guidance in establishing an allowance for individually evaluated loans determined to be impaired and measured under that standard. When analyzing the appropriateness of an allowance, portfolios evaluated collectively should group loans with similar characteristics, such as risk classification, past due status, type of loan, industry, or collateral. A depository institution may, for example, analyze the following groups of loans and provide for them in the ALLL:

- Significant credits reviewed on an individual basis (i.e., impaired loans);
- Loans and leases that are not reviewed individually, but which present elevated risk characteristics, such as delinquency, adverse classification, or Special Mention designation;
- Homogenous loans that are not reviewed individually, and do not present elevated risk characteristics; and
- All other loans that have not been considered or provided for elsewhere.

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 Reserve (or charged to the ALLL), an institution must determine if their ALLL is appropriate to absorb estimated losses from transfer risk associated with its cross-border lending exposure.

Factors to Consider in Estimating Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the portfolio's collectibility as of the evaluation date. While historical loss experience provides a reasonable starting point, historical losses, or even recent trends in losses, are not by themselves, a sufficient basis to determine an appropriate ALLL level.

Management should also consider any relevant qualitative factors that are likely to cause estimated losses to differ from historical loss experience such as:

- Changes in lending policies and procedures, including underwriting, collection, charge-off and recovery practices;
- Changes in local and national economic and business conditions;
- Changes in the volume or type of credit extended;
- Changes in the experience, ability, and depth of lending management;
- Changes in the volume and severity of past due, nonaccrual, troubled debt restructurings, or classified loans;
- Changes in the quality of an institution's loan review system or the degree of oversight by the board of directors; and
- The existence of, or changes in the level of, any concentrations of credit.

Institutions are also encouraged to use ratio analysis as a supplemental check for evaluating the overall reasonableness of an ALLL. Ratio analysis can be useful in identifying trends in the relationship of the ALLL to classified and nonclassified credits, to past due and nonaccrual loans, to total loans and leases and binding commitments, and to historical charge-off levels. However, while such comparisons can be helpful as a supplemental check of the reasonableness of management's assumptions and analysis, they are not, by themselves, a sufficient basis for determining an appropriate ALLL. Such comparisons do not eliminate the need for a comprehensive analysis and documentation of the loan and lease portfolio and the factors affecting its collectibility.

Examiner Responsibilities

Generally, following the quality assessment of the loan and lease portfolio, the loan review system, and the lending policies, examiners are responsible for assessing the appropriateness of the ALLL. Examiners should consider all significant factors that affect the collectibility of the portfolio. Examination procedures for reviewing the appropriateness of the ALLL are included in the Examination Documentation (ED) Modules.

In assessing the overall appropriateness of an ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of judgement. Credit loss estimates will not be precise due to the wide range of factors that must be considered. Furthermore, the ability to estimate credit losses on specific loans and categories of loans should improve over time. Therefore, examiners will generally accept management's estimates of credit losses in their assessment of the overall appropriateness of the ALLL when 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; and
- Established an acceptable ALLL evaluation process that meets the objectives for an appropriate ALLL.

If, after the completion of all aspects of the ALLL review described in this section, the examiner does not concur that the reported ALLL level is appropriate, or the ALLL evaluation process is deficient, recommendations for correcting these problems, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the Report of Examination.

Regulatory Reporting of the ALLL

An ALLL established in accordance with the guidelines provided above should fall within a range of acceptable estimates. When an ALLL is not deemed at an appropriate level, management will be required to increase the provision for loan and lease loss expense sufficiently to restore the ALLL reported in its Call Report to an appropriate level.

Accounting and Reporting Treatment

ASC Subtopic 450-20 provides the basic guidance for recognition of a loss from a contingency that should be accrued through a charge to income (i.e., a provision expense) when available information indicates that it is probable the asset has been impaired and the amount is reasonably estimated. ASC Subtopic 310-10 provides specific guidance about the measurement and disclosure for loans individually evaluated and determined to be impaired. Loans are considered to be impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement. This would generally include all loans restructured as a troubled debt and nonaccrual loans.

For individually impaired loans, ASC Subtopic 310-10 provides guidance on the acceptable methods to measure impairment. Specifically, this standard states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price. However, the Call Report instructions require an institution to use the fair value of the collateral in its determination of impairment for all impaired collateral dependent loans. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing qualitative factors.

Large groups of smaller-balance homogenous loans are *not* included in the scope of ASC Subtopic 310-10, unless the loan is a troubled debt restructuring. Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. Examiners should refer to ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as individual loans that are identified for evaluation on an individual basis and determined not to be impaired.

Institutions should not layer their loan loss allowances. Layering is the inappropriate practice of recording estimates in the ALLL for the same loan under the different accounting standards. Layering can happen when an institution measures impairment on an individually impaired loan and includes that same loan in its estimate of loan losses on a collective basis, thereby estimating the loan loss for the same loan twice.

While different institutions may use different methods, there are certain common elements that should be included in any ALLL methodology. Generally, an institution's methodology should:

- Include a detailed loan portfolio analysis, performed regularly;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under ASC Subtopic 310-10; loans evaluated under ASC Subtopic 310-30; and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under ASC Subtopic 450-20;
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well-documented, in writing, with clear explanations of the supporting analyses and rationale; and
- Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with U.S. GAAP.

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.

Examiners are encouraged, with the acknowledgement of management, to communicate with an institution's external auditors and request an explanation of their rationale and findings, when differences in judgment concerning the appropriateness of the institution's ALLL exist. In case of controversy, an institution and its auditor may be reminded when an institution's supervisory agency's interpretation on how U.S. GAAP should be applied to a specified event or transaction (or series of related events or transactions) differs from the institution's interpretation, the supervisory agency may require the institution to reflect the event(s) or transaction(s) in its Call Report in accordance with the agency's interpretation and to amend previously submitted reports.

Additional information on the documentation of the ALLL, including its methodology, and the establishment of loan review systems is provided in the Interagency Statement of Policy on the Allowance for Loan and Lease Losses, (including frequently asked questions) dated December 13, 2006, and the Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations, dated July 2, 2001.

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PORTFOLIO COMPOSITION

Commercial Loans

General

Loans to business enterprises for commercial or industrial purposes, whether proprietorships, partnerships or corporations, are commonly described as commercial loans. In asset distribution, commercial or business loans frequently comprise one of the most important assets of an institution. They may be secured or unsecured and have short or long-term maturities. Such loans include working capital advances, term loans and loans to individuals for business purposes.

Short-term working capital and seasonal loans provide temporary capital in excess of normal needs. They are used to finance seasonal requirements and are repaid at the end of the cycle by converting inventory and accounts receivable into cash. Such loans may be unsecured; however, many working capital loans are advanced with accounts receivable and/or inventory as collateral. Firms engaged in manufacturing, distribution, retailing and service-oriented businesses use short-term working capital loans.

Term business loans have assumed increasing importance. Such loans normally are granted for the purpose of acquiring capital assets, such as plant and equipment. Term loans may involve a greater risk than do short-term advances, because of the length of time the credit is outstanding. Because of the potential for greater risk, term loans are usually secured and generally require regular amortization. Loan agreements on such credits may contain restrictive covenants during the life of the loan. In some instances, term loans may be used as a means of liquidating, over a period of time, the accumulated and unpaid balance of credits originally advanced for seasonal needs. While such loans may reflect a borrower's past operational problems, they may well prove to be the most viable means of salvaging a problem situation and effecting orderly debt collection.

Commercial lending policies generally address acquisition of credit information, such as property, operating and cash flow statements; factors that might determine the need for collateral acquisition; acceptable collateral margins; perfecting liens on collateral; lending terms, and charge-offs.

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. Typical characteristics of accounts receivable borrowers are those businesses that are growing rapidly and need year-round financing in amounts too large to justify unsecured credit, those that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups, those whose working capital is inadequate for the volume of sales and type of operation, and those whose previous unsecured borrowings are no longer warranted because of various credit factors.

Several advantages of accounts receivable financing from the borrower's viewpoint are: it is an efficient way to finance an expanding operation because borrowing capacity expands as sales increase; it permits the borrower 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; it insures a revolving, expanding line of credit; and actual interest paid may be no more than that for a fixed amount unsecured loan.

Advantages from the institution's viewpoint are: it generates a relatively high yield loan, new business, and a depository relationship; permits continuing banking relationships with long-standing customers whose financial conditions no longer warrant unsecured credit; and minimizes potential loss when the loan is geared 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.

Institutions use two basic methods to make accounts receivable advances. First, blanket assignment, wherein the borrower periodically informs the institution of the amount of receivables outstanding on its books. Based on this information, the institution advances the agreed percentage of the outstanding receivables. 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 institution. The institution applies all or a portion of such funds to the borrower's loan. Second, ledgering the accounts, wherein the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt of satisfactory information, the institution advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the institution maintains complete control of the funds paid on all accounts pledged by requiring the borrower's customer to remit directly to the institution.

In the area of accounts receivable financing, an institution's lending policy typically addresses the acquisition of credit information such as property, operating and cash flow statements. It also typically addresses maintenance of an accounts receivable loan agreement that establishes a percentage advance against acceptable receivables, a maximum dollar amount due from any one account debtor, financial strength of debtor accounts, insurance that "acceptable receivables" are defined in light of the turnover of receivables pledged, aging of accounts receivable, and concentrations of debtor accounts.

Leveraged Lending

The federal institution regulatory agencies initially issued guidance on April 9, 2001, concerning sound risk management practices for institutions engaged in leveraged financing. In light of the developments and experience gained since the initial guidance was issued, the federal institution regulatory agencies issued new Interagency Guidance on Leveraged Lending on May 21, 2013, to update and replace the 2001 guidance. Examiners should also review the related Frequently Asked Questions (FAQ) issued on November 7, 2014.

Applicability

A financial institution's risk management practices should be consistent with the size and risk profile of its leveraged activities relative to its assets, earnings, liquidity, and capital. Institutions that originate or sponsor leveraged transactions can refer to the guidance for suggestions about sound risk management principles.

The agencies do not intend for a financial institution that originates a small number of less complex, leveraged loans to have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions may refer to and consider supervisory guidance provided in the "Participations Purchased" section of the guidance.

General

Leveraged lending is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. In particular, financial institutions should ensure they do not unnecessarily heighten risks by originating poorly underwritten loans. For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system.

Numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- Proceeds used for buyouts, acquisitions, or capital distributions.
- Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0X EBITDA or 3.0X EBITDA, respectively, or other defined levels appropriate to the industry or sector.
- A borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio.
- Transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels.

A financial institution engaging in leveraged lending typically defines the activity within its policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. An appropriate definition describes clearly the purposes and financial characteristics common to these transactions, and covers risk from both direct exposure and indirect exposure via limited recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

In general, sound risk management of leveraged lending activities places importance on institutions developing and maintaining the following:

- Transactions structured to reflect a sound business premise, an appropriate capital structure, and reasonable cash flow and balance sheet leverage. Combined with supportable performance projections, these elements of a safe-and-sound loan structure should clearly support a borrower's capacity to repay and to de-lever to a sustainable level over a reasonable period, whether underwritten to hold or distribute;
- A definition of leveraged lending that facilitates consistent application across all business lines;
- Well-defined underwriting standards that, among other things, define acceptable leverage levels and describe amortization expectations for senior and subordinate debt;
- A credit limit and concentration framework consistent with the institution's risk appetite;
- Sound Management Information Systems (MIS) that enable management to identify, aggregate, and monitor leveraged exposures and comply with policy across all business lines;
- Strong pipeline management policies and procedures that, among other things, provide for real-time information on exposures and limits, and exceptions to the timing of expected distributions and approved hold levels; and
- Guidelines for conducting periodic portfolio and pipeline stress tests to quantify the potential impact of economic and market conditions on the institution's asset quality, earnings, liquidity, and capital.

Risk Management Framework

Given the high-risk profile of leveraged transactions, prudent financial institutions engaged in leveraged lending adopt a risk management framework that has an intensive and frequent review and monitoring process. The framework has as its foundation written risk objectives, risk acceptance criteria, and risk controls. A lack of robust risk management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution is engaged in unsafe-and-unsound banking practices.

General Policies

A financial institution's credit policies and procedures for leveraged lending generally address the following:

- Identification of the financial institution's risk appetite including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The designated risk appetite is commonly supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and is approved by the board of directors;
- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. This limit framework identifies the related management approval authorities and exception tracking provisions. In addition to notional pipeline limits, financial institutions with significant leveraged transactions implement underwriting limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk;
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses;
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms;
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors;
- Expected risk-adjusted returns for leveraged transactions;
- Minimum underwriting standards (see "Underwriting Standards" section below); and,
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Well-managed financial institutions purchasing participations and assignments in leveraged lending transactions make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. Policies typically include requirements for:

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- Carefully monitoring the borrower's performance throughout the life of the loan; and
- Establishing appropriate risk management guidelines as described in this document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. Examiners should review whether a financial institution has clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. Legal and other risks associated with poorly underwritten transactions may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. An institution's underwriting standards typically consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute.
- A borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period.
- Expectations for the depth and breadth of due diligence on leveraged transactions.
- Standards for evaluating expected risk-adjusted returns.
- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with

acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values;

- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors.
- Whether credit agreement terms allow for the material dilution, sale, or exchange of collateral or cash flow-producing assets without lender approval;
- Credit agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed charge coverage), reporting requirements, and compliance monitoring.
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral valuation methodologies. Standards for asset-based loans that are part of the entire debt structure outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements; and
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. An institution's analysis of leveraged lending transactions typically ensures that:

- Cash flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- Liquidity analyses include performance metrics appropriate for the borrower's industry; predictability of the borrower's cash flow; measurement of the borrower's operating cash needs; and ability to meet debt maturities;
- Projections exhibit an adequate margin for unanticipated merger-related integration costs;
- Projections are stress tested for one or two downside scenarios, including a covenant breach;
- Transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status;
- Enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- Collateral liquidation and asset sale estimates are based on current market conditions and trends;
- Potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- Contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or the issuance of new equity; and
- The borrower is adequately protected from interest rate and foreign exchange risk.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and, (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The "capitalized cash flow" method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The "discounted cash flow" method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the "discount rate") that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator's reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a prudent lender will reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower's assets are typically tested under a range of stress scenarios, including business conditions more adverse than the base case scenario. Stress tests of enterprise values and their underlying assumptions are generally conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. Prudent institutions perform their own discounted cash flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral typically have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution's leveraged lending activities, the prudent institution establishes limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise-value estimates typically are clearly documented, well supported, and understood by the institution's appropriate decision-makers and risk oversight units. Further, an institution's valuation methods are appropriate for the borrower's industry and condition.

Risk Rating Leveraged Loans

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period of time. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five-to-seven year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a Substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion Doubtful or Loss and place the loan on nonaccrual status.

Risks in leveraged lending activities are considered in the ALLL and capital adequacy analysis. For allowance purposes, leverage exposures are typically taken into account either through analysis of the estimated credit losses from the discrete portfolio or as part of an overall analysis of the portfolio utilizing the institution's internal risk grades or other factors. At the transaction level, exposures heavily reliant on enterprise value as a secondary source of repayment are typically scrutinized to determine the need for and adequacy of specific allocations.

Problem Credit Management

Individual action plans are typically formulated by management when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution generally formulates credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies typically stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Reporting and Analytics

Diligent financial institutions regularly monitor higher risk credits, including leveraged loans. Monitoring includes management's review of comprehensive reports about the characteristics and trends in such exposures at least quarterly, with summaries provided to the board of directors. Policies and procedures typically identify the fields to be populated and captured by a financial institution's MIS, which then yields accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline;
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile;
- Industry mix and maturity profile;
- Metrics derived from probabilities of default and loss given default;
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs;
- Amount of impaired assets and the nature of impairment, and the amount of the ALLL attributable to leveraged lending;
- The aggregate level of policy exceptions and the performance of that portfolio;
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting also typically considers the implications of defaults that trigger pari-passu treatment for all lenders and, thus, dilute the secondary support from the sale of collateral;
- Secondary market pricing data and trading volume, when available;
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures;
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions;
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Well-designed pipeline definitions clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed; and
- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports typically provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative.

Borrower and counterparty leveraged lending reporting typically consider exposures booked in other business units throughout the institution, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the positions in the held for sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates are typically considered.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment typically develops guidelines for evaluating the qualifications of financial sponsors and implements processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support typically includes the following:

- The sponsor's historical performance in supporting its investments, financially and otherwise;
- The sponsor's economic incentive to support, including the nature and amount of capital contributed at inception;
- Documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance);
- Consideration of the sponsor's contractual investment limitations;

- To the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals;
- Consideration of the sponsor's dividend and capital contribution practices;
- The likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio; and,
- Guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance.

Independent Credit Review

A financial institution with a strong and independent credit review function demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to their senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, there is greater importance for the institution's credit review function to assess the performance of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. To be most effective, such assessments are performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews are generally conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate more frequent reviews.

A financial institution that staffs its internal credit review function appropriately and ensures that the function has sufficient resources is most capable of providing timely, independent, and accurate assessments of leveraged lending transactions. Effective reviews evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Such internal credit reviews that review the institution's leveraged lending practices, policies, and procedures provide management with a complete assessment of the leveraged lending program.

Stress Testing

A financial institution typically develops and implements guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital. The sophistication of stress-testing practices and sensitivity analyses are most effective when they are consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

Conflicts of Interest

A financial institution typically develops appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential conflicts of interest arise between the financial institution and its customers. Effective policies and procedures clearly define potential conflicts of interest, identify appropriate risk management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, an established training program for employees on appropriate practices to follow to avoid conflicts of interest is an effective risk management practice.

Oil and Gas Lending

Industry Overview

Oil and gas (O&G) lending is complex and highly specialized due to factors such as global supply and demand, geopolitical uncertainty, weather-related disruptions, fluctuations and volatility in currency markets (i.e. the strength of the U.S. dollar compared to global currency markets), and changes in environmental and other governmental policies. As such, companies and borrowers that are directly or indirectly tied to the O&G industry frequently experience expansion and contraction within key operational areas of their businesses that will directly impact their financial condition and repayment capacity.

The O&G industry has four interconnected segments:

- Upstream - exploration and production (E&P) companies

- Midstream - transporting, treating, processing, storing, and marketing to Upstream companies
- Downstream - refining and marketing
- Support/Services - equipment, services, or support activities (e.g. drilling, workover units, and water hauling services)

O&G lending to Upstream companies for E&P activities is a specialized form of lending, and is the primary focus of this section (see Reserve-Based Lending below). Loans to Midstream, Downstream and Support/Service companies are generally structured similar to other commercial loans. In addition, Midstream companies often raise capital through Master Limited Partnerships that are publicly traded. The highest credit risk is typically found in Support/Services and Upstream lending, which are more directly affected by changes in production and commodity prices.

Reserve-Based Lending

Loans for E&P activities are typically secured by proved reserves and governed by a borrowing base, an arrangement known as reserve-based lending, or RBL. Effective credit risk management in RBL requires conservative underwriting, appropriate structuring, experienced and knowledgeable lending staff, and sound loan administration practices. It is also important for the board and senior management to consider the unique risks associated with this type of lending when developing RBL policies and approving and administering such loans. These risks include, but are not limited to, credit, concentration, market volatility/pricing, limited purpose collateral, production, operational, legal, compliance/environmental, interest rate, liquidity, strategic, and third-party risk.

RBL may appear similar to traditional asset based lending (ABL), but there are notable differences. The primary source of repayment for ABL is the orderly liquidation of the collateral (receivables and inventory) into cash. Such loans are typically structured with strong controls over the collateral, such as a lock box arrangement. In contrast, the primary source of repayment for RBL is the cash flows derived from the extraction of O&G reserves. An independent, third-party reserve engineering report serves as the primary underwriting tool to estimate the future cash stream and establish a "borrowing base," which is a collateral base agreed to by the borrower and lender that is used to limit the amount of funds the lender advances the borrower. The borrowing base is subject to periodic redeterminations, typically semiannually, that can result in the reduction of the borrowing base commitment when commodity prices and reserves are declining.

<u>Types of Reserves</u>

Lenders should generally only consider proved reserves, defined as having at least a 90 percent probability that the quantities actually recovered will equal or exceed the estimate, in determining collateral value. Within the proved reserves category, Proved Developed Producing (PDP), Proved Developed Non-Producing (PDNP), and Proved Undeveloped (PUD) reserves are collectively known as P1. As described below, PDNP and PUD require capital expenditures (CAPEX) to bring the non-producing and undeveloped reserves online as PDP:

- PDP represents reserves that are recoverable from existing wells with existing equipment and operating methods that are producing at the time of the engineering report estimate.
- PDNP reserves include both shut-in (PDSI) and behind the pipe (PDBP) reserves, and production can be initiated or restored with relatively low expenditures compared to the cost of drilling a new well.
    - PDSI reserves are completion intervals that are open, but have not started producing; were shut-in for market conditions or pipeline connections; or not capable of production for mechanical reasons.
    - PDBP reserves are those expected to be recovered from existing wells that require additional completion work or future completion prior to the start of production.
- PUD reserves are expected to be recovered only after making future investment. These reserves have been proved by independent engineering reports, but do not have a well infrastructure in place.

Other categories of reserves include "probable" (P2) and "possible" (P3). Probable reserves are relatively uncertain, while possible reserves are considered speculative in nature. Probable and possible reserves should not receive any value when determining the borrowing base.

<u>Reserve Engineering Reports</u>

Reserve engineering reports are an estimate of the volumes of O&G reserves that are likely to be recovered based on reasonable assumptions regarding physical characteristics of the reservoir, available technology, and operating efficiencies. The significant reliance on engineering reports in underwriting RBL facilities requires sound internal controls over the collateral evaluation process. Reserve reports must be objective; based on reasonable, well-documented assumptions; and completed independently of the loan origination and collection functions. It is important for management to document the qualifications and independence of the engineer, and to periodically evaluate the production performance, which includes a comparison of production projections to actual results.

RBL collateral value consists of a point-in-time estimate of the present value (PV) of future net revenue (FNR) derived from the production and sale of existing O&G reserves, net of operating expenses, production taxes, royalties, and CAPEX, discounted at an appropriate rate. The engineering reports should contain sufficient information and documentation to support the assumptions and the analysis used to derive the forecasted cash flows and discounted PV. Well-managed banks provide clear guidance to the engineer at engagement regarding discount rates, pricing assumptions, operating expense escalation rates, and risk-adjustment guidelines limiting higher risk reserves. The engineer will conduct an analysis of production reports from the subject properties, and project estimated reserve depletion.

Borrowing Base

The collateral base securing each facility should be primarily comprised of PDP reserves. Inclusion of PDNP reserves in the collateral evaluation should be supported with sufficient documentation to demonstrate that the borrower has the financial capacity to convert PDNP reserves to PDP reserves by making the necessary investments to restore or initiate production within the near-term.

To include PUDs in the borrowing base calculation, the borrower should have sufficient liquidity and positive Free Cash Flow to meet operational needs, and debt service requirements, as well as be able to fund (or obtain the funding for) the CAPEX that would be required to convert these undeveloped reserves into production. Potential sale and/or marketability of the PUDs can also be considered when evaluating collateral values, provided there is adequate documentation of recent PUD sales.

Lenders use risk-adjustment factors to lower the value of unseasoned producing and non-producing reserves before applying borrowing base advance rates. It is important to consider policy limits on production vs. non-production reserves, the oil and gas mix, maximum production coming from one well (single well concentration risk), and other risk-adjustment factors. Ideally, management achieves diversification in the geographic location of reserve fields, and establishes limits on the lowest number of producing wells needed to establish an acceptable borrowing base.

Typically, the advance rate for high-quality proved (P1) reserves rarely exceed 65 percent (a typical range is 50 to 65 percent) of the PV of FNR. If the lender determines that PDNP or PUD reserves are to be considered in the borrowing base, these reserves should generally not exceed 25 to 35 percent of the total borrowing base. In addition, PDNP and PUD reserves should be risk-adjusted (65 to 75 percent for PDNP and 25 to 50 percent for PUD, for example) prior to applying the advance rate. Lenders may apply separate risk-adjusted advance rates for each proved reserve category in the borrowing base. During extended periods of low or declining commodity prices, it is not uncommon for banks to increase the risk adjustment for PDNP and PUD reserves.

As part of the underwriting process, lending personnel typically prepare both base-case and sensitivity-case analyses that focus on the ability of converting the underlying collateral into cash to repay the loan, including an estimate of the impact that sustained adverse changes in market conditions would have on a company's repayment ability. A base-case analysis uses standard assumption scenarios and generally includes a discount to current prices against the forward curve (projected futures pricing estimates of the commodity). A sensitivity case analysis subjects the O&G reserves to adverse external factors such as lower market prices and/or higher operating expenses to ascertain the effect on loan repayment. Full debt service capacity (DSC) is typically analyzed using both the base-case and sensitivity-case scenarios.

Discount Rates

The Securities and Exchange Commission (SEC) requires publicly traded companies to report the value of their reserves using a standard discount rate of 10 percent in accordance with ASC Topic 932, Extractive Activities - Oil and Gas. In evaluating collateral valuations for RBL facilities, banks often utilize alternative discount rates. For creditworthy borrowers and during more benign operating cycles, a 9 percent discount rate is commonly used. For higher-risk borrowers or during volatile or declining market cycles for O&G, higher discount rates are typically used. If a discount rate is selected that significantly differs from generally accepted discount rates, examiners should assess management's documentation supporting its rationale. Some banks may use multiple discount rates under certain circumstances. An example may include establishing a standard discount rate for performing credits and a higher rate for higher risk facilities.

Price Decks

Prudent management regularly evaluates, and updates as necessary, its pricing assumptions for RBL, commonly referred to as the institution's price deck. The price deck is a forecast used to derive cash flow and collateral value assumptions, and typically is approved by the board of directors or a specifically designated board committee. Pricing assumptions typically represent the most significant variable in driving the final estimate of value, and must be well-supported.

Each institution's price deck typically reflects both base-case and sensitivity-case pricing scenarios. Pricing assumptions for the sensitivity case are generally sufficiently conservative and used to determine whether the borrower has the financial capacity to generate adequate cash flow to repay the debt during a prolonged low commodity price environment. Price deck considerations include, for example, current commodity pricing, forward curve projections (future price considerations), cost assumptions, discount rates, and timing of the various reports. Management also typically documents any risk-based adjustments applied to each proved reserve category. While the risk-adjusted base case projections will generally be used to underwrite RBLs, consideration is also given to the ability to repay the debt using the risk-adjusted sensitivity case to determine potential exposure due to adverse market price fluctuations.

<u>Loan Structure</u>

RBL credit facilities are typically structured as a revolving line of credit (RLOC), a reducing revolving line of credit (RRLOC), or an amortizing term loan, governed by a well-supported and fully documented borrowing base. These credit facilities generally fully amortize within the half-life of the reserves (that is, the time in years required to produce one-half of the total estimated recoverable production) with repayment aligning with projected cash flows. In other words, the term of the loans should be tied to the economic life of the underlying asset. This is often represented as the "reserve tail tests" that are based on the economic half-life of the reserves or the cash flow remaining after projected loan payout.

Loan durations should be fairly short-term and directly tied to the economic life of the asset (generally 50 to 60 percent of the economic life of the proved reserves or the proved reserves' half-life). The terms generally depend on the projected and actual reserve production (reserve run data), as well as the type and range of collateral (PDP, PDNP, or PUD). A reasonable portion of the estimated revenues should remain after the debt has fully amortized (reserve tail). Borrowing bases should be re-determined at least semiannually, subject to an updated reserve engineering report.

<u>Covenants</u>

Appropriate use of covenants is imperative in managing credit risk for O&G loans. Lenders typically require financial covenants to instill discipline in the lending relationship, including the borrower's leverage position, repayment capacity, and liquidity. In addition, well-designed covenants limit cash distributions to owners/shareholders, and include standard performance and financial reporting requirements. Examples of commonly used ratios/covenants for evaluating E&P companies include Free Cash Flow (FCF), Interest Coverage, Fixed Charge Coverage, Current Ratio, Quick Ratio, Senior Debt/EBITDA(X), and Total Debt/EBITDA(X). The calculation of earnings before interest, taxes, depreciation, and amortization (EBITDA) typically incorporates maintenance CAPEX (X) due to its impact on the amount of projected FCF that is available after debt service to support operations.

<u>Hedging</u>

When used properly, hedging may be an effective tool to help protect the borrower and the lender from sharp commodity price declines by providing a stable cash flow stream. E&P companies frequently use hedging instruments such as futures contracts, swaps, collars, and put options to reduce price risk exposure. Generally, hedges should be limited to no more than 85 percent of projected production volumes. Counterparties are typically limited to reputable, financially sound companies that are approved in accordance with the institution's O&G loan policy. If the hedges are taken as collateral or part of the borrowing base, the advance rate and any limitations on the hedging position should be documented in the loan agreement. If hedges are sold or monetized, the proceeds of such are generally applied to the respective debt.

<u>Borrower and Financial Analysis</u>

Management should have a clear understanding of the overall financial health of the borrower that includes an assessment of the borrower's ability to maintain operations through adverse market conditions. E&P companies in sound financial condition should have strong cash flow from reliable revenue sources and well-controlled operating expenses. Companies should also have adequate sources of liquidity and effective working capital management, sound reserve development practices, well-defined criteria for divestiture, adequate capital structure, manageable levels of debt, and appropriate financial reporting. As part of the overall financial analysis of the relationship, updated engineering data should be well-documented and should enable the lender to determine the borrower's capacity to service the debt. Any over-advance situation should have a reasonable plan and timeframe to cure the over-advance.

The principals of successful E&P companies should be experienced and have a well-documented track record of managing through all stages of the business cycle. In good times, company management should be able to identify, acquire, and develop reserves profitably and in line with expectations. During declining price cycles, company management should be able to demonstrate the ability to streamline operations, maintain reasonable production, manage working capital, strategically reduce CAPEX, and make sound divestitures to ensure repayment of debt. Bank management should evaluate the borrower's cost cycle, which reflects not only the ability to generate cash flow from production, but also the CAPEX necessary to replace depleted reserves. Working capital management is critically important, as delinquent payments to vendors can result in a negative working capital position (due to accounts payable increasing) and an increased leverage ratio.

Financial analysis typically includes the following:

- Adequacy of operating cash flows to service existing total debt;
- Overall compliance with financial covenants, including borrowing base limitations as detailed in the loan agreement;
- Reasonableness of the company's budget assumptions and projections;
- Comparison of borrower provided production projections with actual results;
- Working capital, tangible net worth, and leverage positions; and
- Impact of capital expenses and recent acquisitions.

O&G Loan Policy Guidelines

The O&G loan policy should provide sufficient guidance to loan officers, clearly convey appropriate policy limitations and monitoring procedures, and detail appropriate underwriting standards and practices. The O&G policy should clearly indicate those industry segments (Upstream, Midstream, Downstream, and Support/Services) the board chooses to lend to and include guidance on each of those segments.

For institutions engaged in RBL, appropriate policies address reserve measurement and valuation analysis, borrowing base determinations, production history analysis, financial statement and ratio analysis, commitment advances, discount rates, price deck formulation, financial covenants, steps to cure an over-advance situation, and ALLL considerations. Specific guidelines typically cover the following areas:

- Lending objectives, risk appetite, portfolio limits, target market, and concentration limits;
- Methodology and requirements for monitoring O&G markets, including pricing, supply and demand trends, overall market trends, and industry analysis;
- Board and committee oversight over the O&G lending and engineering departments;
- Officer and committee lending limits;
- Borrowing base calculations and risk-adjustments;
- Price deck considerations and adjustments;
- Advance rates, risk-adjusted values for PDP, PDNP, and PUD reserves, and requirement to risk adjust the discount value of nonproducing reserves before applying advance rates;
- Frequency and required details of borrowing base redeterminations and price deck revaluations;
- Requirements for independent engineering reports and analysis thereof;
- Well concentration guidelines and maximum per single well limits;
- Financial covenants, minimum ratio and other financial information requirements, and review requirements (e.g. current ratio, fixed charge coverage, cash flow coverage, leverage ratios);
- Collateral valuation requirements, including required remaining collateral at payout;
- Renewal and restructuring guidelines, including nonaccrual and troubled debt restructuring implications;
- Remedies for declining collateral or over-advanced situations, such as Monthly Commitment Reductions, pledge of additional reserves as collateral, and sale of non-productive reserves;
- Minimum required insurance (including property, liability, and environmental);
- Defined loan safety or coverage factors and/or loan value policies, including other debt that is "pari-passu" (i.e. all debts sharing equally in the production cash flows available to amortize debt);
- Typical amortization, payout, and loan repayment terms, including maximum terms for production revolvers and term loans;
- Guarantor requirements;
- Hedging requirements, policies, and limitations;
- Stress-testing and sensitivity analysis and requirements thereof; and
- Monitoring requirements for the risks inherent in loans dependent on royalty interests in production revenues for repayment.

Credit Risk Rating Assessment and Classification Guidelines

An appropriate O&G loan policy also addresses specific credit risk review procedures for the O&G portfolio and O&G loan grading criteria. Risk rating definitions should be clearly defined. RBL that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or underlying collateral generally will not be adversely classified for supervisory purposes. However, if any of the following circumstances are present, a more in-depth and comprehensive analysis of the credit is needed to determine whether the loan has potential or well-defined weaknesses:

- The loan balance exceeds 65 percent of the PV of FNR of PDP, or the cash flow analysis indicates that the loan will not amortize within the reserve half-life;
- The credit is not performing in accordance with contractual terms (repayment of interest and principal);
- Advance rates exceed the institution's limits or industry standards for proved reserves;
- Frequent over-advances occur at subsequent borrowing base redeterminations;
- Excessive operating leverage;
- Covenant defaults;
- Delinquent payables, or other evidence of poor working capital management;
- Significant current or likely future disruptions in production;
- Frequent financial statement revisions or changes in chosen accounting method;
- Maintenance or capital expenditures significantly exceed budgeted forecasts; or
- The credit is identified by the institution as a "distressed" credit.

Examiners are to consider all information relevant to evaluating the prospects that the loan will be repaid, including the borrower's creditworthiness, the cash flow provided by the borrower's operation, the collateral supporting the loan, integrity and reliability of the engineering data, borrowing base considerations, primary source of repayment, and any support provided by financially responsible guarantors and co-borrowers. If the borrower's circumstances reveal well-defined weaknesses, adverse classification of the loan relationship is likely warranted. The level and severity of classification of distressed, collateral-dependent RBLs will depend on the quality of the underlying collateral, based on the most recent re-determined and risk-adjusted borrowing base that is contractually obligated to be funded.

The portion of the loan commitment(s) secured by the NPV of total risk-adjusted proved reserves should be classified Substandard. When the potential for loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined, the remaining balance secured by the NPV of total unrisked proved reserves should be classified Doubtful. The portion of the loan commitment(s) that exceeds 100 percent of the NPV of total unrisked proved reserves, and is uncollectible, should be classified Loss. These guidelines may be adjusted depending on the borrower's specific situation and should not replace examiner judgment.

The following tables illustrate an example of the rating methodology for a classified borrower. Actual pricing, discount rates, and risk adjustment factors applied by the institution may vary according to current market conditions and the nature of the reserves. Examiners should closely review the key assumptions made by the institution in arriving at the current collateral valuation.

Example: Collateral Valuation ($ Million)
Discounted NPV at 9% and using NYMEX Strip Pricing

Valuation Basis	Hedges	PDP	PDNP	PUD	Total Proved
Unrisked NPV	$10	$50	$20	$40	$120
Risk adjustment factors	100%	100%	75%	50%	
Risked & Adjusted NPV	$10	$50	$15	$20	$95
		Total collateral value:			$95

Example: Classification ($ Million)
Borrowing base commitment on RBL is $125 million

	TC	Pass	SM	II	III	IV
RBL	$125			$95	$25	$5
Total	$125			$95	$25	$5

TC: Total Commitment SM: Special Mention
II: Substandard III: Doubtful IV: Loss

Note: The $25 million of Doubtful represents the difference between the unrisked NPV and the risked NPV. If the borrower's prospects for further developing PDNP and PUD reserves to producing status are unlikely or not supported by a pending event, this amount should be reflected as Loss.

Institutions should follow accounting principles when determining whether a loan should be placed on nonaccrual. Each extension should be independently evaluated to determine whether it should be on nonaccrual; that is, nonaccrual status should not be automatically applied to multiple loans or extensions of credit to a single borrower if only one loan meets the criteria for nonaccrual status. However, multiple loans to one borrower that are structured as pari-passu to principal and interest and supported by the same repayment source should not be treated differently for nonaccrual or troubled debt restructuring purposes, regardless of collateral lien position.

Real Estate Loans

General

Real estate loans are part of the loan portfolios of almost all commercial banks. Real estate loans include credits advanced for the purchase of real property. However, the term may also encompass extensions granted for other purposes, but for which primary collateral protection is real property.

The degree of risk in a real estate loan depends primarily on the loan amount in relation to collateral value, the interest rate, and most importantly, the borrower's ability to repay in an orderly fashion. It is extremely important that an institution's real estate loan policy ensure that loans are granted with the reasonable probability the debtor will be able and willing to meet the payment terms. Placing undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a debtor's repayment ability is a potentially dangerous mistake.

Historically, many banks have jeopardized their capital structure by granting ill-considered real estate mortgage loans. Apart from unusual, localized, adverse economic conditions which could not have been foreseen, resulting in a temporary or permanent decline in realty values, the principal errors made in granting real estate loans include inadequate regard to normal or even depressed realty values during periods when it is in great demand thus inflating the price structure, mortgage loan amortization, the maximum debt load and repayment capacity of the borrower, and failure to reasonably restrict mortgage loans on properties for which there is limited demand.

A principal indication of a troublesome real estate loan is an improper relationship between the amount of the loan, the potential sale price of the property, and the availability of a market. The potential sale price of a property may or may not be the same as its appraised value. The current potential sale price or liquidating value of the property is of primary importance and the appraised value is of secondary importance. There may be little or no current demand for the property at its appraised value and it may have to be disposed of at a sacrifice value.

Examiners must appraise not only individual mortgage loans, but also the overall mortgage lending and administration policies to ascertain the soundness of its mortgage loan operations as well as the liquidity contained in the account. Institutions generally establish policies that address the following factors: the maximum amount that may be loaned on a given property, in a given category, and on all real estate loans; the need for appraisals (professional judgments of the present and/or future value of the real property) and for amortization on certain loans.

Real Estate Lending Standards

Section 18(o) of the FDI Act requires the federal banking agencies to adopt uniform regulations prescribing standards for loans secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. For FDIC-supervised institutions, Part 365 of the FDIC Rules and Regulations requires each institution to adopt and maintain written real estate lending policies that are consistent with sound lending principles, appropriate for the size of the institution and the nature and scope of its operations. These policies generally enable management to effectively identify, measure, monitor, and control the risks associated with real estate lending. The level and complexity of risk-monitoring techniques for real estate lending typically is commensurate with the level of real estate activity and the nature and complexity of the institution’s market. Within these general parameters, the regulation specifically requires an institution to establish policies that include:

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

These policies also should consider the Interagency Guidelines for Real Estate Lending Policies and must be reviewed and approved at least annually by the institution's board of directors.

The interagency guidelines, which are an appendix to Part 365, are intended to help institutions satisfy the regulatory requirements by outlining the general factors to consider when developing real estate lending standards. The guidelines suggest maximum supervisory loan-to-value (LTV) limits for various categories of real estate loans and explain how the agencies will monitor their use.

The Interagency Guidelines for Real Estate Lending Policies indicate that institutions should establish their own internal LTV limits consistent with their needs. These internal limits should not exceed the following recommended supervisory limits:

- 65 percent for raw land;
- 75 percent for land development;
- 80 percent for commercial, multi-family, and other non-residential construction;
- 85 percent for construction of a 1-to-4 family residence;

- 85 percent for improved property; and
- Owner-occupied 1-to-4 family home loans have no suggested supervisory LTV limits. However, for any such loan with an LTV ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

Certain real estate loans are exempt from the supervisory LTV limits because of other factors that significantly reduce risk. These include loans guaranteed or insured by the federal, state or local government as well as loans to be sold promptly in the secondary market without recourse. A complete list of excluded transactions is included in the guidelines.

Because there are a number of credit factors besides LTV limits that influence credit quality, loans that meet the supervisory LTV limits should not automatically be considered sound, nor should loans that exceed the supervisory LTV limits automatically be considered high risk. However, loans that exceed the supervisory LTV limit should be identified in the institution's records and the aggregate amount of these loans reported to the institution's board of directors at least quarterly. The guidelines further state that the aggregate amount of loans in excess of the supervisory LTV limits should not exceed the institution's total capital. Moreover, within that aggregate limit, the total loans for all commercial, agricultural and multi-family residential properties (excluding 1-to-4 family home loans) should not exceed 30 percent of total capital.

Management and the board at each institution typically establish an appropriate internal process for the review and approval of loans that do not conform to internal policy standards. The approval of any loan that is an exception to policy typically is supported by a written justification that clearly details all of the relevant credit factors supporting the underwriting decision. Exception loans of a significant size often are individually reported to the board.

Prudent management and boards monitor compliance with internal policies and maintain reports of all exceptions to policy. Examiners should review loan policy exception reports to determine whether exceptions are adequately documented and appropriate in light of all the relevant credit considerations.

Institutions should develop policies that are clear, concise, consistent with sound real estate lending practices, and meet their needs. Policies should not be so complex that they place excessive paperwork burden on the institution. Therefore, when evaluating compliance with Part 365, examiners should carefully consider the following:

- The size and financial condition of the institution;
- The nature and scope of the institution's real estate lending activities;
- The quality of management and internal controls;
- The size and expertise of the lending and administrative staff; and
- Market conditions.

The institution should not be considered in nonconformance of the standards as a result of minor exceptions or inconsistencies. Rather, examiners are to assess management's overall practices and performance when assessing conformance with the standards.

Examination procedures for various real estate loan categories are included in the ED Modules.

Commercial Real Estate Loans

These loans comprise a major portion of many banks' loan portfolios. When problems exist in the real estate markets that the institution is servicing, it is necessary for examiners to devote additional time to the review and evaluation of loans in these markets.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can cause real estate projects and loans to become troubled. Signs of troubled real estate markets or projects include, but are not limited to:

- An excess of similar projects under construction.
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
- Delinquent lease payments from major tenants.
- Changes in concept or plan: for example, a condominium project converting to an apartment project.
- Land values that assume future rezoning.
- Construction delays resulting in cost overruns, which may require renegotiation of loan terms.
- Slow leasing or lack of sustained sales activity and/or increasing cancellations, which may result in protracted repayment or default.
- Lack of any sound feasibility study or analysis.
- Periodic construction draws that exceed the amount needed to cover construction costs and related overhead expenses.
- Tax arrearages.
- Identified problem credits, past due and non-accrual loans.

Real Estate Construction Loans

A well-underwritten construction loan is used to construct a particular project within a specified period of time and should be controlled by supervised disbursement of a predetermined sum of money. It is generally secured by a first mortgage or deed of trust and backed by a purchase or takeout agreement from a financially responsible permanent lender. Construction loans are vulnerable to a wide variety of risks. The major risk arises from the necessity to complete projects within specified cost and time limits. The risk inherent in construction lending can be limited by establishing policies which specify type and extent of institution involvement. Such policies generally define procedures for controlling disbursements and collateral margins and assuring timely completion of the projects and repayment of the institution's loans.

Before entering a construction loan agreement, it is appropriate for the institution to investigate the character, expertise, and financial standing of all related parties. Documentation files would then include background information concerning reputation, work and credit experience, and financial statements. Such documentation indicates that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The appraisal techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The institution should realize that appraised collateral values are not usually met until funds are advanced and improvements made.

The institution, the builder, and the property owner typically join in a written building loan agreement that specifies the performance of each party during the entire course of construction. Loan funds are generally disbursed based upon either a standard payment plan or a progress payment plan. The standard payment plan is normally used for residential and smaller commercial construction loans and utilizes a pre-established schedule for fixed payments at the end of each specified stage of construction. The progress payment plan is normally used for larger, more complex, building projects. The plan is generally based upon monthly disbursements totaling 90 percent of the value with 10 percent held back until the project is completed.

Although many credits advanced for real estate acquisition, development or construction are properly considered loans secured by real estate, other such credits are, in economic substance, "investments in real estate ventures." A key feature of these transactions is that the institution as lender plans to share in the expected residual profit from the ultimate sale or other use of the development. These profit sharing arrangements may take the form of equity kickers, unusually high interest rates, a percentage of the gross rents or net cash flow generated by the project, or some other form of profit participation over and above a reasonable amount for interest and related loan fees. These extensions of credit may also include such other characteristics as nonrecourse debt, 100 percent financing of the development cost (including origination fees, interest payments, construction costs, and even profit draws by the developer), and lack of any substantive financial support from the borrower or other guarantors. Acquisition, Development, and Construction (ADC) arrangements that are in substance real estate investments of the institution should be reported accordingly.

The following are the basic types of construction lending:

- <u>Unsecured Front Money</u> **-** Unsecured front money loans are working capital advances to a borrower who may be engaged in a new and unproven venture. Many bankers believe that unsecured front money lending is not prudent unless the institution is involved in the latter stages of construction financing. A builder planning to start a project before construction funding is obtained often uses front money loans. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and/or meet minimum working capital requirements established by construction lenders. Repayment often comes from the first draw against construction financing. Unsecured front money loans used for a developer's equity investment in a project or to cover initial costs overruns are symptomatic of an undercapitalized, inexperienced or inept builder.

- <u>Land Development Loans</u> **-** Land development loans are generally secured purchase or development loans or unsecured advances to investors and speculators. Secured purchase or development loans are usually a form of financing involving the purchase of land and lot development in anticipation of further construction or sale of the property. A land development loan should be predicated upon a proper title search and/or mortgage insurance. The loan amount should be based on appraisals on an "as is" and "as completed" basis. Projections should be accompanied by a study explaining the effect of property improvements on the market value of the land. There should be a sufficient spread between the amount of the development loan and the estimated market value to allow for unforeseen expenses. Appropriate repayment programs typically are structured to follow the sales or development program. In the case of an unsecured land development loan to investors or speculators, it is prudent for institution management to analyze the borrower's financial statements for sources of repayment other than the expected return on the property development.

- Commercial Construction Loans - Loans financing commercial construction projects are usually collateralized, and such collateral is generally identical to that for commercial real estate loans. Supporting documentation should include a recorded mortgage or deed of trust, title insurance policy and/or title opinions, appropriate liability insurance and other coverages, land appraisals, and evidence that taxes have been paid to date. Additional documents relating to commercial construction loans include loan agreements, takeout commitments, tri-party (buy/sell) agreements, completion or corporate bonds, and inspection or progress reports.

- Residential Construction Loans - Residential construction loans may be made on a speculative basis or as prearranged permanent financing. Smaller banks often engage in this type of financing and the aggregate total of individual construction loans may equal a significant portion of their capital funds. Prudence dictates that permanent financing be assured in advance because the cost of such financing can have a substantial effect on sales. Proposals to finance speculative housing should be evaluated in accordance with predetermined policy standards compatible with the institution's size, technical competence of its management, and housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should be reviewed. The finished project's realistic marketability in favorable and unfavorable market conditions is also an important consideration.

  In addition to normal safeguards such as a recorded first mortgage, acceptable appraisal, construction agreement, draws based on progress payment plans and inspection reports, an institution dealing with speculative contractors should institute control procedures tailored to the individual circumstances. A predetermined limit on the number of unsold units to be financed at any one time is typically included in the loan agreement to avoid overextending the contractor's capacity. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing. Documentation of tract loans frequently includes a master note allocated for the entire project and a master deed of trust or mortgage covering all land involved in the project. Payment of the loan will depend largely upon the sale of the finished homes. As each sale is completed, the institution makes a partial release of the property covered by its master collateral document. In addition to making periodic inspections during the course of construction, periodic progress reports (summary of inventory lists maintained for each tract project) typically are made on the entire project. A comprehensive inventory list shows each lot number, type of structure, release price, sales price, and loan balance.

The exposure in any type of construction lending is that the full value of the collateral does not exist at the time the loan is granted. Therefore, it is important for management to ensure funds are used properly to complete construction or development of the property serving as collateral. If default occurs, the institution must be in a position to either complete the project or to salvage its construction advances. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Every precaution should be taken by the lender to minimize any outside attack on the collateral. The construction lender may not be in the preferred position indicated by documents in the file. Laws of some states favor the subcontractors (materialmen's liens, etc.), although those of other states protect the construction lender to the point of first default, provided certain legal requirements have been met. Depending on the type and size of project being funded, construction lending can be a complex and fairly high-risk venture. For this reason, institution management should ensure that it has enacted policies and retained sufficiently trained personnel before engaging in this type of lending.

Home Equity Loans

A home equity loan is a loan secured by the equity in a borrower's residence. It is generally structured in one of two ways. First, it can be structured as a traditional second mortgage loan, wherein the borrower obtains the funds for the full amount of the loan immediately and repays the debt with a fixed repayment schedule. Second, the home equity borrowing can be structured as a line of credit, with a check, credit card, or other access to the line over its life.

The home equity line of credit has evolved into the dominant form of home equity lending. This credit instrument generally offers variable interest rates and flexible repayment terms. Additional characteristics of this product line include relatively low interest rates as compared to other forms of consumer credit, absorption by some banks of certain fees (origination, title search, appraisal, recordation cost, etc.) associated with establishing a real estate-related loan. The changes imposed by the Tax Reform Act of 1986 relating to the income tax deductibility of interest paid on consumer debt led to the increased popularity of home equity lines of credit.

Home equity lending is widely considered to be a low-risk lending activity. These loans are secured by housing assets, the value of which historically has performed well. Nevertheless, the possibility exists that local housing values or household purchasing power may decline, stimulating abandonment of the property and default on the debt secured by the housing. Certain features of home equity loans make them particularly susceptible to such risks. First, while the variable rate feature of the debt reduces the interest rate risk of the lender, the variable payment size exposes the borrower to greater cash flow risks than would a fixed-rate loan, everything else being equal. This, in turn, exposes the lender to greater credit risk. Another risk is introduced by the very nature of the home equity loan. Such loans are generally secured by a junior lien. Thus, there is less effective equity protection than in a first lien instrument. Consequently, a decline in the value of the underlying housing results in a much greater than proportional decline in the coverage of a home equity loan. This added leverage makes them correspondingly riskier than first mortgages.

Institutions that make these kinds of loans typically adopt specific policies and procedures for dealing with this product line. Management expertise in mortgage lending and open-end credit procedures is critical to the appropriate administration of the portfolio. Another major concern is that borrowers will become overextended and the institution will have to initiate foreclosure proceedings. Therefore, underwriting standards should emphasize the borrower's ability to service the line from cash flow rather than the sale of the collateral, especially if the home equity line is written on a variable rate basis. If the institution has offered a low introductory interest rate, repayment capacity should be analyzed at the rate that could be in effect at the conclusion of the initial term.

Other important considerations include acceptable loan-to-value and debt-to-income ratios, and proper credit and collateral documentation, including adequate appraisals and written evidence of prior lien status. Another significant risk concerns the continued lien priority for subsequent advances under a home equity line of credit. State law governs the status of these subsequent advances. It is also important that the institution's program include periodic reviews of the borrower's financial condition and continuing ability to repay the indebtedness.

The variation in contract characteristics of home equity debt affects the liquidity of this form of lending. For debt to be easily pooled and sold in the secondary market, it needs to be fairly consistent in its credit and interest rate characteristics. The complexity of the collateral structures, coupled with the uncertain maturity of revolving credit, makes home equity loans considerably less liquid than straight first lien, fixed maturity mortgage loans.

While home equity lending is considered to be fairly low-risk, subprime home equity loans and lending programs exist at some banks. These programs have a higher level of risk than traditional home equity lending programs. Individual or pooled home equity loans that have subprime characteristics should be analyzed using the information provided in the subprime section of this Manual.

Agricultural Loans

Introduction

Agricultural loans are an important component of many community institution loan portfolios. Agricultural banks represent a material segment of commercial banks and constitute an important portion of the group of banks over which the FDIC has the primary federal supervisory responsibility.

Agricultural loans are used to fund the production of crops, fruits, vegetables, and livestock, or to fund the purchase or refinance of capital assets such as farmland, machinery and equipment, breeder livestock, and farm real estate improvements (for example, facilities for the storage, housing, and handling of grain or livestock). The production of crops and livestock is especially vulnerable to two risk factors that are largely outside the control of individual lenders and borrowers: commodity prices and weather conditions. While examiners must be alert to, and critical of, operational and managerial weaknesses in agricultural lending activities, they must also recognize when the institution is taking reasonable steps to deal with these external risk factors. Accordingly, loan restructurings or extended repayment terms, or other constructive steps to deal with financial difficulties faced by agricultural borrowers because of adverse weather or commodity conditions, will not be criticized if done in a prudent manner and with proper risk controls and management oversight. Examiners should recognize these constructive steps and fairly portray them in oral and written communications regarding examination findings. This does not imply, however, that analytical or classification standards should be compromised. Rather, it means that the institution’s response to these challenges will be considered in supervisory decisions.

Agricultural Loan Types and Maturities

Production or Operating Loans **-** Short-term (one year or less) credits to finance seed, fuel, chemicals, land and machinery rent, labor, and other costs associated with the production of crops. Family living expenses are also sometimes funded, at least in part, with these loans. The primary repayment source is sale of the crops at the end of the production season when the harvest is completed.

<u>Feeder Livestock Loans</u> **-** Short-term loans for the purchase of, or production expenses associated with, cattle, hogs, sheep, poultry or other livestock. When the animals attain market weight and are sold for slaughter, the proceeds are used to repay the debt.

Breeder Stock Loans - Intermediate-term credits (generally three to five years) used to fund the acquisition of breeding stock such as beef cows, sows, sheep, dairy cows, and poultry. The primary repayment source is the proceeds from the sale of the offspring of these stock animals, or their milk or egg production.

Machinery and Equipment Loans - Intermediate-term loans for the purchase of a wide array of equipment used in the production and handling of crops and livestock. Cash flow from farm earnings is the primary repayment source. Loans for grain handling and storage facilities are also sometimes included in this category, especially if the facilities are not permanently affixed to real estate.

Farm Real Estate Acquisition Loans - Long-term credits for the purchase of farm real estate, with cash flow from earnings representing the primary repayment source. Significant, permanent improvements to the real estate, such as for livestock housing or grain storage, may also be included within this group.

Carryover Loans - This term is used to describe two types of agricultural credit. The first is production or feeder livestock loans that are unable to be paid at their initial, short-term maturity, and which are rescheduled into an intermediate or long-term amortization. This situation arises when weather conditions cause lower crop yields, commodity prices are lower than anticipated, production costs are higher than expected, or other factors result in a shortfall in available funds for debt repayment. The second type of carryover loan refers to already-existing term debt whose repayment terms or maturities need to be rescheduled because of inadequate cash flow to meet existing repayment requirements. This need for restructuring can arise from the same factors that lead to carryover production or feeder livestock loans. Carryover loans are generally restructured on an intermediate or long-term amortization, depending upon the type of collateral provided, the borrower's debt service capacity from ongoing operations, the debtor's overall financial condition and trends, or other variables. The restructuring may also be accompanied by acquisition of federal guarantees through the farm credit system to lessen risk to the institution.

Agricultural Loan Underwriting Guidelines

Many underwriting standards applicable to commercial loans also apply to agricultural credits. The discussion of those shared standards is therefore not repeated. Some items, however, are especially pertinent to agricultural credit and therefore warrant emphasis.

Financial and Other Credit Information - As with any type of lending, sufficient information must be available so that the institution can make informed credit decisions. Basic information includes balance sheets, income statements, cash flow projections, loan officer file comments, and collateral inspections, verifications, and valuations. Generally, financial information should be updated not less than annually (loan officer files should be updated as needed and document all significant meetings and events). Credit information should be analyzed by management so that appropriate and timely actions are taken, as necessary, to administer the credit.

Institutions should be given some reasonable flexibility as to the level of sophistication or comprehensiveness of the aforementioned financial information, and the frequency with which it is obtained, depending upon such factors as the credit size, the type of loans involved, the financial strength and trends of the borrower, and the economic, climatic or other external conditions which may affect loan repayment. It may therefore be inappropriate for the examiner to insist that all agricultural borrowers be supported with the full complement of balance sheets, income statements, and other data discussed above, regardless of the nature and amount of the credit or the debtor's financial strength and payment record. Nonetheless, while recognizing some leeway is appropriate, most of the institution's agricultural credit lines, and all of its larger or more significant ones, should be sufficiently supported by the financial information mentioned.

Cash Flow Analysis - History clearly demonstrated that significant problems can develop when banks fail to pay sufficient attention to cash flow adequacy in underwriting agricultural loans. While collateral coverage is important, the primary repayment source for intermediate and long-term agricultural loans is not collateral but cash flow from ordinary operations. This principle should be evident in the institution's agricultural lending policies and implemented in its actual practices. Cash flow analysis is therefore an important aspect of the examiner's review of agricultural loans. Assumptions in cash flow projections should be reasonable and consider not only current conditions but also the historical performance of the farming operation.

Collateral Support - Whether a loan or line of credit warrants unsecured versus secured status in order to be prudent and sound is a matter the examiner has to determine based on the facts of the specific case. The decision should generally consider such elements as the borrower's overall financial strength and trends, profitability, financial leverage, degree of liquidity in asset holdings, managerial and financial expertise, and amount and type of credit. Nonetheless, as a general rule, intermediate and long-term agricultural credit is typically secured, and many times production and feeder livestock advances will also be collateralized. Often the security takes the form of an all-inclusive lien on farm personal property, such as growing crops, machinery and equipment, livestock, and harvested grain. A lien on real estate is customarily taken if the loan was granted for the purchase of the property, or if the borrower's debts are being restructured because of debt servicing problems. In some cases, the institution may perfect a lien on real estate as an abundance of caution.

Examiner review of agricultural related collateral valuations varies depending on the type of security involved. Real estate collateral should be reviewed using normal procedures. Feeder livestock and grain are highly liquid commodities that are bought and sold daily in active, well-established markets. Their prices are widely reported in the daily media; so, obtaining their market values is generally easy. The market for breeder livestock may be somewhat less liquid than feeder livestock or grain, but values are nonetheless reasonably well known and reported through local or regional media or auction houses. If such information on breeding livestock is unavailable or is considered unreliable, slaughter prices may be used as an alternative (these slaughter prices comprise "liquidation" rather than "going concern" values). The extent of use and level of maintenance received significantly affect machinery and equipment values. Determining collateral values can therefore be very difficult as maintenance and usage levels vary significantly. Nonetheless, values for certain pre-owned machinery and equipment, especially tractors, combines, and other harvesting or crop tillage equipment, are published in specialized guides and are based on prices paid at farm equipment dealerships or auctions. These used machinery guides may be used as a reasonableness check on the valuations presented on financial statements or in management's internal collateral analyses.

Prudent agricultural loan underwriting also includes systems and procedures to ensure that the institution has a valid note receivable from the borrower and an enforceable security interest in the collateral, should judicial collection measures be necessary. Among other things, such systems and procedures will confirm that promissory notes, loan agreements, collateral assignments, and lien perfection documents are signed by the appropriate parties and are filed, as needed, with the appropriate state, county, and/or municipal authorities. Flaws in the legal enforceability of loan instruments or collateral documents will generally be unable to be corrected if they are discovered only when the credit is distressed and the borrower relationship strained.

Structuring - Orderly liquidation of agricultural debt, based on an appropriate repayment schedule and a clear understanding by the borrower of repayment expectations, helps prevent collection problems from developing. Amortization periods for term indebtedness should correlate with the useful economic life of the underlying collateral and with the operation's debt service capacity. A too-lengthy amortization period can leave the institution under secured in the latter part of the life of the loan, when the borrower's financial circumstances may have changed. A too-rapid amortization, on the other hand, can impose an undue burden on the cash flow capacity of the farming operation and thus lead to loan default or disruption of other legitimate financing needs of the enterprise. It is also generally preferable that separate loans or lines of credit be established for each loan purpose category financed by the institution.

Administration of Agricultural Loans

Two aspects of prudent loan administration deserve emphasis: collateral control and renewal practices for production loans.

Collateral Control - Production and feeder livestock loans are sometimes referred to as self-liquidating because sale of the crops after harvest, and of the livestock when they reach maturity, provides a ready repayment source for these credits. These self-liquidating benefits may be lost, however, if the institution does not monitor and exercise sufficient control over the disposition of the proceeds from the sale. In agricultural lending, collateral control is mainly accomplished by periodic on-site inspections and verifications of the security pledged, with the results of those inspections documented, and by implementing procedures to ensure sales proceeds are applied to the associated debt before those proceeds are released for other purposes. The recommended frequency of collateral inspections varies depending upon such things as the nature of the farming operation, the overall credit soundness, and the turnover rate of grain and livestock inventories.

Renewal of Production Loans - After completion of the harvest, some farm borrowers may wish to defer repayment of some or all of that season's production loans, in anticipation of higher market prices at a later point (typically, crop prices are lower at harvest time when the supply is greater). Such delayed crop marketing will generally require production loan extensions or renewals. In these situations, the institution must strike an appropriate balance of, on the one hand, not interfering with the debtor's legitimate managerial decisions and marketing plans while, at the same time, taking prudent steps to ensure its production loans are adequately protected and repaid on an appropriate basis. Examiners should generally not take exception to reasonable renewals or extensions of production loans when the following factors are favorably resolved:

- The borrower has sufficient financial strength to absorb market price fluctuations. Leverage and liquidity in the balance sheet, financial statement trends, profitability of the operation, and past repayment performance are relevant indices.

- The borrower has sufficient financial capacity to support both old and new production loans. That is, in a few months subsequent to harvest, the farmer will typically be incurring additional production debt for the upcoming crop season.
- The institution has adequately satisfied itself of the amount and condition of grain in inventory, so that the renewed or extended production loans are adequately supported. Generally, this means that a current inspection report will be available.

Classification Guidelines for Agricultural Credit

When determining the level of risk in a specific lending relationship, the relevant factual circumstances must be reviewed in total. This means, among other things, that when an agricultural loan's primary repayment source is jeopardized or unavailable, adverse classification is **not** automatic. Rather, such factors as the borrower's historical performance and financial strength, overall financial condition and trends, the value of any collateral, and other sources of repayment must be considered. In considering whether a given agricultural loan or line of credit should be adversely classified, collateral margin is an important, though not necessarily the determinative, factor. If that margin is so overwhelming as to remove all reasonable prospect of the institution sustaining some loss, it is generally inappropriate to adversely classify such a loan. Note, however, that if there is reasonable uncertainty as to the value of that security, because of an illiquid market or other reasons, that uncertainty can, when taken in conjunction with other weaknesses, justify an adverse classification of the credit, or, at minimum, may mean that the margin in the collateral needs to be greater to offset this uncertainty. Moreover, when assessing the adequacy of the collateral margin, it must be remembered that deteriorating financial trends will, if not arrested, typically result in a shrinking of that margin. Such deterioration can also reduce the amount of cash available for debt service needs.

That portion of an agricultural loan(s) or line of credit, which is secured by grain, feeder livestock, and/or breeder livestock, will generally be withheld from adverse classification. The basis for this approach is that grain and livestock are highly marketable and provide good protection from credit loss. However, that high marketability also poses potential risks that must be recognized and controlled. The following conditions must therefore be met in order for this provision to apply:

- The institution must take reasonable steps to verify the existence and value of the grain and livestock. This generally means that on-site inspections must be made and documented. Although the circumstances of each case must be taken into account, the general policy is that, for the classification exclusion to apply, inspections should have been performed not more than 90 days prior to the examination start date for feeder livestock and grain collateral, and not more than six months prior to the examination start date for breeder stock collateral. Copies of invoices or bills of sale are acceptable substitutes for inspection reports prepared by institution management, in the case of loans for the purchase of livestock.
- Loans secured by grain warehouse receipts are generally excluded from adverse classification, up to the market value of the grain represented by the receipts.
- The amount of credit to be given for the livestock or grain collateral should be based on the daily, published, market value as of the examination start date, less marketing and transportation costs, feed and veterinary expenses (to the extent determinable), and, if material in amount, the accrued interest associated with the loan(s). Current market values for breeder stock may be derived from local or regional newspapers, area auction barns, or other sources considered reliable. If such valuations for breeding livestock cannot be obtained, the animals' slaughter values may be used.
- The institution must have satisfactory practices for controlling sales proceeds when the borrower sells livestock and feed and grain.
- The institution must have a properly perfected and enforceable security interest in the assets in question.

Examiners should exercise great caution in granting the grain and livestock exclusion from adverse classification in those instances where the borrower is highly leveraged, or where the debtor's basic operational viability is seriously in question, or if the institution is in an under-secured position. The issue of control over proceeds becomes extremely critical in such highly distressed credit situations. If the livestock and grain exclusion from adverse classification is not given in a particular case, institution management should be informed of the reasons why.

With the above principles, requirements, and standards in mind, the general guidelines for determining adverse classification for agricultural loans are as follows, listed by loan type.

<u>Feeder Livestock Loans</u> **-** The self-liquidating nature of these credits means that they are generally not subject to adverse classification. However, declines in livestock prices, increases in production costs, or other unanticipated developments may result in the revenues from the sale of the livestock not being adequate to fully repay the loans. Adverse classification may then be appropriate, depending upon the support of secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

Production Loans - These loans are generally not subject to adverse classification if the debtor has good liquidity and/or significant fixed asset equities, or if the cash flow information suggests that current year's operations should be sufficient to repay the advances. The examiner should also take into account any governmental support programs or federal crop insurance benefits from which the borrower may benefit. If cash flow from ongoing operations appears insufficient to repay production loans, adverse classification may be in order, depending upon the secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

Breeder Stock Loans - These loans are generally not adversely classified if they are adequately secured by the livestock and if the term debt payments are being met through the sale of offspring (or milk and eggs in the case of dairy and poultry operations). If one or both of these conditions is not met, adverse classification may be in order, depending upon the support of secondary repayment sources and collateral, and the borrower's overall financial condition and trends.

Machinery and Equipment Loans - Loans for the acquisition of machinery and equipment will generally not be subject to adverse classification if they are adequately secured, structured on an appropriate amortization program (see above), and are paying as agreed. Farm machinery and equipment is often the second largest class of agricultural collateral, hence its existence, general state of repair, and valuation are generally verified and documented during the institution's periodic on-site inspections of the borrower's operation. Funding for the payments on machinery and equipment loans sometimes comes, at least in part, from other loans provided by the institution, especially production loans. When this is the case, the question arises whether the payments are truly being "made as agreed." For examination purposes, such loans will be considered to be paying as agreed if cash flow projections, payment history, or other available information, suggests there is sufficient capacity to fully repay the production loans when they mature at the end of the current production cycle. If the machinery and equipment loan is not adequately secured, or if the payments are not being made as agreed, adverse classification should be considered.

Carryover Debt - Carryover debt results from the debtor's inability to generate sufficient cash flow to service the obligation as it is currently structured. It therefore tends to contain a greater degree of credit risk and must receive close analysis by the examiner. When carryover debt arises, the institution should determine the basic viability of the borrower's operation, so that an informed decision can be made on whether debt restructuring is appropriate. It will thus be useful for institution management to know how the carryover debt came about: Did it result from the obligor's financial, operational or other managerial weaknesses; from inappropriate credit administration on the institution's part, such as over lending or improper debt structuring; from external events such as adverse weather conditions that affected crop yields; or from other causes? In many instances, it will be in the long-term best interests of both the institution and the debtor to restructure the obligations. The restructured obligation should generally be rescheduled on a term basis and require clearly identified collateral, amortization period, and payment amounts. The amortization period may be intermediate or long term depending upon the useful economic life of the available collateral, and on realistic projections of the operation's payment capacity.

There are no hard and fast rules on whether carryover debt should be adversely classified, but the decision should generally consider the following: borrower's overall financial condition and trends, especially financial leverage (often measured in farm debtors with the debt-to-assets ratio); profitability levels, trends, and prospects; historical repayment performance; the amount of carryover debt relative to the operation's size; realistic projections of debt service capacity; and the support provided by secondary collateral. Accordingly, carryover loans to borrowers who are moderately to highly leveraged, who have a history of weak or no profitability and barely sufficient cash flow projections, as well as an adequate but slim collateral margin, will generally be adversely classified, at least until it is demonstrated through actual repayment performance that there is adequate capacity to service the rescheduled obligation. The classification severity will normally depend upon the collateral position. At the other extreme are cases where the customer remains fundamentally healthy financially, generates good profitability and ample cash flow, and who provides a comfortable margin in the security pledged. Carryover loans to this group of borrowers will not ordinarily be adversely classified.

Installment Loans

An installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. In addition, the department may grant indirect loans for the purchase of consumer goods.

The examiner's emphasis in reviewing the installment loan department should be on the overall procedures, policies and credit qualities. The goal should not be limited to identifying current portfolio problems, but should include potential future problems that may result from ineffective policies, unfavorable trends, potentially dangerous concentrations, or nonadherence to established policies.

Direct installment lending policies typically address the following factors: loan applications and credit checks; terms in relation to collateral; collateral margins; perfection of liens; extensions, renewals and rewrites; delinquency notification and follow-up; and charge-offs and collections. For indirect lending, the policy typically addresses direct payment to the institution versus payment to the dealer, acquisition of dealer financial information, possible upper limits for any one dealer's paper, other standards governing acceptance of dealer paper, and dealer reserves and charge-backs.

Lease Accounting

ASC Topic 840, *Leases*, is the current lease accounting standard for non-public business entities and entities that have not adopted ASC Topic 842, *Leases*. ASC Topic 842 is effective for public business entities (as defined in U.S. GAAP) and will become effective for banks that are not public business entities, for fiscal years beginning after December 15, 2021, and interim reporting periods within fiscal years beginning after December 15, 2022. As such, a calendar year end non-public business entity's first reporting period will be December 31, 2022. Early adoption is permitted.

Direct Lease Financing

Leasing is a recognized form of term debt financing for fixed assets. While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management and projections of future operations. Additional considerations for a lease transaction are the property type and its marketability in the event of default or lease termination. Those latter considerations do not radically alter the manner in which an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Sale of leased property/collateral remains a secondary repayment source and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance. When the institution is requested to purchase property of significant value for lease, it may issue a commitment to lease, describing the property, indicating cost, and generally outlining the lease terms. After all terms in the lease transaction are resolved by negotiation between the institution and its customer, an order is usually written requesting the institution to purchase the property. Upon receipt of that order, the institution purchases the property requested and arranges for delivery and, if necessary, installation. A lease contract is drawn incorporating all the points covered in the commitment letter, as well as the rights of the institution and lessee in the event of default. The lease contract is generally signed simultaneously with the signing of the order to purchase and the agreement to lease.

Lessor Accounting under ASC Topic 840

The types of assets that may be leased are numerous, and the accounting for direct leasing is a complex subject which is discussed in detail in ASC Topic 840, *Leases*. Familiarity with ASC Topic 840 is a prerequisite for the management of any institution engaging in or planning to engage in direct lease financing. The following terms are commonly encountered in direct lease financing:

- Net Lease, one in which the institution is not directly or indirectly obligated to assume the expenses of maintaining the equipment. This restriction does not prohibit the institution from paying delivery and set up charges on the property.
- Full Payout Lease, one for which the institution expects to realize both the return of its full investment and the cost of financing the property over the term of the lease. This payout can come from rentals, estimated tax benefits, and estimated residual value of the property.
- Leveraged Lease, in which the institution as lessor purchases and becomes the equipment owner by providing a relatively small percentage (20-40%) of the capital needed. Balance of the funds is borrowed by the lessor from long-term lenders who hold a first lien on the equipment and assignments of the lease and lease rental payments. This specialized and complex form of leasing is prompted mainly by a desire on the part of the lessor to shelter income from taxation. Creditworthiness of the lessee is paramount and the general rule is an institution should not enter into a leveraged lease transaction with any party to whom it would not normally extend unsecured credit.
- Rentals, which include only those payments reasonably anticipated by the institution at the time the lease is executed.

Lessor Accounting under ASC Topic 842

ASC Topic 842, *Leases* does not fundamentally change lessor accounting; however, it aligns terminology between lessee and lessor accounting and brings key aspects of lessor accounting into alignment with the FASB's new revenue recognition guidance in ASC Topic 606. As a result, the classification difference between direct financing leases and sales-type leases for lessors moves from a risk-and-rewards principle to a transfer of control principle. As such, an institution as lessor is required to classify a lease as a sales-type, direct financing, or operating leases. Additionally, there is no longer a distinction in the treatment of real estate and non-real estate leases by lessors.

Leases classified as leveraged leases prior to the adoption of ASC Topic 842 may continue to be accounted for under ASC Topic 840 unless subsequently modified. ASC Topic 842 eliminates leveraged lease accounting for leases that commence after an institution adopts the new accounting standard.

For more information refer to the Call Report Glossary for the accounting for leases or ASC Topic 842.

Examiner Consideration

Examiners should determine whether bank management carefully evaluates all lease variables, including the estimate of the residual value. Institutions may be able to realize unwarranted lease income in the early years of a contract by manipulating the lease variables. In addition, an institution can offer the lessee a lower payment by assuming an artificially high residual value during the initial structuring of the lease. But this technique may present the institution with serious long-term problems because of the reliance on speculative or nonexistent residual values.

Often, lease contracts contain an option permitting the lessee to continue use of the property at the end of the original term, working capital restrictions and other restrictions or requirements similar to debt agreements and lease termination penalties. Each lease is an individual contract written to fulfill the lessee's needs. Consequently, there may be many variations of each of the above provisions. However, the underlying factors remain the same: there is a definite contractual understanding of the positive right to use the property for a specific period of time, and required payments are irrevocable.

Examination procedures for reviewing lease financing activities are included in the ED Modules in the Loan References section.

Floor Plan Loans

Floor plan (wholesale) lending is a form of retail goods inventory financing in which each loan advance is made against a specific piece of collateral. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid. Items commonly subject to floor plan debt are automobiles, home appliances, furniture, television and stereophonic equipment, boats, mobile homes and other types of merchandise usually sold under a sales finance contract. Drafting agreements are a relatively common approach utilized in conjunction with floor plan financing. Under this arrangement, the institution establishes a line of credit for the borrower and authorizes the good’s manufacturer to draw drafts on the institution in payment for goods shipped. The institution agrees to honor these drafts, assuming proper documentation (such as invoices, manufacturer's statement of origin, etc.) is provided. The method facilitates inventory purchases by, in effect, guaranteeing payment to the manufacturer for merchandise supplied. Floor plan loans involve all the basic risks inherent in any form of inventory financing. However, because of the banker's inability to exercise full control over the floored items, the exposure to loss may be greater than in other similar types of financing. Most dealers have minimal capital bases relative to debt. As a result, close and frequent review of the dealer's financial information is necessary. As with all inventory financing, collateral value is of prime importance. Control requires the institution to determine the collateral value at the time the loan is placed on the books, frequently inspect the collateral to determine its condition, and impose a curtailment requirement sufficient to keep collateral value in line with loan balances.

Handling procedures for floor plan lines will vary greatly depending on institution size and location, dealer size and the type of merchandise being financed. In many cases, the term "trust receipt" is used to describe the debt instrument existing between the institution and the dealer. Trust receipts may result from drafting agreements between an institution and a manufacturer for the benefit of a dealer. In other instances, the dealer may order inventory, bring titles or invoices to the institution, and then obtain a loan secured or to be secured by the inventory. Some banks may use master debt instruments, and others may use a trust receipt or note for each piece of inventory. The method of perfecting a security interest also varies from state to state. The important point is that an institution enacts realistic handling policies and ensures that its collateral position is properly protected.

Examination procedures and examiner considerations for reviewing floor plan lending activities are included in the ED Modules in the Loan References section.

Check Credit and Credit Card Loans

Check credit is defined as the granting of unsecured revolving lines of credit to individuals or businesses. Check credit services are provided by the overdraft system, cash reserve system, and special draft system. The most common is the overdraft system. In that method, a transfer is made from a pre-established line of credit to a customer's demand deposit account when a check which would cause an overdraft position is presented. Transfers normally are made in stated increments, up to the maximum line of credit approved by the institution, and the customer is notified that the funds have been transferred. In a cash reserve system, customers must request that the institution transfer funds from their pre-established line of credit to their demand deposit account before negotiating a check against them. A special draft system involves the customer negotiating a special check drawn directly against a pre-established line of credit. In that method, demand deposit accounts are not affected. In all three systems, the institution periodically provides its check credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance of the account on the cycle date and may be made by automatic charges to a demand deposit account.

Most institution credit card plans are similar. The institution solicits retail merchants, service organizations and others who agree to accept a credit card in lieu of cash for sales or services rendered. The parties also agree to a discount percentage of each sales draft and a maximum dollar amount per transaction. Amounts exceeding that limit require prior approval by the institution. Merchants also may be assessed a fee for imprinters or promotional materials. The merchant deposits the institution credit card sales draft at the institution and receives immediate credit for the discounted amount. The institution assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. Monthly statements are rendered by the institution to the customer who may elect to remit the entire amount, generally without service charge, or pay in monthly installments, with an additional percentage charged on the outstanding balance each month. A cardholder also may obtain cash advances from the institution or dispensing machines. Those advances accrue interest from the transaction date. An institution may be involved in a credit card plan in three ways:

- Agent Bank, which receives credit card applications from customers and sales drafts from merchants and forwards such documents to banks described below, and is accountable for such documents during the process of receiving and forwarding.
- Sublicensee Bank, which maintains accountability for credit card loans and merchant's accounts; may maintain its own center for processing payments and drafts; and may maintain facilities for embossing credit cards.
- Licensee Bank, which is the same as sublicensee institution, but in addition may perform transaction processing and credit card embossing services for sublicensee banks, and also acts as a regional or national clearinghouse for sublicensee banks.

Check credit and credit card loan policies typically address procedures for careful screening of account applicants; establishment of internal controls to prevent interception of cards before delivery, merchants from obtaining control of cards, or customers from making fraudulent use of lost or stolen card; frequent review of delinquent accounts, accounts where payments are made by drawing on reserves, and accounts with steady usage; delinquency notification procedures; guidelines for realistic charge-offs; removal of accounts from delinquent status (curing) through performance not requiring a catch-up of delinquent principal; and provisions that preclude automatic reissuance of expired cards to obligors with charged-off balances or an otherwise unsatisfactory credit history with the institution.

Examination procedures for reviewing these activities are included in the ED Modules. Also, the FDIC has separate manuals on Credit Card Specialty Bank Examination Guidelines and Credit Card Securitization Activities.

Credit Card-related Merchant Activities

Merchant credit card activities basically involve the acceptance of credit card sales drafts for clearing by a financial institution (clearing institution). For the clearing institution, these activities are generally characterized by thin profit margins amidst high transactional and sales volumes. Typically, a merchant's customer will charge an item on a credit card, and the clearing institution will give credit to the merchant's account. Should the customer dispute a charge transaction, the clearing institution is obligated to honor the customer's legitimate request to reverse the transaction. The Clearing Institution must then seek reimbursement from the merchant. Problems arise when the merchant is not creditworthy and is unable, or unwilling, to reimburse the clearing institution. In these instances, the clearing institution will incur a loss. Examiners should review for the existence of any such contingent liabilities.

To avoid losses and to ensure the safe and profitable operation of a clearing institution's credit card activities, the merchants with whom it contracts for clearing services should be financially sound and honestly operated. To this end, safe and sound merchant credit card activities include clear and detailed acceptance standards for merchants, such as the following:

- Scrutinizing prospective merchants using the same care and diligence used in evaluating prospective borrowers.
- Closely monitoring merchants with controls to ensure that early warning signs are recognized so that problem merchants can be removed from a clearing institution's program promptly to minimize loss exposure.
- Establishing an account administration program that incorporates periodic reviews of merchants' financial statements and business activities in cases of merchants clearing large dollar volumes.
- Establishing an internal periodic reporting system of merchant account activities regardless of the amount or number of transactions cleared, with these reports

reviewed for irregularities so problematic merchant activity is identified quickly.

- Developing policies that follow the guidelines established by the card issuing networks.

Another possible problem with merchant activities involves clearing institutions that sometimes engage the services of agents, such as an independent sales organization (ISO). ISOs solicit merchants' credit card transactions for a clearing institution. In some cases, the ISOs actually contract with merchants on behalf of clearing institutions. Some of these contracts are entered into by the ISOs without the review and approval of the clearing institutions. At times, clearing institutions unfortunately rely too much on the ISOs to oversee account activity. In some cases, clearing institutions have permitted ISOs to contract with disreputable merchants. Because of the poor condition of the merchant, or ISO, or both, these clearing institutions can ultimately incur heavy losses.

A financial institution with credit card clearing activities typically develops its own internal controls and procedures to ensure sound agent selection standards before engaging an ISO. ISOs that seek to be compensated solely on the basis of the volume of signed-up merchants should be carefully scrutinized. A clearing institution should adequately supervise the ISO's activities, just as the institution would supervise any third party engaged to perform services for any aspect of the institution's operations. Also, institutions typically and appropriately reserve the right to ratify or reject any merchant contract that is initiated by an ISO.

Examination procedures for reviewing credit card related merchant activities are included in the ED Modules in the Supplemental Modules Section and in the Credit Card Activities Manual.

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OTHER CREDIT ISSUES

Appraisals

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property; the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and are referenced in parallel regulations issued by each of the federal banking agencies. When evaluating collateral, the three valuation approaches are not equally appropriate.

- **Cost Approach -** In this approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.
- **Market Data or Direct Sales Comparison Approach -** This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling prices. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data is typically available. When adequate sales data is available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties is not sufficient to justify a conclusion.
- **The Income Approach -** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in depressed markets, value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property. The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, the more explicit discounted cash flow (net present value) method is more typically utilized for analytical purposes. In the rent method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value

represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales is often difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity - not just in today's market but over time - offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses, and rates of occupancy. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. If current market activity is dominated by a limited number of transactions or liquidation sales, high capitalization and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are neither highly speculative nor depressed.

Appraisal Regulation

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 requires that appraisals prepared by certified or licensed appraisers be obtained in support of real estate lending and mandates that the federal financial institutions regulatory agencies adopt regulations regarding the preparation and use of appraisals in certain real estate related transactions by financial institutions under their jurisdiction. In addition, Title XI created the Appraisal Subcommittee of the Federal Financial Institutions Examination Council (FFIEC) to provide oversight of the real estate appraisal process as it relates to federally related real estate transactions. The Appraisal Subcommittee is composed of six members, each of whom is designated by the head of their respective agencies. Each of the five financial institution regulatory agencies which comprise the FFIEC and the U.S. Department of Housing and Urban Development are represented on the Appraisal Subcommittee. A responsibility of the Appraisal Subcommittee is to monitor the state certification and licensing of appraisers. It has the authority to disapprove a state appraiser regulatory program, thereby disqualifying the state's licensed and certified appraisers from conducting appraisals for federally related transactions. The Appraisal Subcommittee also has the authority to temporarily waive the credential requirement if certain criteria are met. The Appraisal Subcommittee gets its funding by charging state certified and licensed appraisers an annual registration fee. The fee income is used to cover Appraisal Subcommittee administrative expenses and to provide grants to the Appraisal Foundation.

Formed in 1987, the Appraisal Foundation was established as a private not for profit corporation bringing together interested parties within the appraisal industry, as well as users of appraiser services, to promote professional standards within the appraisal industry. The Foundation sponsors two independent boards referred to in Title XI, The Appraiser Qualifications Board (AQB) and The Appraisal Standards Board (ASB). Title XI specifies that the minimum standards for state appraiser certification are to be the criteria for certification issued by the AQB. Title XI does not set specific criteria for the licensed classification. These are individually determined by each state. Additionally, Title XI requires that the appraisal standards prescribed by the federal agencies, at a minimum, must be the appraisal standards promulgated by the ASB. The ASB has issued The Uniform Standards of Professional Appraisal Practice (USPAP) which set the appraisal industry standards for conducting an appraisal of real estate. To the appraisal industry, USPAP is analogous to generally accepted accounting principles for the accounting profession.

In conformance with Title XI, Part 323 of the FDIC regulations identifies which real estate related transactions require an appraisal by a certified or licensed appraiser and establishes minimum standards for performing appraisals. Substantially similar regulations have been adopted by each of the federal financial institutions regulatory agencies.

Real estate-related transactions include real estate loans, mortgage-backed securities, institution premises, real estate investments, and other real estate owned. All real estate-related transactions by FDIC-insured institutions not specifically exempt are, by definition, "federally related transactions" subject to the requirements of the regulation. Exempt real estate-related transactions include:

(1) The transaction is a residential real estate transaction that has a transaction value of $400,000 or less;
(2) A lien on real estate has been taken as collateral in an abundance of caution;
(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;
(5) The transaction is a business loan that: (i) has a transaction value of $1 million or less; and (ii) is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
(7) The transaction involves an existing extension of credit at the lending institution, provided that: (i) There has been no obvious and material change in the market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
(8) 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 mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met FDIC regulatory requirements for appraisals at the time of origination;
(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;
(10) The transaction either; (i) Qualifies for sale to a United States government agency or United States government sponsored agency; or (ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;
(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law;
(12) The FDIC determines that the services of an appraiser are not necessary in order to protect federal financial and public policy interests in real estate-related financial transaction or to protect the safety and soundness of the institution;
(13) The transaction is a commercial real estate transaction that has a transaction value of $500,000 or less; or
(14) The transaction is exempted from the appraisal requirement pursuant to the rural residential exemption under 12 U.S.C. 3356.

The regulation also requires an institution to obtain an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices for a transaction that does not require the services of a state certified or licensed appraiser per exemption (1), (5), (7), (13), or (14).

Section 323.4 establishes minimum standards for all appraisals in connection with federally related transactions. Appraisals performed in conformance with the regulation must conform to the requirements of the USPAP and certain other listed standards. The applicable sections of USPAP are the Preamble (ethics and competency), Standard 1 (appraisal techniques), Standard 2 (report content), and Standard 3 (review procedures). USPAP Standards 4 through 10 concerning appraisal services and appraising personal property do not apply to federally related transactions. An appraisal satisfies the regulation if it is performed in accordance with all of its provisions and it is still current and meaningful. The regulation also requires that the appraisal report contain the appraiser's certification that the appraisal was prepared in conformance with USPAP.

In addition, the regulation requires appraisals for federally related transactions to be subject to appropriate review for compliance with USPAP. Specific review procedures in an institution's written appraisal program that produce some form of documented evidence would facilitate meeting this regulatory requirement. Procedures for maintaining some form of documented evidence of the review of other appraisals help ensure those appraisals facilitate making informed lending decisions. Examiners should note that such evidence could take the form of an appraisal checklist that includes the signature of an appropriately trained external person or an internal staff member, indicates the appraisal was reviewed, and finds that all USPAP standards were met. An effective appraisal program's review escalation procedures will facilitate internal staff's ability to take appropriate action to address appraisals that do not comply with USPAP.

Adherence to the appraisal regulations should be part of the examiner's overall review of the lending function. When analyzing individual transactions, examiners should review appraisal reports to determine the institution's conformity to its own internal appraisal policies and for compliance with the regulation. Examiners may need to conduct a more detailed review if the appraisal does not have sufficient information, does not explain assumptions, is not logical, or has other major deficiencies that cast doubt as to the validity of its opinion of value. Examination procedures regarding appraisal reviews are included in the Examination Documentation Modules.

Loans in a pool such as an investment in mortgage- backed securities or collateralized mortgage obligations should have some documented assurance that each loan in the pool has an appraisal in accordance with the regulation.

Appropriate evidence could include an issuer's certification of compliance.

All apparent violations of Part 323 should be listed in the examination report in the usual manner. Significant systemic failures to meet standards and procedures could call for formal corrective measures.

Interagency Appraisal and Evaluation Guidelines

The Interagency Appraisal and Evaluation Guidelines dated December 2, 2010 address supervisory matters relating to real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards that are consistent with the appraisal regulation.

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. An institution's policies and procedures typically are incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners should review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and comply with the agencies' appraisal regulations and the institution's internal policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program **-** An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. Effective programs:

- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations;
- Provide for the independence of the person performing appraisals or evaluations;
- Identify the appropriate appraisal for various lending transactions;
- Establish criteria for contents of an evaluation;
- Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision;
- Assess the validity of existing appraisals or evaluations to support subsequent transactions;
- Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations; and
- Establish internal controls that promote compliance with these program standards.

<u>Selection of Individuals Who May Perform Appraisals and Evaluations</u> **-** An institution's program establishes criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. Appropriate criteria ensure that:

- The selection process is non-preferential and unbiased;
- The individual selected possesses the requisite education, expertise and competence to complete the assignment;
- The individual selected is capable of rendering an unbiased opinion; and
- The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. Also, an institution may not use an appraisal that has been "readdressed" – appraisal reports that are altered by the appraiser to replace any references to the original client with the institution's name. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

<u>Independence of the Appraisal and Evaluation Function</u> **-** Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. In addition, individuals independent from the loan production area should oversee the selection of appraisers and individuals providing evaluation services. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process. That is, no

single person should have sole authority to render credit decisions on loans which they ordered or reviewed appraisals or evaluations.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals - Although the agencies' appraisal regulations exempt certain categories of real estate-related financial transactions from the appraisal requirements, most real estate transactions over $400,000 ($500,000 for commercial real estate transactions) are considered federally related transactions and thus require appraisals. A "federally related transaction" means any real estate-related financial transaction, in which the agencies engage, contract for, or regulate and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.

Minimum Appraisal Standards - The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must:

- Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards. Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise;
- Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction. As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.
- Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units. This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy;
- Be based upon the definition of market value set forth in the regulation. Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations; and
- Be performed by state licensed or certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options - An appraiser typically uses three market value approaches to analyze the value of a property cost, income, and sales market. The appraiser reconciles the results of each approach to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards - without departing from any binding requirements - and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value;

however, departure from standards designated as binding requirements is not permitted. There are numerous binding requirements which are detailed in the USPAP. Use of the USPAP Standards publication as a reference is recommended. The book provides details on each appraisal standard and advisory opinions issued by the Appraisal Standards Board.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulated report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations - A formal opinion of market value prepared by a state licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. Additionally, prudent institutions establish criteria for obtaining appraisals or evaluations for safety and soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content - Prudent standards for preparing evaluations typically require that evaluations:

- Be written;
- Include the preparer's name, address, and signature, and the effective date of the evaluation;
- Describe the real estate collateral, its condition, its current and projected use;
- Describe the source(s) of information used in the analysis;
- Describe the analysis and supporting information; and
- Provide an estimate of the real estate's market value, with any limiting conditions.

An appropriate evaluation report includes calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An appropriate evaluation provides an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices may include more detailed evaluations as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property describes the current and expected use of the property and includes an analysis of the property's rental income and expenses.

Qualifications of Evaluation Providers **-** Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Well-managed institutions document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use state licensed or certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate-related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations **-** The institution may use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program includes criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions **-** The agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings; however, in certain situations an appraisal is required. If new funds are advanced in excess of reasonable closing costs, an institution is expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or in the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the regulatory exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds would be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance **-** Appropriate appraisal and evaluation programs establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appraisal regulations should ensure that the institution's appraisals and evaluations comply with the appraisal regulations and the institution's program. Typically, loan administration files document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Examiners should determine whether corrective action for noted deficiencies was undertaken by the individual who prepared the appraisal or evaluation.

Effective appraisal and evaluation programs have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures are typically designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations are responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Examiners should be mindful that changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state licensed or certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring - The institution also typically develops criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques, even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals - Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state licensed or certified appraiser violates USPAP, applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

Examination Treatment

All apparent violations of the appraisal regulation should be described in the schedule of violations of laws and regulations. Management's comments and any commitments for correcting the practices that led to the apparent violation should be included. Violations that are technical in nature and do not impact the value conclusion generally should not require a new appraisal. (These technical violations should not be relisted in subsequent examinations.) Since the point of an appraisal is to help make sound loan underwriting decisions, getting an appraisal on a loan already made simply to fulfill the requirements of the appraisal regulation, would be of little benefit. However, an institution should be expected to obtain a new appraisal on a loan in violation of the appraisal regulation when there is a safety and soundness reason for such action. For example, construction loans and lines of credit need to have the value of the real estate reviewed frequently in order for the institution to properly manage the credit relationship. A new appraisal might also be needed to determine the proper classification for examination purposes of a collateral dependent loan.

Loan Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead institution originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead (originating) institution retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests which would otherwise exceed lending limits, diversify risk, and improve liquidity. Participating banks are able to compensate for low local loan demand or invest in large loans without servicing burdens and origination costs. If not appropriately structured and documented, a participation loan can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement as well as analyze the credit quality of the loan.

Accounting

The proper accounting treatment for loan participations is governed by ASC Topic 860, *Transfers and Servicing,* that applies to the transferor (seller) of assets and the transferee (purchaser).

Before considering whether the conditions for a sale have been met, the transfer of a portion of an entire financial asset must first meet the definition of a participating interest.

A participating interest in an entire financial asset, as defined in ASC Topic 860, has all of the following characteristics:

- From the date of transfer, it must represent a proportionate (pro-rata) ownership interest in the entire financial asset;
- From the date of the transfer, all cash flows received from the entire financial asset, except any cash flows allocated as compensation for servicing or other services performed (which must not be subordinated and must not significantly exceed an amount that would fairly compensate a substitute service provider should one be required), must be divided proportionately among the participating interest holders in an amount equal to their share of ownership;
- The rights of each participating interest holder (including the lead lender) must have the same priority, no interest is subordinated to another interest, and no participating interest holder has recourse to the lead lender or another participating interest holder other than standard representations and warranties and ongoing contractual servicing and administration obligations; and
- No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

If the financial asset meets the definition of a participating interest, the institution must then determine if the participating interest qualifies for sale treatment. The sale criteria focus on whether or not control is effectively transferred to the purchaser.

A transfer of an entire financial asset, a group of financial assets, or a participating interest in an entire financial asset in which the transferor surrenders control over those financial assets shall be accounted for as a sale if and only if all of the following conditions are met:

- The transferred financial assets have been isolated from the seller, meaning that the purchaser's interest in the loan is presumptively beyond the reach of the seller and its creditors, even in bankruptcy or other receivership;
- Each purchaser has the right to pledge or exchange its interest in the loan, and there are no conditions that both constrain the purchaser from taking advantage of that right to pledge or exchange and provide more than a trivial benefit to the seller; and
- The seller or their agents do not maintain effective control over the transferred financial assets. Examples of a seller maintaining effective control include an agreement that both entitles and obligates the seller to repurchase or redeem the purchaser's interest in the loan prior to the loan's maturity, an agreement that provides the seller with the unilateral ability to cause the purchaser to return its interest in the loan to the seller (other than through a cleanup call), or an agreement that permits the purchaser to require the seller to repurchase its interest in the loan at a price so favorable to the purchaser that it is probable that the purchaser will require the seller to repurchase.

Right to Repurchase

Some loan participation agreements may give the seller a contractual right to repurchase the participated interest in the loan at any time. In this case, the seller's right to repurchase the participation effectively provides the seller with a call option on a specific asset that would preclude sale accounting if the asset is not readily obtainable in the marketplace. If a loan participation agreement contains such a provision, freestanding or attached, it constrains the purchaser from pledging or exchanging its participating interest, and results in the seller maintaining effective control over the participating interest. In such cases, the transfer would be accounted for as a secured borrowing.

For additional information on the transfer of loan participations refer to the Call Report Glossary entry: “Transfers of Financial Assets”.

Recourse Arrangements

Recourse arrangements may, or may not, preclude loan participations from being accounted for as sales for financial reporting purposes. The date of the participation and the formality of the recourse provision affect the accounting for the transaction. Formal recourse provisions may affect the accounting treatment of a participation depending upon the date that the participation is transferred to another institution. Implicit recourse provisions would not affect the financial reporting treatment of a participation because the accounting standards look to the contractual terms of asset transfers in determining whether or not the criteria necessary for sales accounting treatment have been met. Although implicit recourse provisions would not affect the accounting treatment of a loan participation, they may affect the risk-based capital treatment of a participation.

If an originating selling institution has transferred a loan participation to a participating institution with recourse on or before December 31, 2001, the existence of the recourse obligation in and of itself does not preclude sale accounting for the transfer. If a loan participation transferred with recourse on or before December 31, 2001, meets the three conditions then in effect for the transferor to have surrendered control over the transferred assets, the transfer should be accounted for as a sale for financial reporting purposes. However, a loan participation sold with recourse is subject to the banking agencies’ risk-based capital requirements.

If an originating selling institution transfers a loan participation with recourse on or after January 1, 2002, the participation generally will not be considered isolated from the originating lender in an FDIC receivership. Section 360.6 of the FDIC Rules and Regulations limits the FDIC's ability to reclaim loan participations transferred *without recourse* as defined in the regulations, but does not limit the FDIC's ability to reclaim loan participations transferred with recourse. Under Section 360.6, a participation subject to an agreement that requires the originating lender to repurchase the participation or to otherwise compensate the participating institution due to a default on the underlying loan is considered a participation *with recourse*. As a result, a loan participation transferred *with recourse* on or after January 1, 2002, generally should be accounted for as a secured borrowing and not as a sale for financial reporting purposes. This means that the originating lender should not remove the participation from its loan assets on the balance sheet, but should report the loan participation as a secured borrowing.

Call Report Treatment

When a loan participation meets the definition of a participating interest and the conditions for sale treatment are met, the seller removes the participated interest in the loan from the balance sheet. The purchaser reports the participating interest in “Loans” in the Report of Condition, and in Call Report Schedule RC-C - Loans and Lease Financing Receivables, based upon collateral, borrower, or purpose. When a loan participation does not meet the definition of a participating interest, or if a transfer of a participating interest does not meet all of the conditions for sale accounting, the transfer must be reported as a secured borrowing with a pledge of collateral. In these situations, because the transferred loan participation does not qualify for sale accounting, the transferring institution must continue to report the transferred participation (as well as the retained portion of the loan) in “Loans” in the Report of Condition, based upon collateral, borrower, and purpose. As a consequence, the transferred loan participation should be included in the originating lender’s loans and leases for purposes of determining the appropriate level for the institution’s allowance for loan and lease losses. The transferring institution should also report the transferred loan participation as a secured borrowing in “Other Borrowed Money” in the Report of Condition.

Independent Credit Analysis

An institution purchasing a participation loan is expected to perform the same degree of independent credit analysis on the loan as if it were the originator. To determine if a participation loan meets its credit standards, a participating institution must obtain all relevant credit information and details on collateral values, lien status, loan agreements and participation agreements before a commitment is made to purchase. The absence of such information may be evidence that the participating institution has not been prudent in its credit decision.

During the life of the participation, the participant should monitor the servicing and the status of the loan. In order to exercise control of its ownership interest, a purchasing institution must ascertain that the selling institution will provide complete and timely credit information on a continuing basis.

The procedures for purchasing loan participations should be provided for in the institution's formal lending policy. The criteria for participation loans should be consistent with that for similar direct loans. The policy would normally require the complete analysis of the credit quality of obligations to be purchased, determination of value and lien status of collateral, and the maintenance of full credit information for the life of the participation.

Participation Agreements

A participation loan can present unique problems if the borrower defaults, the lead institution becomes insolvent, or a party to the participation arrangement does not perform as expected. These contingencies should be considered in a written participation agreement. The agreement should clearly state the limitations the originating and participating banks impose on each other and the rights all parties retain. In addition to the general terms of the participation transaction, comprehensive participation agreements specifically include the following considerations:

- The obligation of the lead institution to furnish timely credit information and to provide notification of material changes in the borrower's status;
- Requirements that the lead institution consult with participants prior to modifying any loan, guaranty, or security agreements and before taking any action on defaulted loans;
- The specific rights and remedies available to the lead and participating banks upon default of the borrower;
- Resolution procedures when the lead and participating banks cannot agree on the handling of a defaulted loan;
- Resolution of any potential conflicts between the lead institution and participants in the event that more than one loan to the borrower defaults; and
- Provisions for terminating the agency relationship between the lead and participating banks upon such events as insolvency, breach of duty, negligence, or misappropriation by one of the parties.

Participations Between Affiliated Institutions

Examiners should ascertain that banks do not relax their credit standards when dealing with affiliated institutions and that participation loans between affiliated institutions comply with Section 23A of the Federal Reserve Act. The Federal Reserve Board’s staff has interpreted that the purchase of a participation loan from an affiliate is exempt from Section 23A provided that the commitment to purchase is obtained by the affiliate before the loan is consummated by the affiliate, and the decision to participate is based upon the institution's independent evaluation of the creditworthiness of the loan. If these criteria are not strictly met, the loan participation could be subject to the qualitative and/or quantitative restrictions of Section 23A. Refer to the Related Organizations Section of this Manual which describes transactions with affiliates.

Sales of 100 Percent Loan Participations

In some cases, depository institutions structure loan originations and participations with the intention of selling 100 percent of the underlying loan amount. Certain 100 percent loan participation programs raise unique safety and soundness issues that should be addressed by an institution’s policies, procedures, and practices.

If not appropriately structured, these 100 percent participation programs can present unwarranted risks to the originating institution including legal, and compliance risks. Therefore, agreements to mitigate these risks clearly state the limitations the originating and participating institutions impose on each other and the rights all parties retain. This typically includes the originating institution stating that loan participants are participating in loans and are not investing in a business enterprise. The policies of an institution engaged in these originations typically address safety and soundness concerns and include criteria to address:

- The program's objectives – these should be of a commercial nature (structured as commercial undertakings and not as investments in securities).
- The plan of distribution – participants should be limited to sophisticated financial and commercial entities and sophisticated persons and the participations should not be sold directly to the public.
- The credit requirements applicable to the borrower - the originating institution should structure 100% loan participation programs only for borrowers who meet the originating institution's credit requirements.
- Access afforded program participants to financial information on the borrower - the originating institution should allow potential loan participants to obtain and review appropriate credit and other information to enable the participants to make an informed credit decision.

Environmental Risk Program

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors for institution management to consider in evaluating real estate transactions and making loans secured by real estate. Institutions that establish appropriate environmental risk programs lower their potential liability for certain types of environmental risks and penalties per the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA).[1]

An appropriate environmental risk program is consistent with the safety and soundness standards prescribed in Appendix A to Part 364 of the FDIC Rules and Regulations. The environmental risk program enables institution management to make an informed lending decision and to assess risk, as necessary, and helps provide for consideration of the nature and value of any underlying collateral. Such a program also is consistent with the real estate lending standards prescribed in Part 365 of the FDIC's Rules and Regulations relating to compliance with all real estate related laws and regulations, which include the CERCLA.

Thus, examiners should verify that institutions maintain an environmental risk program to evaluate the potential adverse effect of environmental contamination on the value of real property and the potential environmental liability associated with the real property. An effective environmental risk program aids management's decision-making process by establishing procedures for identifying and evaluating potential environmental concerns associated with lending practices and other actions relating to real property.

Examiners should determine whether the board of directors reviews and approves the program periodically and designates a senior officer knowledgeable in environmental matters to be responsible for program implementation. Examiners should assess whether the environmental risk program is commensurate with the institution's operations. That is, institutions that have a heavier concentration of loans to higher risk industries or localities of known contamination may require a more elaborate and sophisticated environmental risk program than institutions that lend more to lower risk industries or localities. For example, loans collateralized by 1- to 4-family residences normally have less exposure to environmental liability than loans to finance industrial properties.

Elements of an Effective Environmental Risk Program

The environmental risk program typically provides for staff training, sets environmental policy guidelines and procedures, requires an environmental review or analysis during the application or due diligence process, includes loan documentation standards, and establishes appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

Training

The environmental risk program generally incorporates training sufficient to ensure that the environmental risk program is implemented and followed, and that the appropriate personnel have the knowledge and experience to identify and evaluate potential environmental concerns that might affect the institution, including its interests in real property. Such training programs typically address circumstances where the complexity of the environmental issue is beyond the expertise of the institution's staff to adequately assess by instructing staff to consult legal counsel, environmental consultants, or other qualified experts.

[1] See CERCLA, as amended by the Superfund Amendments and Reauthorization Act of 1986, 42 U.S.C. §§ 9601 *et seq.*, the Resource Conservation and Recovery Act of 1976, as amended, 42 U.S.C. §§ 6901 *et seq.*, and the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996 (Asset Conservation Act).

Policies

Loan policies and written procedures typically address environmental issues pertinent to the institution's specific lending activities. For example, the lending policy may identify the types of environmental risks associated with industries and real estate in the institution's trade area, provide guidelines for conducting an analysis of potential environmental liability, and describe procedures for the resolution of potential environmental concerns. Procedures for the resolution of environmental concerns might also be developed for credit monitoring, loan workout situations, and foreclosures.

Environmental Risk Analysis

Examiners should determine whether management conducts an initial environmental risk analysis during the application process prior to making a loan. An appropriate analysis helps management to minimize potential environmental liability and facilitates implementation of appropriate mitigation strategies prior to closing a loan. Much of the needed information may be gathered by the account officer when interviewing the loan applicant concerning his or her business activities. Some institutions use the loan application to request relevant environmental information, such as the present and past uses of the property and the occurrence of any contacts by federal, state or local governmental agencies about environmental matters. For some transactions, the loan officer or other representative of an institution may visit the site to evaluate whether there is obvious visual evidence of environmental concerns; such visits are usually documented in the loan file.

Structured Environmental Risk Assessment

Whenever the application, interview, or visitation indicates a possible environmental concern, examiners should determine whether a more detailed structured investigation was conducted by a qualified individual. This investigation may include surveying prior owners of the property, researching past uses of the property, inspecting the site and contiguous parcels, and reviewing company records for past use or disposal of hazardous materials. A review of public records and contact with federal and state environmental protection agencies often helps institution management determine whether the borrower has been cited for violations concerning environmental laws or if the property has been identified on federal and state lists of real property with significant environmental contamination. Examiners should also determine whether the institution's policies and procedures consider the Environmental Protection Agency's (EPA) "All Appropriate Inquiry Rule."

EPA All Appropriate Inquiry Rule – In January 2002, Congress amended the CERCLA to establish, among other things, additional protections from cleanup liability for a new owner of a property. The bona fide prospective purchaser provision establishes that a person may purchase property with the knowledge that the property is contaminated without being held potentially liable for the cleanup of contamination at the property.

The new owner must meet certain statutory requirements to qualify as a bona fide prospective purchaser and, prior to the date of acquiring the property, undertake "all appropriate inquiries" into the prior ownership and uses of the property.

In November 2005, the EPA promulgated its "Standards and Practices for All Appropriate Inquiries" final rule (EPA All Appropriate Inquiry Rule) which establishes the standards and practices that are necessary to meet the requirements for an "all appropriate inquiry" into the prior ownership and uses of a property. The All Appropriate Inquiry Rule became effective on November 1, 2006.

An environmental evaluation of the property that meets the standards and practices of the EPA All Appropriate Inquiry Rule will provide the borrower with added protection from CERCLA cleanup liability, provided the borrower meets the requirements to be a bona fide purchaser and other statutory requirements. This protection, however, is limited to CERCLA and does not apply to the Resource Compensation and Recovery Act (RCRA), including liability associated with underground storage tanks, and other federal environmental statutes, and, depending on state law, state environmental statutes. In addition, such an environmental evaluation may provide a more detailed assessment of the property than an evaluation that does not conform to the EPA All Appropriate Inquiry Rule.

Examiners should determine whether, as part of its environmental risk analysis of any particular extension of credit, a lender evaluates whether it is appropriate or necessary to require the borrower to perform an environmental evaluation that meets the standards and practices of the EPA All Appropriate Inquiry Rule. This decision involves judgment and is made on a case-by-case basis considering the risk characteristics of the transaction, the type of property, and the environmental information gained during an initial environmental risk analysis. If indications of environmental concern are known or discovered during the loan application process, an institution may decide to require the borrower to perform an environmental evaluation that meets the requirements of the EPA All Appropriate Inquiry Rule.

The decision to require the borrower to perform a property assessment that meets the requirements of the EPA All Appropriate Inquiry Rule is generally made in the context of the institution's environmental risk program. An effective environmental risk program is generally designed to ensure management makes an informed judgment about potential environmental risk and considers such risks in its overall consideration of risks associated with the extension of credit. In addition, an institution's environmental risk program may be tailored to its lending practices. Thus, a lender makes its decision concerning when and under what circumstances to require the borrower to perform an environmental property assessment based on its environmental risk program. Individuals who administer an institution's environmental risk program are typically familiar with these statutory elements. More information concerning the EPA All Appropriate Rule can be found on the EPA website at EPA-Brownfields Link.

Monitoring

Examiners should assess whether the environmental risk assessment continues during the life of the loan, including monitoring the borrower and the real property collateral for potential environmental concerns. Examiners should assess whether loan officers are aware of changes in the business activities of a borrower that may result in a significant increase in risk of environmental liability associated with real property collateral. When there is a potential for environmental contamination to adversely affect the value of the collateral, management might exercise its rights under the loan covenants to require the borrower to resolve the environmental condition and to take actions to protect the value of the real property.

Loan Documentation

Loan documents typically include language to safeguard the institution against potential environmental losses and liabilities. Such language might require that the borrower comply with environmental laws, disclose information about the environmental status of the real property collateral, and grant the institution the right to acquire additional information about potential hazardous contamination by inspecting the collateral property for environmental concerns. The loan documents might also provide the institution the right to call the loan, refuse to extend funds under a line of credit, or foreclose if hazardous contamination is discovered. The loan documents might also call for an indemnity of the institution by the borrower and guarantors for environmental liability associated with the real property collateral.

Involvement in the Borrower's Operations

Under CERCLA and many state environmental cleanup statutes, an institution may have an exemption from environmental liability as the holder of a security interest in real property collateral. Examiners should determine whether institution management, in monitoring a loan, takes action to resolve environmental situations and evaluates whether its actions may constitute "participating in the management" of the business located on the real property collateral within the meaning of CERCLA. If its actions are considered participation in the management, the institution may lose its exemption from liability under CERCLA or similar state statutes.

Foreclosure

A lender's exposure to environmental liability may increase significantly if it takes title to real property held as collateral. Examiners should determine whether management evaluates the potential costs and liability for environmental contamination in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means. Based on the type of property involved, a lender often includes as part of this evaluation of potential environmental liability, an assessment of the property that meets the requirements of the EPA All Appropriate Inquiry Rule.

Examination Procedures

Examiners should review an institution's environmental risk program as part of the examination of lending and investment activities. When analyzing individual credits, examiners should review the institution's compliance with its environmental risk program. Failure to establish or comply with an appropriate environmental program is to be criticized.

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LOAN PROBLEMS

It would be impossible to list all sources and causes of problem loans. They cover a multitude of mistakes an institution may permit a borrower to make, as well as mistakes directly attributable to weaknesses in the institution's credit administration and management. Some well-constructed loans may develop problems due to unforeseen circumstances on the part of the borrower; however, institution management must endeavor to protect a loan by every means possible. One or more of the items in the following list is often basic to the development of loan problems.

Many of these items may also be indicative of potential institution fraud and/or insider abuse. Additional information on the warning signs and suggested areas for investigation are included in the Bank Fraud and Insider Abuse Section of this Manual.

Poor Selection of Risks

Problems in this area may reflect the absence of sound lending policies, and/or management's lack of sound credit judgment in advancing certain loans. The following are general types of loans which may fall within the category of poor risk selection. It should be kept in mind that these examples are generalizations, and the examiner must weigh all relevant factors in determining whether a given loan is indeed a poor risk.

- Loans to finance new and untried business ventures which are inadequately capitalized.
- Loans based more upon the expectation of successfully completing a business transaction than on sound worth or collateral.
- Loans for the speculative purchase of securities or goods.
- Collateral loans made without adequate margin of security.
- Loans made because of other benefits, such as the control of large deposit balances, and not based upon sound worth or collateral.
- Loans made without adequate owner equity in underlying real estate security.
- Loans predicated on collateral which has questionable liquidation value.
- Loans predicated on the unmarketable stock of a local corporation when the institution is at the same time lending directly to the corporation. Action which may be beneficial to the institution from the standpoint of the one loan may be detrimental from the standpoint of the other loan.
- Loans which appear to be adequately protected by collateral or sound worth, but which involve a borrower of poor character risk and credit reputation.
- Loans which appear to be adequately protected by collateral, but which involve a borrower with limited or unassessed repayment ability.
- An abnormal amount of loans involving out-of-territory borrowers (excluding large banks properly staffed to handle such loans).
- Loans involving brokered deposits or link financing.

Overlending

It is almost as serious, from the standpoint of ultimate losses, to lend a sound financial risk too much money as it is to lend to an unsound risk. Loans beyond the reasonable capacity of the borrower to repay invariably lead to the development of problem loans.

Failure to Establish or Enforce Liquidation Agreements

Loans granted without a well-defined repayment program violate a fundamental principle of sound lending. Regardless of what appears to be adequate collateral protection, failure to establish at inception or thereafter enforce a program of repayment almost invariably leads to troublesome and awkward servicing problems, and in many instances is responsible for serious loan problems including eventual losses. This axiom of sound lending is important not only from the lender's standpoint, but also the borrower’s.

Incomplete Credit Information

Lending errors frequently result because of management's failure to obtain and properly evaluate credit information. Adequate comparative financial statements, income statements, cash flow statements and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing and intended plan or sources of repayment, progress reports, inspections, memoranda of outside information and loan conferences, correspondence, etc., should be contained in the institution's credit files. Failure of an institution's management to give proper attention to credit files makes sound credit judgment difficult if not impossible.

Overemphasis on Loan Income

Misplaced emphasis upon loan income, rather than soundness, almost always leads to the granting of loans possessing undue risk. In the long run, unsound loans usually are far more expensive than the amount of revenue they may initially produce.

Self-Dealing

Pronounced self-dealing practices are often present in serious problem institution situations and in banks which fail. Such practices with regard to loans are found in the form of overextensions of unsound credit to insiders, or their interests, who have improperly used their positions to obtain unjustified loans. Active officers, who serve at the pleasure of the ownership interests, are at times subjected to pressures which make it difficult to objectively evaluate such loans. Loans made for the benefit of ownership interests that are carried in the name of a seemingly unrelated party are sometimes used to conceal self-dealing loans.

Technical Incompetence

Technical incompetence usually is manifested in management's inability to obtain and evaluate credit information or put together a well-conceived loan package. Management weaknesses in this area are almost certain to lead to eventual loan losses. Problems can also develop when management, technically sound in some forms of lending, becomes involved in specialized types of credit in which it lacks expertise and experience.

Lack of Supervision

Loan problems encountered in this area normally arise for one of two reasons:

- Absence of effective active management supervision of loans which possessed reasonable soundness at inception. Ineffective supervision almost invariably results from lack of knowledge of a borrower's affairs over the life of the loan. It may well be coupled with one or more of the causes and sources of loan problems previously mentioned.
- Failure of the board and/or senior management to properly oversee subordinates to determine that sound policies are being carried out.

Lack of Attention to Changing Economic Conditions

Economic conditions, both national and local, are continuously changing, management must be responsive to these changes. This is not to suggest that lending policies should be in a constant state of flux, nor does it suggest that management should be able to forecast totally the results of economic changes. It does mean, however, that bankers should realistically evaluate lending policies and individual loans in light of changing conditions. Economic downturns can adversely affect borrowers' repayment potential and can lessen an institution's collateral protection. Reliance on previously existing conditions as well as optimistic hopes for economic improvement can, particularly when coupled with one or more of the causes and sources of loan problems previously mentioned, lead to serious loan portfolio deterioration.

Competition

Competition among financial institutions for growth, profitability, and community influence sometimes results in the compromise of sound credit principles and acquisition of unsound loans. The ultimate cost of unsound loans outweighs temporary gains in growth, income and influence.

Potential Problem Indicators by Document

The preceding discussions describe various practices or conditions which may serve as a source or cause of weak loans. Weak loans resulting from these practices or conditions may manifest themselves in a variety of ways. While it is impossible to provide a complete detailing of potential "trouble indicators", the following list, by document, may aid the examiner in identifying potential problem loans during the examination process.

- **Debt Instrument -** Delinquency; irregular payments or payments not in accordance with terms; unusual or frequently modified terms; numerous renewals with little or no principal reduction; renewals that include interest; and extremely high interest rate in relation to comparable loans granted by the institution or the going rate for such loans in the institution's market area.
- **Liability Ledger -** Depending on the type of debt, failure to amortize in a regular fashion over a reasonable period of time, e.g., on an annual basis, seasonally, etc.; and a large number of out-of-territory borrowers, particularly in cases where these types of loans have increased substantially since the previous examination.
- **Financial and Operating Statements -** Inadequate or declining working capital position; excessive volume or negative trend in receivables; unfavorable level or negative trend in inventory; no recent aging of receivables, or a marked slowing in receivables; drastic increase in volume of payables; repeated and increasing renewals of carry-over operating debt; unfavorable trends in sales and profits; rapidly expanding expenses; heavy debt-to-worth level and/or deterioration in this relationship; large dividend or other payments without adequate or reasonable earnings retention; and net worth enhancements resulting solely from reappraisal in the value of fixed assets.
- **Cash Flow Documentation -** Absence of cash flow statements or projections, particularly as related to newly established term borrowers; projections indicating an inability to meet required interest and principal payments; and statements reflecting that cash flow is being provided by the sale of fixed assets or nonrecurring situations.
- **Correspondence and Credit Files -** Missing and/or inadequate collateral or loan documentation, such as financial statements, security agreements, guarantees,

assignments, hypothecation agreements, mortgages, appraisals, legal opinions and title insurance, property insurance, loan applications; evidence of borrower credit checks; corporate or partnership borrowing authorizations; letters indicating that a borrower has suffered financial difficulties or has been unable to meet established repayment programs; and documents that reveal other unfavorable factors relative to a line of credit.

- **Collateral -** Collateral evidencing a speculative loan purpose or collateral with inferior marketability characteristics (single purpose real estate, restricted stock, etc.) which has not been compensated for by other reliable repayment sources; and collateral of questionable value acquired subsequent to the extension of the credit.

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SELECTING A LOAN REVIEW SAMPLE IN A RISK-FOCUSED EXAMINATION

Examiners are expected to select a sample of loans that is of sufficient size, scope, and variety to enable them to reach reliable conclusions about the aforementioned aspects of an institution's overall lending function, and tailor the loan review sample based on an institution's business model, complexity, risk profile, and lending activities. The review may include all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other commitments.

Assessing the Risk Profile

Prior to developing the loan review sample, examiners are to assess the risk profile of the loan portfolio by reviewing the institution's management reports and policies as well as agency available information. This includes evaluating concerns detailed in prior Reports of Examination (ROEs), issues detailed in the institution's loan exception reports and internal loan reviews, and the historical accuracy of independent credit rating or grading systems. The Uniform Bank Performance Report provides information relative to loan mix and recent trends, such as concentrations of credit, rapid growth, and loan yields higher or lower than peer in different portfolio segments. Examiners are also to consider changes in local economic or market conditions that could affect the portfolio's risk profile. Numerous economic tools and resources are available to examiners to assist in planning the loan review.

As part of the examination planning activities, examiners are to consider whether management has implemented any material changes in the institution's business lines, loan products, lending policies, markets, or personnel since the prior examination. Additionally, examiners should consider whether activities conducted by a branch, subsidiary, affiliate, or third party partner warrant particular attention.

Examiners are to consider the historical adequacy of the institution's policies and practices relative to credit underwriting, administration, and loan grading for each significant loan type. Examiners should review recent management reports and Board or committee packages before selecting a targeted sample to determine whether the Board of Directors and officers are receiving sufficient information to remain abreast of emerging trends and changes in the loan portfolio's risk profile.

Selecting the Sample

The size and composition of the loan sample should be commensurate with the quantity of credit risk, the adequacy of risk management practices, and the institution's financial condition and business model. There are no established or expected levels of minimum or maximum coverage, or penetration, ratios for loan review samples. Rather, examiners should use judgment when determining the focus and extent of loan sampling. Ensuring that the appropriate types of loans are in the sample is more meaningful than how much of the overall portfolio is reviewed.

Examiners must make the most efficient use of resources, and should sample loans of sufficient size, scope and variety to enable them to form reliable conclusions about overall credit quality and the adequacy of credit risk management and governance. Examiners' understanding of the institution's business model, risk profile, complexity, external and internal reports, as well as discussions with management, will be highly instrumental in identifying loans to be included in a judgmental sample. Examiners may also leverage the institution's external and internal loan reviews when determining the loan sample. For example, examiners may want to exclude loans already covered in institution loan reviews or follow-up on loans identified as problems in the loan reviews.

If information gathered indicates weaknesses in underwriting or credit administration practices, or if the institution is engaging in lending activities with significant or increasing risk, the examiner should select a robust sample to fully assess the risk areas. Conversely, institutions with stable, well-managed loan functions exhibiting few signs of change should have more streamlined reviews, focusing more on newer originations and less on loans that were deemed of satisfactory quality at previous examinations that continue to perform as agreed. However, in all instances, examiners should sample enough credits, including new and various-sized credits, to assess the adequacy of asset quality, underwriting practices, and credit risk management, in order to support ROE findings and assigned ratings.

Nonhomogeneous Loan Sample

Nonhomogeneous loans include acquisition, development and construction, commercial real estate, commercial and industrial, and agricultural credits. The nonhomogeneous loan sample generally should include a sufficient number of loans to transaction test various segments of the loan portfolio, but it is unnecessary to review all loans in a particular segment. Rather, the loan review should encompass enough loans in each portfolio segment to support examination conclusions about credit quality and credit management practices relative to underwriting standards and credit administration.

In general, a sampling of loans in the following segments should be included in the overall loan review sample, as applicable to a particular institution:

- Adversely classified or listed for Special Mention in prior ROEs.
- Delinquent, nonaccrual, impaired, or renegotiated/restructured (particularly loans with multiple renewals).
- Internally adversely classified by the institution.
- Rated by the institution as a marginally acceptable credit.
- Subject to prior supervisory criticism or corrective actions.
- Upgraded or removed from internal adverse classification since the prior examination, to ensure that procedures for managing the watch list are appropriate.
- Insider loans (directors, officers, employees, principal shareholders, or related interests at any insured depository institution).
- Originated since the prior examination, including those in new or expanding product lines.
- Participations.
- Out of territory.
- Part of a significant credit concentration or growth area.
- Flagged for potential fraud.
- Contain outlier characteristics (e.g. higher risk loans, credits with policy exceptions).
- Originated by specific loan officers, particularly those with known concerns or weaknesses.
- In geographic areas exposed to changes in market conditions.
- Various sized loans (larger, mid-sized, and smaller loan amounts).

As part of a risk-focused and forward-looking approach to loan review, loans that had been reviewed at previous examinations that had sufficient performance, collateral and documentation, and continue to amortize as agreed, may be more appropriate for Discuss Only or not included at all, which would allow more resources to be focused on new originations or other loans not previously reviewed that would help evaluate areas of significant or growing risk.

Homogeneous Pool Sample

Assessing the quality of homogeneous retail consumer credit on a loan-by-loan basis is burdensome for both institutions and examiners due to portfolios generally consisting of a large number of loans with relatively low balances. Instead, examiners should assess the quality of retail consumer loans based on the borrowers' repayment performance. Examiners generally should review and classify retail consumer loans in accordance with the procedures discussed later in this section under the Interagency Retail Credit Classification Policy subheading.

The EIC may supplement the classification of retail loans with a direct review of larger consumer loans or by sampling various segments when the risk assessment supports doing so. Such an expansion may be warranted when homogeneous lending is a major business line of the institution or when examiners note rapid growth, new products, weaknesses in the loan review or audit program, weaknesses in management information systems, or other factors that raise concerns. The EIC also may conduct limited transaction testing to focus on specific risk characteristics, such as the underwriting standards for new loans or the revised terms granted in workouts or modifications.

Sampling for Trading and Derivatives Activities. At institutions that are active in such markets, examiners should include an assessment of credit exposures arising from matching loans with derivatives (generally swaps or forwards) to hedge a particular type of risk. For example, an institution can use a swap to contractually exchange a stream of floating-rate payments for a stream of fixed-rate payments to hedge interest rate risk. Such activities create a credit exposure relative to both the loan and the derivative. When warranted, examiners should review a sufficient number of loan relationships with these exposures to assess the institution's overall exposure and management's ability to prudently manage derivatives activities. Examiners also should review a sample of credit relationships established solely for the purpose of facilitating derivatives activities.

Determining the Depth of the Review

Examiners should assign loans to be reviewed into one of three groupings, "In Scope" (full review), "Discuss Only" (limited review), and, when applicable, "Group" (pooled loans).

In Scope. This sample consists of loans that warrant the most comprehensive level of review. Examiners are to review loan files to the extent needed to assess the risk in the credit, conformance to lending risk management policies and procedures, and compliance with applicable laws and regulations. Examiners should document the assessment of the borrower's repayment capacity, collateral protection, and overall risk to the institution on individual linesheets. Documentation should also note underwriting exceptions, administrative weaknesses, and apparent violations.

For institutions with stable, well-managed loan functions, In Scope loans should generally focus on newer originations and insider loans. In these situations, if certain loans from previous examinations are included In Scope, examiners have the ability to leverage documentation from previous reviews and focus on updates to the essential credit information.

Discuss Only. This sample is to consist of loans subject to a limited level of review, and examiners are to discuss these credits with institution management. Such discussions can be an effective method of confirming the adequacy of loan grading systems and credit administration practices, particularly when the In Scope sample indicates the institution has adequate risk management practices, and when the institution has a stable, well-managed loan function and exhibits few signs of change. Examiners should briefly document key issues raised during these discussions, but examiners do not need to complete full linesheets. When warranted, examiners may conduct a limited file review or assessment of specific work-out plans and performance metrics for these loans.

Credits should be reallocated from Discuss Only to In Scope if management disagrees with the classification, material concerns with credit underwriting or administration practices are identified, or the EIC or Asset Manager determines a more comprehensive review is warranted.

Group. This sample could include loans with similar risk characteristics that merit review on a pooled basis. Examiners generally should discuss or classify the loans not on an individual basis but as a pool, and apply the findings and conclusions to the entire Group. Examiners may use multiple Groups to focus on the adequacy of credit underwriting and administration practices or to address different risk attributes in stratified segments. The Group sample may be appropriate for specific categories of homogeneous retail consumer credit, such as automobile, credit card, or residential mortgage loans.

Adjusting Loan Review

The EIC has the flexibility, after communicating with the case manager and receiving concurrence of field management, to adjust the loan review sample at any point during the examination based on findings. The rationale for significant changes in the examination plan will be clearly communicated to institution management, along with any adjustments to the breadth or depth of procedures, personnel, and examination schedule.

Accepting an Institution's Internal Ratings

If the institution's internal grading system (watch list) is determined to be accurate and reliable, examiners can use the institution's data for preparing the applicable examination report pages and schedules, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio.

Loan Penetration Ratio

The FDIC has not established any minimum or maximum loan penetration ratios.

The objectives for loan review on an examination include an analysis of credit quality through transaction testing and an assessment of credit administration practices. Achieving a specific loan penetration ratio is not to be the driving factor in determining the loan review sample. Rather, examiners should focus on reviewing a sufficient number of loans in various segments of the portfolio to assess overall risk in the portfolio and to support examination findings, and then calculate the resultant loan penetration ratio for informational purposes only and enter the ratio in the Summary Analysis of Examination Report.

Large Bank Loan Review

In addition to point-in-time examinations conducted at most community banks, the FDIC utilizes targeted loan reviews conducted under a supervisory plan, guiding a continuous examination program for certain institutions. These targeted programs are generally warranted to ensure effective monitoring and examination activity related to larger and more complex institutions. While the supervisory plan and continuous examination processes and procedures may differ in some respects from the point in time approach, the principles contained in the preceding loan review instructions are applicable to examination activities for all institutions supervised by the FDIC.

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LOAN EVALUATION AND CLASSIFICATION

Loan Evaluation

To properly analyze any credit, an examiner must acquire certain fundamental information about a borrower's financial condition, purpose and terms of the borrowing, and prospects for its orderly repayment. The process involved in acquiring the foregoing information will necessarily vary with the type and sophistication of records utilized by the institution.

Review of Files and Records

Commercial loan liability ledgers or comparable subsidiary records vary greatly in quality and detail. Generally, they will provide the borrower's total commercial loan liability to the institution, and the postings thereto will depict a history of the debt. Collateral records should be scrutinized to acquire the necessary descriptive information and to ascertain that the collateral held to secure the notes is as transcribed.

Gathering credit information is an important process and should be done with care to obtain the essential information, which will enable the examiner to appraise the loans accurately and fairly. Failure to obtain and record pertinent information contained in the credit files can reflect unfavorably on examiners, and a good deal of examiner and loan officer time can be saved by carefully analyzing the files. Ideally, credit files will also contain important correspondence between the institution and the borrower. However, this is not universally the case; in some instances, important correspondence is deliberately lodged in separate files because of its sensitive character. Correspondence between the institution and the borrower can be especially valuable to the examiner in developing added insight into the status of problem credits.

Verification of loan proceeds is one of the most valuable and effective loan examining techniques available to the examiner and often one of the most ignored. This verification process can disclose fraudulent or fictitious notes, misapplication of funds, loans made for the benefit or accommodation of parties other than the borrower of record, or utilization of loans for purposes other than those reflected in the institution's files. Verification of the disbursement of a selected group of large or unusual loans, particularly those subject to classification or Special Mention and those granted under circumstances which appear illogical or incongruous is important. However, it is more important to carry the verification process one step further to the apparent utilization of loan proceeds as reflected by the customer's deposit account or other related institution records. The examiner should also determine the purpose of the credit and the expected source of repayment.

Examination Procedures regarding loan portfolio analysis are included in the ED Modules.

Additional Transaction Testing

Part of the assessment of loan administration practices includes transaction testing. Such testing can verify that the institution's written policies and practices are implemented as intended. Testing can also be useful in detecting potential fraudulent or irregular activity. In particular, examiners are required to verify a sample of loans that paid off during or just prior to the on-site portion of the examination. Such verification would include reviewing the loan file, payoff tickets, and tracing the source of funds for the payoff.

Loan Discussion

The examiner must comprehensively review all data collected on the individual loans. In most banks, this review should allow the majority of loans to be passed without criticism, eliminating the need for discussing these lines with the appropriate institution officer(s). No matter how thoroughly the supporting loan files have been reviewed, there will invariably be a number of loans which will require additional information or discussion before an appropriate judgment can be made as to their credit quality, relationship to other loans, proper documentation, or other circumstances related to the overall examination of the loan portfolio. Such loans require discussion with the appropriate institution officer(s) as do other loans for which adequate information has been assembled to indicate that classification or Special Mention is warranted.

Proper preparation for the loan discussion is essential, and the following points should be given due consideration by the examiner. Loans which have been narrowed down for discussion should be reviewed in depth to insure a comprehensive grasp of all factual material. Careful advance preparation can save time for all concerned. Particularly with regard to large, complicated lines, undue reliance should not be placed on memory to cover important points in loan discussion. Important weaknesses and salient points to be covered in discussion, questions to be asked, and information to be sought should be noted. The loan discussion should not involve discussion of trivialities since the banker's time is valuable, and it is no place for antagonistic remarks and snide comments directed at loan officers. The examiner should listen carefully to what the banker has to say, and concisely and accurately note this information. Failure to do so can result in inaccuracies and make follow-up at the next examination more difficult.

Loan Analysis

In the evaluation of individual loans, the examiner should weigh carefully the information obtained and arrive at a judgment as to the credit quality of the loans under review. Each loan is appraised on the basis of its own characteristics. Consideration is given to the risk involved in the project being financed; the nature and degree of collateral security; the character, capacity, financial responsibility, and record of the borrower; and the feasibility and probability of its orderly liquidation in accordance with specified terms. The willingness and ability of a debtor to perform as agreed remains the primary measure of a loan's risk. 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. However, it does not mean that borrowers must at all times be in a position to liquidate their loans, for that would defeat the original purpose of extending credit.

Following analysis of specific credits, it is important that the examiner ascertain whether troublesome loans result from inadequate lending and collection policies and practices or merely reflect exceptions to basically sound credit policies and practices. In instances where troublesome loans exist due to ineffective lending practices and/or inadequate supervision, it is quite possible that existing problems will go uncorrected and further loan quality deterioration may occur. Therefore, the examiner should not only identify problem loans, but also ascertain the cause(s) of these problems. Weaknesses in lending policies or practices should be stressed, along with possible corrective measures, in discussions with the institution's senior management and/or the directorate and in the Report of Examination.

Loan Classification

To quantify and communicate the results of the loan review, the examiner must arrive at a decision as to which loans are to be subjected to criticism and/or comment in the examination report. Adversely classified loans are allocated on the basis of risk to three categories: Substandard; Doubtful; and Loss.

Other loans of questionable quality, but involving insufficient risk to warrant classification, are designated as Special Mention loans. Loans lacking technical or legal support, whether or not adversely classified, should be brought to the attention of the institution's management. If the deficiencies in documentation are severe in scope or volume, a schedule of such loans should be included in the Report of Examination.

Loan classifications are expressions of different degrees of a common factor, risk of nonpayment. All loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound loans. The practice of lending to sound businesses or individuals for reasonable periods is a legitimate banking function. Adverse classifications should be confined to those loans which are unsafe for the investment of depositors' funds.

If the internal grading system is determined to be accurate and reliable, examiners can use the institution's data for preparing the applicable examination report pages and schedules, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio. If the internal classifications are overly conservative, examiners should make appropriate adjustments and include explanations in the report's comments.

The Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions was issued on October 29, 2013, by the Office of the Comptroller of the Currency, the FDIC, and the Federal Reserve Board. The attachment to this interagency statement provides definitions of Substandard, Doubtful, and Loss categories used for adversely classifying institution assets. Amounts classified Loss should be promptly eliminated from the institution's books.

Uniform guidelines have been established by the FDIC regarding the Report of Exam treatment of assets classified Doubtful. The general policy is not to require charge-off or similar action for Doubtful classifications. Examiners should make a statement calling for an institution to charge-off a portion of loans classified Doubtful only when state law or policy requires. Further, any such statement should be clear as to the intended purpose of bringing the institution into conformity with those state requirements. An exception is made for formal actions under Section 8 of the FDI Act.

A statement addressing the chargeoff of loans classified Loss is a required comment Report of Examination when the amount is material. Amounts classified Loss should be promptly eliminated from the institution's books.

Definitions

- **Substandard -** Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

- **Doubtful -** Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable.
- **Loss -** Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

There is a close relationship between classifications, and no classification category should be viewed as more important than the other. The uncollectibility aspect of Doubtful and Loss classifications makes their segregation of obvious importance. The function of the Substandard classification is to indicate those loans which are unduly risky and, if unimproved, may be a future hazard.

A complete list of adversely classified loans is to be provided to management, either during or at the close of an examination.

Special Mention Assets

Definition - A 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.

Use of Special Mention - The Special Mention category is not to be used as a means of avoiding a clear decision to adversely classify an asset or pass it without critique. Neither should it include assets listed merely “for the record” when uncertainties and complexities, perhaps coupled with large size, create some reservations about the asset. If potential weaknesses warranting management’s close attention are not identified, inclusion of such assets in Special Mention is not justified.

Special Mention assets have characteristics that deserve close attention. These assets pose elevated risk, but their weaknesses do not justify an adverse classification. Weak underwriting, administration, and/or imprudent lending practices may be the cause for the Special Mention designation. However, borrowers with adverse operating trends (declining revenues or margins), ill-proportioned balance sheet (e.g., increasing inventory without an increase in sales, high leverage, tight liquidity), or collateral concerns also are factors to consider when assigning a Special Mention designation. Instances may also be encountered where technical exceptions are a factor in scheduling loans for Special Mention, but examiners should not construe that assets involving less significant technical exceptions belong in this category.

Careful identification of assets that properly belong in this category is important in determining the extent of risk within asset quality and providing constructive criticism for institution management. While Special Mention assets should not be combined with adversely classified asset dollar totals in the Report of Examination, their level and trend should be considered in the assessment of asset quality and management, as appropriate. Therefore, examiners are permitted to use ratios combining Special Mention with adversely classified assets, but only when used in a supplemental fashion and in conjunction with the standard asset quality measure, adversely classified assets ratios.

Comments on assets included on the Items Listed for Special Mention schedule in the Report of Examination should be drafted in a fashion similar to those for adversely classified assets. There is no less of a requirement upon the examiner to clearly record the reasons why the asset is listed. The major emphasis of the comments should be towards identifying potential weaknesses and risks that warrant management’s close attention.

Technical Exceptions

Deficiencies in documentation of loans should be brought to the attention of management for remedial action. Failure of management to effect corrections may lead to the development of greater credit risk in the future. Moreover, an excessive number of technical exceptions may be a reflection on management's quality and ability. Inclusion of the schedule "Assets With Credit Data or Collateral Documentation Exceptions" and various comments in the Report of Examination is appropriate in certain circumstances. Refer to the Report of Examination Instructions for further guidance.

Past Due and Nonaccrual

Overdue loans are not necessarily subject to adverse criticism. Nevertheless, a high volume of overdue loans almost always indicates liberal credit standards, weak servicing practices, or both. Because loan renewal and extension policies vary among banks, comparison of their delinquency ratios may be misleading. A more significant method of evaluating this factor lies in determination of the trend within the institution under examination, keeping in mind the distortion resulting from seasonal influences, economic conditions, or the timing of examinations. It is important for the examiner to carefully consider the makeup and reasons for the volume of overdue loans. Only then can it be determined whether the volume of past due paper is a significant factor reflecting adversely on the quality or soundness of the overall loan portfolio or the efficiency and quality of management. It is important that overdue loans be computed on a uniform basis. This allows for comparison of overdue totals between examinations and/or with other banks.

The Report of Examination includes information on overdue and nonaccrual loans. Loans which are still accruing interest but are past their maturity or on which either interest or principal is due and unpaid (including unplanned overdrafts) are separated by loan type into two distinct groupings: 30 to 89 days past due and 90 days or more past due. Nonaccrual loans may include both current and past due loans. In the case of installment credit, a loan will not be considered overdue until at least two monthly payments are delinquent. The same will apply to real estate mortgage loans, term loans or any other loans payable on regular monthly installments of principal and interest.

Some modification of the overdue criteria may be necessary because of applicable state law, joint examinations, or unusual circumstances surrounding certain kinds of loans or in individual loan situations. It will always be necessary for the examiner to ascertain the institution's renewal and extension policies and procedures for collecting interest prior to determining which loans are overdue, since such practices often vary considerably from institution to institution. This is important not only to validate which loans are actually overdue, but also to evaluate the soundness of such policies. Standards for renewal should be aimed at achieving an orderly liquidation of loans and not at maintaining a low ratio of past due paper through unwarranted extensions or renewals.

In larger departmentalized banks or banks with large branch systems, it may be informative to analyze delinquencies by determining the source of overdue loans by department or branch. This is particularly true if a large volume of overdue loans exist. The production of schedules delineating overdue loans by department or branch is encouraged if it will aid in pinpointing the source of a problem or be otherwise informative.

Continuing to accrue income on assets which are in default as to principal and interest overstates an institution's assets, earnings, and capital. Call Report Instructions indicate that where the period of default of principal or interest equals or exceeds 90 days, the accruing of income should be discontinued unless the asset is well-secured and in process of collection. A debt is well-secured if collateralized 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 by the guarantee of a financially responsible party. A debt is in process of collection if collection is proceeding in due course either through legal action, including judgment enforcement procedures, or, in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or its restoration to a current status. Institutions are strongly encouraged to follow this guideline not only for reporting purposes but also bookkeeping purposes. There are several exceptions, modifications and clarifications to this general standard. First, consumer loans and real estate loans secured by one-to-four family residential properties are exempt from the nonaccrual guidelines. Nonetheless, these exempt loans should be subject to other alternative methods of evaluation to assure the institution's net income is not materially overstated. Second, any state statute, regulation or rule which imposes more stringent standards for nonaccrual of interest should take precedence over these instructions. Third, reversal of previously accrued but uncollected interest applicable to any asset placed in a nonaccrual status, and treatment of subsequent payments as either principal or interest, should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes reversal of all previously accrued but uncollected interest against appropriate income and balance sheet accounts.

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

The following information applies to borrowers who have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although a prior arrearage may not have been eliminated by payments from a borrower, the borrower may have demonstrated sustained performance over a period of time in accordance with the contractual terms. Such loans to be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met:

- All principal and interest amounts contractually due (including arrearage) are reasonably assured of repayment within a reasonable period, and
- There is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms involving payments of cash or cash equivalents.

When the regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status. Loans that meet the above criteria would continue to be disclosed as past due, as appropriate, until they have been brought fully current.

Troubled Debt Restructuring - Multiple Note Structure

The basic example of a trouble debt restructuring (TDR) multiple note structure is a troubled loan that is restructured into two notes where the first or "A" note represents the portion of the original loan principal amount which is expected to be fully collected along with contractual interest. The second part of the restructured loan, or "B" note, represents the portion of the original loan that has been charged-off.

Such TDRs generally may take any of three forms. In certain TDRs, the "B" note may be a contingent receivable that is payable only if certain conditions are met (e.g., sufficient cash flow from property). For other TDRs, the "B" note may be contingently forgiven (e.g., note "B" is forgiven if note "A" is paid in full). In other instances, an institution would have granted a concession (e.g., rate reduction) to the troubled borrower, but the "B" note would remain a contractual obligation of the borrower. Because the "B" note is not reflected as an asset on the institution's books and is unlikely to be collected, for reporting purposes the "B" note could be viewed as a contingent receivable.

Institutions may return the "A" note to accrual status provided the following conditions are met:

- The restructuring qualifies as a TDR as defined by ASC Subtopic 310-40*, Receivables – Troubled Debt Restructurings by Creditors* and there is economic substance to the restructuring.
- The portion of the original loan represented by the "B" note has been charged-off. The charge-off must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.
- The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.
- In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the "A" note is returned to accrual status. A sustained period of payment performance generally would be a minimum of six months and involve payments in the form of cash or cash equivalents.

Under existing reporting requirements, the "A" note would be disclosed as a TDR. In accordance with these requirements, if the "A" note yields a market rate of interest and performs in accordance with the restructured terms, such disclosures could be eliminated in the year following restructuring. To be considered a market rate of interest, the interest rate on the "A" note at the time of restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk.

Interagency Retail Credit Classification Policy

The quality of consumer credit soundness is best indicated by the repayment performance demonstrated by the borrower. Because retail credit generally is comprised of a large number of relatively small balance loans, evaluating the quality of the retail credit portfolio on a loan-by-loan basis is burdensome for the institution being examined and examiners. To promote an efficient and consistent credit risk evaluation, the FDIC, the Comptroller of Currency, the Federal Reserve and the former Office of Thrift Supervision adopted the Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy.)

Retail credit includes open-end and closed-end credit extended to individuals for household, family, and other personal expenditures. It includes consumer loans and credit cards. For purposes of the policy, retail credit also includes loans to individuals secured by their personal residence, including home equity and home improvement loans.

In general, retail credit should be classified based on the following criteria:

- Open-end and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified Substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be charged-off. The charge-off should be taken by the end of the month in which the 120-or 180-day time period elapses.
- Unless the institution can clearly demonstrate and document that repayment on accounts in bankruptcy is likely to occur, accounts in bankruptcy should be charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses. Any loan balance not charged-off should be classified

Substandard until the borrower re-establishes the ability and willingness to repay (with demonstrated payment performance for six months at a minimum) or there is a receipt of proceeds from liquidation of collateral.

- Fraudulent loans should be charged off within 90 days of discovery or within the delinquency time frames specified in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- Loans of deceased persons should be charged off when the loss is determined or within the delinquency time frames adopted in this classification policy, whichever is shorter. The charge-off should be taken by the end of the month in which the applicable time period elapses.
- One-to-four family residential real estate loans and home equity loans that are delinquent 90 days or more with loan-to-value ratios greater than 60 percent, should be classified Substandard.

When an open- or closed-end residential or home equity loan is 180 days past due, a current assessment of value should be made and any outstanding loan balance in excess of the fair value of the property, less cost to sell, should be classified Loss.

Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent should not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are delinquent 90 days or more should be classified Substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

If an institution can clearly document that the delinquent loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities, with an estimated fair value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. In the process of collection means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

This policy does not preclude an institution from adopting an internal classification policy more conservative than the one detailed above. It also does not preclude a regulatory agency from using the Doubtful or Loss classification in certain situations if a rating more severe than Substandard is justified. Loss in retail credit should be recognized when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy.

Re-aging, Extensions, Deferrals, Renewals, or Rewrites

Re-aging is the practice of bringing a delinquent account current after the borrower has demonstrated a renewed willingness and ability to repay the loan by making some, but not all, past due payments. Re-aging of open-end accounts, or extensions, deferrals, renewals, or rewrites of closed-end accounts should only be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use of a policy is acceptable when it is based on recent, satisfactory performance and the true improvement in a borrower's other credit factors, and when it is structured in accordance with internal policies.

The decision to re-age a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that institution personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower shows the ability to repay the loan.

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. An account eligible for re-aging, extension, deferral, renewal, or rewrite should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The account should exist for at least nine months before allowing a re-aging, extension, renewal, referral, or rewrite.
- The borrower should make at least three minimum consecutive monthly payments or the equivalent lump sum payment before an account is re-aged. Funds may not be advanced by the institution for this purpose.
- No loan should be re-aged, extended, deferred, renewed, or rewritten more than once within any twelve-month period; that is, at least twelve months must have elapsed since a prior re-aging. In addition, no loan should be re-aged, extended, deferred,

renewed, or rewritten more than two times within any five-year period.

- For open-end credit, an over limit account may be re-aged at its outstanding balance (including the over limit balance, interest, and fees). No new credit may be extended to the borrower until the balance falls below the designated predelinquency credit limit.

Partial Payments on Open-End and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing delinquency. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, the loan would be $900, or three full months delinquent. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

Examination Considerations

Examiners should determine whether institutions' policies and practices consider the Retail Classification Policy, understanding that there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur regardless of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims. Conversely, the Retail Classification Policy does not preclude examiners from reviewing and classifying individual large dollar retail credit loans that exhibit signs of credit weakness regardless of delinquency status.

In addition to reviewing loan classifications, the examiner should review the ALLL to assess whether it is at an appropriate level. Sound risk and account management systems typically include:

- Prudent retail credit lending policies,
- Measures to monitor adherence to policy,
- Detailed operating procedures, and
- Appropriate internal controls.

Institutions lacking sound policies or failing to implement or effectively follow established policies will be subject to criticism.

Examination Treatment

Use of the formula classification approach can result in numerous small dollar adversely classified items. Although these classification details are not always included in the Report of Examination, an itemized list is to be left with management. A copy of the listing should also be retained in the examination work papers.

Examiner support packages are available which have built in parameters of the formula classification policy, and which generate a listing of delinquent consumer loans to be classified in accordance with the policy. Use of this package may expedite the examination in certain cases, especially in larger banks.

Losses are one of the costs of doing business in consumer installment credit departments. It is important for the examiner to give consideration to the amount and severity of installment loan charge-offs when examining the department. Excessive loan losses are the product of weak lending and collection policies and therefore provide a good indication of the soundness of the consumer installment loan operation. The examiner should be alert also to the absence of installment loan charge-offs, which may indicate that losses are being deferred or concealed through unwarranted rewrites or extensions.

Dealer lines should be scheduled in the report under the dealer's name regardless of whether the contracts are accepted with or without recourse. Any classification or totaling of the nonrecourse line can be separately identified from the direct or indirect liability of the dealer. Comments and format for scheduling the indirect contracts will be essentially the same as for direct paper. If there is direct debt, comments will necessarily have to be more extensive and probably will help form a basis for the indirect classification.

No general rule can be established as to the proper application of dealers' reserves to the examiner's classifications. Such a rule would be impractical because of the many methods used by banks in setting up such reserves and the various dealer agreements utilized. Generally, where the institution is handling a dealer who is not financially responsible, weak contracts warrant classification irrespective of any balance in the dealer's reserve. Fair and reasonable judgment on the part of the examiner will determine application of dealer reserves.

If the amount involved would have a material impact on capital, consumer loans should be classified net of unearned income. Large business-type loans placed in consumer installment loan departments should receive individual review and, in all cases, the applicable unearned income discount should be deducted when such loans are classified.

Impaired Loans, Troubled Debt Restructurings, Foreclosures, and Repossessions

Loan Impairment – The accounting standard for impaired loans is ASC Subtopic 310-10. A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due according to the contractual terms of the loan agreement (i.e., principal and interest). Impaired loans encompass all loans that are restructured in a troubled debt restructuring, including smaller balance homogenous loans that are typically exempt from ASC Subtopic 310-10. However, the standard does not include loans that are measured at fair value or the lower of cost or fair value.

When a loan is impaired under ASC Subtopic 310-10, the amount of impairment should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs and premium or discount existing at the origination or acquisition of the loan). As a practical expedient, impairment may also be measured based on a loan's observable market price. The fair value of the collateral must be used if the loan is collateral dependent. An impaired loan is collateral dependent if repayment would be expected to be provided solely by the sale or continued operation of the underlying collateral.

If the measure of a loan calculated in accordance with ASC Subtopic 310-10 is less than the recorded investment in the loan (typically the face amount of the loan, plus accrued interest, adjusted for any premium or discount, deferred fee or cost, less any charge-offs), impairment on that loan should be recognized as a part of the ALLL. In general, when the amount of the recorded investment in the loan exceeds the amount calculated under ASC Subtopic 310-10 and that amount is determined to be uncollectible, this excess amount should be promptly charged-off against the ALLL. In all cases, when an impaired loan is collateral dependent and the repayment of the loan is expected from the sale of the collateral, any portion of the recorded investment in the loan in excess of the fair value less cost to sell of the collateral should be charged-off.

Troubled Debt Restructuring - The accounting for TDRs is set forth in ASC Subtopic 310-40, *Receivables-Troubled Debt Restructurings by Creditors*. A restructuring constitutes a troubled debt restructuring if the institution for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. A troubled debt restructuring takes place when an institution grants a concession to a debtor in financial difficulty. Examiners are expected to reflect all TDRs in examination reports in accordance with this accounting guidance and institutions are expected to follow these principles when filing the Call Report.

TDRs may be divided into two broad groups: those where the borrower transfers assets to the creditor in full or partial satisfaction of the debt, which would include foreclosures; and those in which the terms of a debtor's obligation are modified, which may include reduction in the stated interest rate to an interest rate that is less than the current market rate for new obligations with similar risk, extension of the maturity date, or forgiveness of principal or interest. A third type of restructuring combines a receipt of assets and a modification of loan terms. A loan extended or renewed at an interest rate equal to the current market interest rate for new debt with similar risk is not reported as a restructured loan for examination purposes.

Transfer of Assets to the Creditor - An institution that receives assets (except long-lived assets that will be sold) from a borrower in full satisfaction of the recorded investment in the loan should record those assets at fair value. If the fair value of the assets received is less than the institution's recorded investment in the loan, a loss is charged to the ALLL. When property is received in full satisfaction of an asset other than a loan (e.g., a debt security), the loss should be reflected in a manner consistent with the balance sheet classification of the asset satisfied. When long-lived assets that will be sold, such as real estate, are received in full satisfaction of a loan, the real estate is recorded at its fair value less cost to sell. This fair value (less cost to sell) becomes the "cost" of the foreclosed asset.

To illustrate, assume an institution forecloses on a defaulted mortgage loan of $100,000 and takes title to the property. If the fair value of the property at the time of foreclosure is $90,000 and costs to sell are estimated at $10,000, a $20,000 loss should be immediately recognized by a charge to the ALLL. The cost of the foreclosed asset becomes $80,000. If the institution is on an accrual basis of accounting, there may also be adjusting entries necessary to reduce both the accrued interest receivable and loan interest income accounts. Assume further that in order to effect sale of the realty to a third party, the institution is willing to offer a new mortgage loan (e.g., of $100,000) at a concessionary rate of interest (e.g., 10 percent while the market interest rate for new loans with similar risk is 20 percent). Before booking this new transaction, the institution must establish its "economic value" or what would be the cash price paid. Pursuant to ASC Subtopic 835-30, *Interest – Imputation of Interest*, the value is represented by the sum of the present value of the income stream to be received from the new loan, discounted at the current market interest rate for this type of credit, and the present value of the principal to be received, also discounted at the current market interest rate.

This economic value (calculated by discounting the cash flows at the current market interest rate) becomes the proper carrying value for the property at its sale date. Since the sales price of $78,000 is less than the property's carrying amount of $80,000), an additional loss has been incurred and should be immediately recognized. This additional loss should be reflected in the allowance if a relatively brief period has elapsed between foreclosure and subsequent resale of the property. However, the loss should be treated as loss on the sale of real estate if the asset has been held for a longer period. The new loan would be placed on the books at its face value ($100,000) and the difference between the new loan amount and the "economic value" ($78,000) is treated as unearned discount ($22,000). For examination and Call Report purposes, the asset would be shown net of the unearned discount which is reduced periodically as it is earned over the life of the new loan. The $22,000 discount is accreted into interest income over the life of the loan as long as the loan remains in accrual status.

The basis for this accounting approach is the assumption that financing the resale of the property at a concessionary rate exacts an opportunity cost which the institution must recognize. That is, unearned discount represents the present value of the "imputed" interest differential between the concessionary and market rates of interest. Present value accounting also assumes that both the institution and the third party who purchased the property are indifferent to a cash sales price at the "economic value" or a higher financed price repayable over time.

Modification of Terms - When the terms of a TDR provide for a reduction of interest <u>or</u> principal, the institution should measure any loss on the restructuring in accordance with the guidance for impaired loans as set forth in ASC Subtopic 310-10 unless the loans are measured at fair value or the lower of cost or fair value. The amount of impairment of the restructured loan using the appropriate measurement method in ASC Subtopic 310-10 is reported as a component in determining the overall ALLL. If any amount of the calculated impairment is determined to be uncollectible, that amount should be promptly charged-off against the ALLL.

For example, in lieu of foreclosure, an institution chooses to restructure a $100,000 loan to a borrower which had originally been granted with an interest rate of 10 percent for 10 years. The institution and the borrower have agreed to capitalize the accrued interest ($10,000) into the note balance, but the restructured terms will permit the borrower to repay the debt over 10 years at a six percent interest rate. The institution does not believe the loan is collateral dependent. In this situation, the institution would determine the amount of impairment on the TDR as the difference between the present value of the expected cash flows discounted at the 10 percent rate specified in the original contract and the recorded investment in loan of $110,000. This amount of the calculated impairment becomes a component of the overall ALLL.

Combination Approach - In some instances, the institution may receive assets in partial rather than full satisfaction of a loan or security and may also agree to alter the original repayment terms. In these cases, the recorded investment in the loan should be reduced by the fair value of the assets received (less cost to sell, if appropriate). The remaining recorded investment in the loan is accounted for as a TDR.

Examination Report Treatment - Examiners should continue to classify TDRs, including any impaired collateral dependent loans, based on the definitions of Loss, Doubtful, and Substandard. When an impaired loan is collateral dependent and the loan is expected to be satisfied by the sale of the collateral, any portion of the recorded investment in the loan which exceeds the fair value of the collateral, less cost to sell is the amount of impairment included in the ALLL. This is the amount of Loss on that loan that should be promptly charged-off. For other loans that are impaired loans, the amount of the recorded investment in the loan over the amount of the calculated impairment is recognized as a component of the ALLL. However, when available information confirms that loans and leases (including any recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) other than impaired collateral dependent loans (dependent on the sale of the collateral), or portions thereof, are uncollectible, these amounts should be promptly charged-off against the ALLL.

An examiner should not require an additional allowance for credit losses of impaired loans over and above what is calculated in accordance with these standards. An additional allowance on impaired loans may be supported based on consideration of institution-specific factors, such as historical loss experience compared with estimates of such losses and concerns about the reliability of cash flow estimates, the quality of an institution's loan review function, and controls over its process for estimating its ASC Subtopic 310-10 allowance.

Other Considerations - Examiners may encounter situations where impaired loans and TDRs are identified, but the institution has not properly accounted for the transactions. Where incorrect accounting treatment resulted in an overstatement of earnings, capital and assets, it will be necessary to determine the proper carrying values for these assets, utilizing the best available information developed by the examiner after consultation with institution management. Nonetheless, proper accounting for impaired loans and TDRs is the responsibility of institution management. Examiners should not spend a disproportionate amount of time developing the appropriate accounting entries, but instead discuss with and require corrective action by institution management when the institution's treatment is not in accordance with accepted accounting guidelines. It must also be emphasized that collectibility and proper accounting and reporting are separate matters; restructuring a borrower's debt does not ensure collection of the loan or security. As with all other assets, adverse classification should be assigned if analysis indicates there is risk of loss present. Examiners should take care, however, not to discourage or be critical of institution management's legitimate and reasonable attempts to achieve debt settlements through concessionary terms. In many cases, restructurings offer the only realistic means for an institution to bring about collection of weak or nonearning assets. Finally, the volume of impaired loans and restructured debts having concessionary interest rates should be considered when evaluating the institution's earnings performance and assigning the earnings performance rating.

Examination procedures for reviewing TDRs are included in the ED Modules.

Report of Examination Treatment of Classified Loans

The Items Subject to Adverse Classification page allows an examiner to present pertinent and readily understandable comments related to loans which are adversely classified. In addition, the Analysis of Loans Subject to Adverse Classification page permits analysis of present and previous classifications from the standpoint of source and disposition. These loan schedules should be prepared in accordance with the Report of Examination Instructions.

An examiner must present, in writing, relevant and readily understandable comments related to criticized loans. Therefore, a thorough understanding of all factors surrounding the loan is required and only those germane to description, collectibility, and management plans should be included in the comments. Comments should be concise, but brevity is not to be accomplished by omission of appropriate information. Comments should be informative and factual data emphasized. The important weaknesses of the loan should not be overshadowed by extraneous information which might well have been omitted. An ineffective presentation of a classified loan weakens the value of a Report of Examination and frequently casts doubt on the accuracy of the classifications. The essential test of loan comments is whether they justify the classification.

Careful organization is an important ingredient of good loan comments. Generally, loan comments should include the following items:

- **Identification -** Indicate the name and occupation or type of business of the borrower. Cosigners, endorsers and guarantors should be identified and in the case of business loans, it should be clear whether the borrower is a corporation, partnership, or sole proprietorship.
- **Description -** The make-up of the debt should be concisely described as to type of loan, amount, origin and terms. The history, purpose, and source of repayment should also be indicated.
- **Collateral -** Describe and evaluate any collateral, indicating the marketability and/or condition thereof. If values are estimated, note the source.
- **Financial Data -** Current balance sheet information along with operating figures should be presented, if such data are considered necessary. The examiner must exercise judgment as to whether a statement should be detailed in its entirety. When the statement is relevant to the classification, it is generally more effective to summarize weaknesses with the entire statement presented. On the other hand, if the statement does not significantly support or detract from the loan, a very brief summarization of the statement is in order.
- **Summarize the Problem -** The examiner's comments should explicitly point out reasons for the classification. Where portions of the line are accorded different classifications or are not subject to classification, comments should clearly set forth the reasoning for the split treatment.
- **Management's Intentions -** Comments should include any corrective program contemplated by management.

Examiners should avoid arbitrary or penalty classifications, nor should "conceded" or "agreed" be given as the principal reason for adverse classifications. Management's opinions and ideas should not have to be emphasized; if a classification is well-founded, the facts will speak for themselves. If well-written, there is little need for long summary comments reemphasizing major points of the loan write-up.

When the volume of loan classifications reaches the point of causing supervisory concern, analysis of present and previous classifications from the standpoint of source and disposition becomes very important. For this reason, the Analysis of Loans Subject to Adverse Classification page should be completed in banks possessing characteristics which present special supervisory problems; when the volume or composition of adversely classified loans has changed significantly since the previous examination, including both upward and downward movements; and, in such other special or unusual situations as examiners deem appropriate. Generally, the page should not include consumer loans and overdrafts and it should be footnoted to indicate that these assets are not included.

Issuance of "Express Determination" Letters to Institutions for Federal Income Tax Purposes

Tax Rules - The Internal Revenue Code and tax regulations allow a deduction for a loan that becomes wholly or partially worthless. All pertinent evidence is taken into account in determining worthlessness. Special tax rules permit a federally supervised depository institution to elect a method of accounting under which it conforms its tax accounting for bad debts to its regulatory accounting for loan charge-offs, provided certain conditions are satisfied. Under these rules, loans that are charged-off pursuant to specific orders of the institution's supervisory authority or that are classified by the institution as Loss assets under applicable regulatory standards are conclusively presumed to have become worthless in the taxable year of the charge-offs.

To be eligible for this accounting method for tax purposes, an institution must file a conformity election with its federal income tax return. The tax regulations also require the institution's primary federal supervisory authority to expressly determine that the institution maintains and applies loan loss classification standards that are consistent with the regulatory standards of its supervisory authority.

An institution must request an "express determination" letter before making the election. To continue using the tax-book conformity method, the institution must request a new letter at each subsequent examination that covers the loan review process. If the examiner does not issue an "express determination" letter at the end of such an examination, the institution's election of the tax-book conformity method is revoked automatically as of the beginning of the taxable year that includes the date of examination. However, that examiner's decision not to issue an "express determination" letter does not invalidate an institution's election for any prior years. The supervisory authority is not required to rescind any previously issued "express determination" letters.

When an examiner does not issue an "express determination" letter, the institution is still allowed tax deductions for loans that are wholly or partially worthless. However, the burden of proof is placed on the institution to support its tax deductions for loan charge-offs.

Examination Guidelines - Institutions are responsible for requesting "express determination" letters during each examination that covers their loan review process, i.e., during safety and soundness examinations. The request can be made verbally or in writing. For continuous examination programs, reviewing the loan review process would include targeted reviews of an institution's loan review area outside of the annual rollup examination. Examiners should not alter the scope or frequency of examinations merely to permit banks to use the tax-book conformity method.

When requested by an institution that has made or intends to make the election under 12 CFR Section 1.166-2(d)(3) of the tax regulations, the examiner-in-charge should issue an "express determination" letter, provided the institution does maintain and apply loan loss classification standards that are consistent with the FDIC's regulatory standards. The letter should only be issued at the completion of a safety and soundness examination, including annual rollup examinations under a continuous examination program, at which the examiner-in-charge has concluded that the issuance of the letter is appropriate.

An "express determination" letter should be issued to an institution only if:

- The examination indicates that the institution maintains and applies loan loss classification standards that are consistent with the FDIC's standards regarding the identification and charge-off of such loans; and
- There are no material deviations from the FDIC's standards.

Minor criticisms of the institution's loan review process as it relates to loan charge-offs or immaterial individual deviations from the FDIC's standards should not preclude the issuance of an "express determination" letter.

An "express determination" letter should not be issued if:

- The institution's loan review process relating to charge-offs is subject to significant criticism;
- Loan charge-offs reported in the Consolidated Reports of Condition and Income (Call Report) are consistently overstated or understated; or
- There is a pattern of loan charge-offs not being recognized in the appropriate year.

When the issuance of an "express determination" letter is appropriate, it should be prepared on FDIC letterhead using the following format. The letter should be signed and dated by the examiner-in-charge and provided to the institution for its files. The letter is not part of the Report of Examination.

Express Determination Letter for IRS Regulation 1.166-2(d)(3)

"In connection with the most recent examination of [Name of Bank], by the Federal Deposit Insurance Corporation, as of [Examination Start Date], we reviewed the institution's loan review process as it relates to loan charge-offs. Based on our review, we concluded that the institution, 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. 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 credit losses[1].

Sincerely,
[signature]
Examiner-in-Charge
[date signed]

[1]Accounting Standards Update 2016-13, issued by the Financial Accounting Standards Board, has replaced the former allowance for loan and lease losses under the incurred loss methodology with an allowance for credit losses on loans, leases, and other financial instruments using the current expected credit losses (CECL) methodology. The new accounting standard applies to all banks, savings associations, credit unions, and financial institution holding companies that file regulatory reports for which the reporting requirements conform to U.S. generally accepted accounting principles (GAAP).

When an "express determination" letter is issued to an institution, a copy of the letter as well as documentation of the work performed by examiners in their review of the institution's loan loss classification standards should be maintained in the workpapers. A copy of the letter should also be forwarded to the regional office with the Report of Examination. The issuance of an "express determination" letter, including if concluded based on a targeted review that occurred earlier in the continuous examination program, should be noted in the Report of Examination according to procedures in the Report of Examination Instructions. An express determination letter should not be issued subsequent to the Report of Examination being finalized and distributed to the institution.

When an examiner-in-charge concludes that the conditions for issuing a requested "express determination" letter have not been met, the examiner-in-charge should discuss the reasons for this conclusion with the regional office. The examiner-in-charge should then advise institution management that the letter cannot be issued and explain the basis for this conclusion. A comment indicating that a requested "express determination" letter could not be issued, together with a brief statement of the reasons for not issuing the letter are addressed in the Report of Examination Instructions.

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CONCENTRATIONS

Generally a concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution. Adequate diversification of risk allows the institution to avoid the excessive risks imposed by credit concentrations. It should also be recognized, however, that factors such as location and economic environment of the area limit some institutions' ability to diversify. Where reasonable diversification realistically cannot be achieved, the resultant concentration calls for capital levels higher than the regulatory minimums.

Concentrations generally are not inherently bad, but do add a dimension of risk which the management of the institution should consider when formulating plans and policies. In formulating these policies, management typically addresses goals for portfolio mix and limits within the loan and other asset categories. The institution's business strategy, management expertise and location should be considered when reviewing the policy. Management should also consider the need to track and monitor the economic and financial condition of specific geographic locations, industries and groups of borrowers in which the institution has invested heavily. All concentrations should be monitored closely by management and receive a more in-depth review than the diversified portions of the institution's assets. Failure to monitor concentrations can result in management being unaware how significant economic events might impact the overall portfolio. This will also allow management to consider areas where concentration reductions may be necessary. Management and the board can monitor any reduction program using accurate concentration reports. If management is not properly monitoring concentration levels and limits, examiners may consider criticizing management.

To establish a meaningful tracking system for concentrations of credit, financial institutions should be encouraged to consider the use of codes to track individual borrowers, related groups of borrowers, industries, and individual foreign countries. Financial institutions should also be encouraged to use the North American Industry Classification System (NAICS) or similar code to track industry concentrations. Any monitoring program should be reported regularly to the board of directors.

Refer to the Report of Examination Instructions for guidance in identifying and listing concentrations in the examination report.

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FEDERAL FUNDS SOLD AND REPURCHASE AGREEMENTS

Federal funds sold and securities purchased under agreement for resale represent convenient methods to employ excess funds to enhance earnings. Federal funds are excess reserve balances and take the form of a one-day transfer of funds between banks. These funds carry a specified rate of interest and are free of the risk of loss due to fluctuations in market prices entailed in buying and selling securities. However, these transactions are usually unsecured and therefore do entail potential credit risk. Securities purchased under agreement for resale represent an agreement between the buying and selling banks that stipulates the selling institution will buy back the securities sold at an agreed price at the expiration of a specified period of time.

Federal funds sold are not "risk free" as is often supposed, and the examiner will need to recognize the elements of risk involved in such transactions. While the selling of funds is on a one-day basis, these transactions may evolve into a continuing situation. This development is usually the result of liability management techniques whereby the buying institution attempts to utilize the acquired funds to support a rapid expansion of its loan-investment posture and as a means of enhancing profits. Of particular concern to the examiner is that, in many cases, the selling institution will automatically conclude that the buying institution's financial condition is above reproach without proper investigation and analysis. If this becomes the case, the selling institution may be taking an unacceptable risk unknowingly.

Another area of potential risk involves selling federal funds to an institution which may be acting as an intermediary between the selling institution and the ultimate buying institution. In this instance, the intermediary institution is acting as agent with the true liability for repayment accruing to the third institution. Therefore, it is particularly important that the original selling institution be aware of this situation, ascertain the ultimate disposition of its funds, and be satisfied as to the creditworthiness of the ultimate buyer of the funds.

Clearly, the "risk free" philosophy regarding the sale of federal funds is inappropriate. Selling banks must take the necessary steps to assure protection of their position. The examiner is charged with the responsibility of ascertaining that selling banks have implemented and adhered to policy directives in this regard to forestall any potentially hazardous situations.

Examiners should encourage management of banks engaged in selling federal funds to implement a policy with respect to such activity. This policy generally would consider matters such as the aggregate sum to be sold at any one time, the maximum amount to be sold to any one buyer, the maximum duration of time the institution will sell to any one buyer, a list of acceptable buyers, and the terms under which a sale will be made. As in any form of lending, thorough credit evaluation of the prospective purchaser, both before granting the credit extension and on a continuing basis, is a necessity. Such credit analysis emphasizes the borrower's ability to repay, the source of repayment, and alternative sources of repayment should the primary source fail to materialize. While sales of federal funds are normally unsecured unless otherwise regulated by state statutes, and while collateral protection is no substitute for thorough credit review, it is prudent for the selling institution to consider the possibility of requiring security if sales agreements are entered into on a continuing basis for specific but extended periods of time, or for overnight transactions which have evolved into longer term sales. Where the decision is made to sell federal funds on an unsecured basis, the selling institution should be able to present logical reasons for such action based on conclusions drawn from its credit analysis of the buyer and bearing in mind the potential risk involved.

A review of federal funds sold between examinations may prompt examiners to broaden the scope of their analysis of such activity if the transactions are not being handled in accordance with sound practices as outlined above. Where the institution has not developed a formal policy regarding the sale of federal funds or fails to conduct a credit analysis of the buyer prior to a sale and during a continuous sale of such funds, the matter should be discussed with management. In such discussion, it is incumbent upon examiners to inform management that their remarks are not intended to cast doubt upon the financial strength of any institution to whom federal funds are sold. Rather, the intent is to advise the banker of the potential risks of such practices unless safeguards are developed. The need for policy formulation and credit review on all Federal funds sold should be reinforced via a comment in the Report of Examination. Also, if federal funds sold to any one buyer equals or exceeds 100 percent of the selling institution's Tier 1 Capital, it should be listed on the Concentrations schedule unless secured by U.S. Government securities. Based on the circumstances, the examiner should determine the appropriateness of additional comments regarding risk diversification.

Securities purchased under an agreement to resell are generally purchased at prevailing market rates of interest. The purchasing institution must keep in mind that the transaction merely represents another form of lending. Therefore, considerations normally associated with granting secured credit should be made. Repayment or repurchases by the selling institution is a major consideration, and the buying institution should satisfy itself that the selling institution will be able to generate the necessary funds to repurchase the securities on the prescribed date. Policy guidelines typically limit the amount of money extended to one seller. Collateral coverage arrangements should be controlled by procedures similar to the safeguards used to control any type of liquid collateral. Securities held under such an arrangement should not be included in the institution's investment portfolio but should be reflected in the Report of Examination under the caption Securities Purchased Under Agreements to Resell. Transactions of this nature do not require entries to the securities account of either institution with the selling institution continuing to collect all interest and transmit such payments to the buying institution.

Assessing Bank-to-Bank Credit

Because of the FDIC's regulatory role, examiners often possess confidential information concerning a bank obligated on unsecured lines, Federal funds, or subordinated notes and debentures to another bank under examination. The files of the bank under examination may contain insufficient information to make an informed assessment of the credit. When this is the case, and when there is information in the public domain to suggest that the line involves more than a normal degree of risk, the matter should be brought to the attention of management and the board of the bank under examination.

However, if the bank's credit files or public record contain sufficient information to justify adverse classification of the debt, then it should be classified in the report of examination.

The following is a statement regarding such credits which may be used in applicable situations:

The foregoing obligation of a federally insured banking institution is listed for special mention because of publicly available information which suggests the obligation contains risk which is some degree greater than normal. The following is a standard statement of the FDIC's position regarding such credits.

"In reviewing bank-to-bank debt, the FDIC is placed in a position of basic conflict. We may or may not be in possession of confidential information arising from our regulatory function with respect to the other institution. The responsibility for properly appraising the assets of the bank under examination in such an instance may suggest the need to disclose adverse information, while the implied arrangement under which we received the information would preclude us, in good faith, from making the disclosure. It is our policy, in view of the foregoing, not to classify such credits adversely except where we can support the classification without the use of information gathered solely through privileged sources. Rather, we bring the existence of this credit to the board's attention for whatever review or other action it believes consistent with its sworn responsibilities to the stockholders and depositors of the bank under examination."

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FUNDAMENTAL LEGAL CONCEPTS AND DEFINITIONS

Laws and regulations that apply to credit extended by banks are more complicated and continually in a state of change. However, certain fundamental legal principles apply no matter how complex or innovative a lending transaction. To avoid needless litigation and ensure that each loan is a legally enforceable claim against the borrower or collateral, adherence to certain rules and prudent practices relating to loan transactions and documentation is essential. An important objective of the examiner's analysis of collateral and credit files is not only to obtain information about the loan, but also to determine if proper documentation procedures and practices are being utilized. While examiners are not expected to be experts on legal matters, it is important they be familiar with the Uniform Commercial Code (UCC) adopted by their respective states as well as other applicable state laws governing credit transactions. A good working knowledge of the various documents necessary to attain the desired collateral or secured position, and how those documents are to be used or handled in the jurisdiction relevant to the institution under examination, is also essential.

Uniform Commercial Code – Secured Transactions

Article 9 of the UCC governs secured transactions; i.e., those transactions which create a security interest in personal property or fixtures including goods, documents, instruments, general intangibles, chattel paper or accounts. Article 9 was significantly revised effective July 1, 2001, but each individual state must adopt the changes for it to become law. Because some states have enacted modified versions of the UCC and subsequent revisions, each applicable state statute should be consulted.

General Provisions

A Security Agreement is an agreement between a debtor and a secured party that creates or provides for a security interest. The Debtor is the person that has an interest in the collateral other than a security interest. The term Debtor also includes a seller of payment intangibles or promissory notes. The obligor is the person who owes on a secured transaction. The Secured Party is the lender, seller or other person in whose favor there is a security interest.

Grant of Security Interest

For a security interest to be enforceable against the debtor or third party with respect to the collateral, the collateral must be in the possession of the secured party pursuant to agreement, or the debtor must sign a security agreement which covers the description of the collateral.

Collateral

Any description of personal property or real estate is a sufficient description of the collateral whether or not it is specific if it reasonably identifies what is described. If the parties seek to include property acquired after the signing of the security agreement as collateral, additional requirements must be met.

Unless otherwise agreed a security agreement gives the secured party the rights to proceeds from the sale, exchange, collection or disposition of the collateral.
In some cases, the collateral that secures an obligation under one security agreement can be used to secure a new loan, too. This can be done by using a cross-collateralization clause in the security agreement.

Perfecting the Security Interest

Three terms basic to secured transactions are attachment, security agreement and security interest. Attachment refers to that point when the creditor's legal rights in the debtor's property come into existence or "attach." This does not mean the creditor necessarily takes physical possession of the property, or does it mean acquisition of ownership of the property. Rather, it means that before attachment, the borrower's property is free of any legal encumbrance, but after attachment, the property is legally bound by the creditor's security interest. In order for the creditor's security interest to attach, there must be a security agreement in which the debtor authenticates and provides a description of the collateral. A creditor's security interest can be possessory or nonpossessory, a secured party with possession pursuant to "agreement" means that the "agreement" for possession has to be an agreement that the person will have possession for purposes of security. The general rule is an institution must take possession of deposit accounts (proprietary), letter of credit rights, electronic chattel, paper, stocks and bonds to perfect a security interest therein. In a transaction involving a nonpossessory security interest, the debtor retains possession of the collateral. A security interest in collateral automatically attaches to the proceeds of the collateral and is automatically perfected in the proceeds if the credit was advanced to enable the purchase
A party's security interest in personal property is not protected against a debtor's other creditors unless it has been perfected. A security interest is perfected when it has attached and when all of the applicable steps required for perfection, such as the filing of a financing statement or possession of the collateral, have been taken. These provisions are designed to give notice to others of the secured party's interest in the collateral, and offer the secured party the first opportunity at the collateral if the need to foreclose should arise. If the security interest is not perfected, the secured party loses its secured status.

Right to Possess and Dispose of Collateral

Unless otherwise agreed, when a debtor defaults on a secured loan, a secured party has the right to take possession of the collateral without going to court if this can be done without breaching the peace. Alternatively, if the security agreement so provides, the secured party may require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties.

A secured party may then sell, lease or otherwise dispose of the collateral with the proceeds applied as follows: (a) foreclosure expenses, including reasonable attorneys' fees and legal expenses; (b) the satisfaction of indebtedness secured by the secured party's security interest in the collateral; and (c) the satisfaction of indebtedness secured by any subordinate security interest in the collateral if the secured party receives written notification of demand before the distribution of the proceeds is completed. If requested by the secured party, the holder of a subordinate security interest must furnish reasonable proof of his interest, and unless he does so, the secured party need not comply with his demand.

Examiners should determine institution policy concerning the verification of lien positions prior to advancing funds. Failure to perform this simple procedure may result in the institution unknowingly assuming a junior lien position and, thereby, greater potential loss exposure. Management may check filing records personally or a lien search may be performed by the filing authority or other responsible party. This is especially important when the institution grants new credit lines.

Agricultural Liens

An agricultural lien is generally defined as an interest, other than a security interest, in farm products that meets the following three conditions:

- The lien secures payment or performance of an obligation for goods or services furnished in connection with a debtor's farming operation or rent on real property leased by a debtor in connection with its farming operation.
- The lien is created by statute in favor of a person that in the ordinary course of its business furnished goods or services to a debtor in connection with a debtor's farming operation or leased property to a debtor in connection with the debtor's farming operation.
- The lien's effectiveness does not depend on the person's possession of the personal property.

An agricultural lien is therefore non-possessory. Law outside of UCC-9 governs creation of agricultural liens and their attachment to collateral. An agricultural lien cannot be created or attached under Article 9. Article 9, however, does govern perfection. In order to perfect an agricultural lien, a financing statement must be filed. A perfected agricultural lien on collateral has priority over a conflicting security interest in or agricultural lien on the same collateral if the statute creating the agricultural lien provides for such priority. Otherwise, the agricultural lien is subject to the same priority rules as security interests (for example, date of filing).

A distinction is made with respect to proceeds of collateral for security interests and agricultural liens. For security interests, collateral includes the proceeds under Article 9. For agricultural liens, the collateral does not include proceeds unless state law creating the agricultural lien gives the secured party a lien on proceeds of the collateral subject to the lien.

Special Filing Requirements – There is a national uniform Filing System form. Filers, however are not required to use them. If permitted by the filing office, parties may file and otherwise communicate by means of records communicated and stored in a media other than paper. A peculiarity common to all states is the filing of a lien on aircraft; the security agreement must be submitted to the Federal Aviation Administration in Oklahoma City, Oklahoma.

Default and Foreclosure - As a secured party, an institution's rights in collateral only come into play when the obligor is in default. What constitutes default varies according to the specific provisions of each promissory note, loan agreement, security agreement, or other related documents. After an obligor has defaulted, the creditor usually has the right to foreclose, which means the creditor seizes the security pledged to the loan, sells it and applies the proceeds to the unpaid balance of the loan. For consumer transactions, there are strict consumer notification requirements prior to disposition of the collateral. For consumer transactions, the lender must provide the debtor with certain information regarding the surplus or deficiency in the disposition of collateral. There may be more than one creditor claiming a right to the sale proceeds in foreclosure situations. When this occurs, priority is generally established as follows: (1) Creditors with a perfected security interest (in the order in which lien perfection was attained); (2) Creditors with an unperfected security interest; and (3) General creditors.

Under the UCC procedure for foreclosing security interests, four concepts are involved. First is repossession or taking physical possession of the collateral, which may be accomplished with judicial process or without judicial process (known as self-help repossession), so long as the creditor commits no breach of the peace. The former is usually initiated by a replevin action in which the sheriff seizes the collateral under court order. A second important concept of UCC foreclosure procedures is redemption or the debtor's right to redeem the security after it has been repossessed. Generally, the borrower must pay the entire balance of the debt plus all expenses incurred by the institution in repossessing and holding the collateral. The third concept is retention that allows the institution to retain the collateral in return for releasing the debtor from all further liability on the loan. The borrower must agree to this action, hence would likely be so motivated only when the value of the security is likely to be less than or about equal to the outstanding debt. Finally, if retention is not agreeable to both borrower and lender, the fourth concept, resale of the security, comes into play. Although sale of the collateral may be public or private, notice to the debtor and other secured parties must generally be given. The sale must be commercially reasonable in all respects. Debtors are entitled to any surplus resulting from sale price of the collateral less any unpaid debt. If a deficiency occurs (i.e., the proceeds from sale of the collateral were inadequate to fully extinguish the debt obligation), the institution has the right to sue the borrower for this shortfall. This is a right it does not have under the retention concept.

Exceptions to the Rule of Priority - There are three exceptions to the general rule that the creditor with the earliest perfected security interest has priority. The first concerns a specific secured transaction in which a creditor makes a loan to a dealer and takes a security interest in the dealer's inventory. Suppose such a creditor files a financing statement with the appropriate public official to perfect the security interest. While it might be possible for the dealer's customers to determine if an outstanding security interest already exists against the inventory, it would be impractical to do so. Therefore, an exception is made to the general rule and provides that a buyer in the ordinary course of business, i.e., an innocent purchaser for value who buys in the normal manner, cuts off a prior perfected security interest in the collateral.

The second exception to the rule of priority concerns the vulnerability of security interests perfected by doing nothing. While these interests are perfected automatically, with the date of perfection being the date of attachment, they are extremely vulnerable at the hands of subsequent bona fide purchasers. Suppose, for example, a dealer sells a television set on a secured basis to an ultimate consumer. Since the collateral is consumer goods, the security interest is perfected the moment if attaches. But if the original buyer sells the television set to another person who buys it in good faith and in ignorance of the outstanding security interest, the UCC provides that the subsequent purchase cuts off the dealer's security interest. This second exception is much the same as the first except for one important difference: the dealer (creditor) in this case can be protected against purchase of a customer's collateral by filing a financing statement with the appropriate public official.

The third exception regards the after-acquired property clause that protects the value of the collateral in which the creditor has a perfected security interest. The after-acquired property clause ordinarily gives the original creditor senior priority over creditors with later perfected interests. However, it is waived as regards the creditor who supplies replacements or additions to the collateral or the artisan who supplies materials and services that enhance the value of the collateral as long as a perfected security interest in the replacement or additions, or collateral is held.

Borrowing Authorization

Borrowing authorizations in essence permit one party to incur liability for another. In the context of lending, this usually concerns corporations. A corporation may enter into contracts within the scope of the powers authorized by its charter. In order to make binding contracts on behalf of the corporation, the officers must be authorized to do so either by the board of directors or by expressed or implied general powers. Usually a special resolution expressly gives certain officers the right to obligate the corporate entity, pledge assets as collateral, agree to other terms of the indebtedness and sign all necessary documentation on behalf of the corporate entity.

Although a general resolution is perhaps satisfactory for the short-term, unsecured borrowings of a corporation, a specific resolution of the corporation's board of directors is generally advisable to authorize such transactions as term loans, loans secured by security interests in the corporation's personal property, or mortgages on real estate. Further, mortgaging or pledging substantially all of the corporation's assets without prior approval of the shareholders of the corporation is often prohibited, therefore, an institution may need to seek advice of counsel to determine if shareholder consent is required for certain contemplated transactions.

Loans to corporations should indicate on their face that the corporation is the borrower. The corporate name should appear followed by the name, title and signature of the appropriate officer. If the writing is a negotiable instrument, the UCC states the party signing is personally liable as a general rule. To enforce payment against a corporation, the note or other writing should clearly show that the debtor is a corporation.

Bond and Stock Powers

As mentioned previously, an institution generally obtains a security interest in stocks and bonds by possession. The documents which allow the institution to sell the securities if the borrower defaults are called stock powers and bond powers. The examiner should ensure the institution has, for each borrower who has pledged stocks or bonds, one signed stock power for all stock certificates of a single issuer, and a separate signed bond power for each bond instrument. The signature must agree with the name on the actual stock certificate or bond instrument. Refer to Federal Reserve Board Regulations Part 221 (Reg U) for further information on loans secured by investment securities.

Co-maker

Two or more persons who are parties to a contract or promise to pay are known as co-makers. They are a unit to the performance of one act and are considered primarily liable. In the case of default on an unsecured loan, a judgment would be obtained against all. A release against one is a release against all because there is but one obligation and if that obligation is released as to one obligor, it is released as to all others.

Loan Guarantee

Since banks often condition credit advances upon the backup support provided by third party guarantees, examiners should understand the legal fundamentals governing guarantees. A guarantee may be a guarantee of payment or of collection. "Payment guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it according to its terms without resort by the holder to any other party. "Collection guaranteed" or equivalent words added to a signature means that if the instrument is not paid when due, the guarantor will pay it, but only after the holder has reduced to judgment a claim against the maker and execution has been returned unsatisfied, or after the maker has become insolvent or it is otherwise useless to proceed against such a party.

Contracts of guarantee are further divided into a limited guarantee which relates to a specific note (often referred to as an "endorsement") or for a fixed period of time, or a continuing guarantee which, in contrast, is represented by a separate instrument and enforceable for future (duration depends upon state law) transactions between the institution and the borrower or until revoked. A well-drawn continuing guarantee contains language substantially similar to the following: "This is an absolute and unconditional guarantee of payment, is unconditionally delivered, and is not subject to the procurement of a guarantee from any person other than the undersigned, or to the performance or happening of any other condition." The aforementioned unambiguous terms are necessary to the enforceability of contracts of guarantee, as they are frequently entered into solely as an accommodation for the borrower and without the guarantor's participation in the benefits of the loan. Thus, courts tend to construe contracts of guarantee strictly against the party claiming under the contract. Unless the guarantee is given prior to or at the time the initial loan is made, the guarantee may not be enforceable because of the difficulty of establishing that consideration was given. Institutions should not disburse funds on such loans until they have the executed guarantee agreement in their possession. Institutions should also require the guarantee be signed in the presence of the loan officer, or, alternatively, that the guarantor's signature be notarized. If the proposed guarantor is a partnership, joint venture, or corporation, the examiner should ensure the signing party has the legal authority to enter into the guarantee agreement. Whenever there is a question concerning a corporation's authority to guarantee a loan, counsel should be consulted and a special corporate resolution passed by the organization's board of directors.

Subordination Agreement

An institution extending credit to a closely held corporation may want to have the company's officers and shareholders subordinate to the institution's loan any indebtedness owed them by the corporation. This is accomplished by execution of a subordination agreement by the officers and shareholders. Subordination agreements are also commonly referred to as standby agreements. Their basic purpose is to prevent diversion of funds from reduction of institution debt to reduction of advances made by the firm's owners or officers.

Hypothecation Agreement

This is an agreement whereby the owner of property grants a security interest in collateral to the institution to secure the indebtedness of a third party. Institutions often take possession of the stock certificates, plus stock powers endorsed in blank, in lieu of a hypothecation agreement. Caution, however, dictates that the institution take a hypothecation agreement setting forth the institution's rights in the event of default.

Real Estate Mortgage

A mortgage may be defined as a conveyance of realty given with the intention of providing security for the payment of debt. There are several different types of mortgage instruments but those commonly encountered are regular mortgages, deeds of trust, equitable mortgages, and deeds absolute given as security.

Regular Mortgages - The regular mortgage involves only two parties, the borrower and the lender. The mortgage document encountered in many states today is referred to as the regular mortgage. It is, in form, a deed or conveyance of realty by the borrower to the lender followed or preceded by a description of the debt and the property, and includes a provision to the effect that the mortgage be released upon full payment of the debt. Content of additional paragraphs and provisions varies considerably.

Deeds of Trust - In the trust deed, also known as the deed of trust, the borrower conveys the realty not to the lender but to a third party, a trustee, in trust for the benefit of the holder of the notes(s) that constitutes the mortgage debt. The deed of trust form of mortgage has certain advantages, the principle being that in a number of states it can be foreclosed by trustee's sale under the power of sale clause without court proceedings.

Equitable Mortgages - As a general rule, any instrument in writing by which the parties show their intention that realty be held as security for the payment of a debt, constitutes an equitable mortgage capable of being foreclosed in a court of equity.

Deeds Absolute Given as Security - Landowners who borrow money may give as security an absolute deed to the land. "Absolute deed" means a quitclaim or warranty deed such as is used in an ordinary realty sale. On its face, the transaction appears to be a sale of the realty; however, the courts treat such a deed as a mortgage where the evidence shows that the instrument was really intended only as security for a debt. If such proof is available, the borrower is entitled to pay the debt and demand reconveyance from the lender, as in the case of an ordinary mortgage. If the debt is not paid, the grantee must foreclose as if a regular mortgage had been made.

The examiner should determine whether the institution has performed a title and lien search of the property prior to taking a mortgage or advancing funds. Proper procedure calls for an abstractor bringing the abstract up to date, and review of the abstract by an attorney or title insurance company. If an attorney performs the task, the abstract will be examined and an opinion prepared indicating with whom title rests, along with any defects and encumbrances disclosed by the abstract. Like an abstractor, an attorney is liable only for damages caused by negligence. If a title insurance company performs the task of reviewing the abstract, it does essentially the same thing; however, when title insurance is obtained, it represents a contract to make good, loss arising through defects in title to real estate or liens or encumbrances thereon. Title insurance covers various items not covered in an abstract and title opinion. Some of the more common are errors by abstractors or attorneys include unauthorized corporate action, mistaken legal interpretations, and unintentional errors in public records by public officials. Once the institution determines title and lien status of the property, the mortgage can be prepared and funds advanced. The institution should record the mortgage immediately after closing the loan. Form, execution, and recording of mortgages vary from state to state and therefore must conform to the requirements of state law.

Collateral Assignment

An assignment is generally considered as the transfer of a legal right from one person to another. The rights acquired under a contract may be assigned if they relate to money or property, but personal services may not be assigned. Collateral assignments are used to establish the institution's rights as lender in the property or asset serving as collateral. It is generally used for loans secured by savings deposits, certificates of deposit or other cash accounts as well as loans backed by cash surrender value of life insurance. In some instances, it is used in financing accounts receivable and contracts. If a third party holder of the collateral is involved, such as life insurance company or the payor of an assigned contract, an acknowledgement should be obtained from that party as to the institution's assigned interest in the asset for collateral purposes.

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CONSIDERATION OF BANKRUPTCY LAW AS IT RELATES TO COLLECTIBILITY OF A DEBT

Introduction

Familiarity with the basic terms and concepts of the federal bankruptcy law (formally known as the Bankruptcy Reform Act of 1978) is necessary in order for examiners to make informed judgments concerning the likelihood of collection of loans to bankrupt individuals or organizations. The following paragraphs present an overview of the subject. Complex situations may arise where more in-depth consideration of the bankruptcy provisions may be necessary and warrant consultation with the institution's attorney, regional counsel or other member of the regional office staff. For the most part, however, knowledge of the following information when coupled with review of credit file data and discussion with institution management should enable examiners to reach sound conclusions as to the eventual repayment of the institution's loans.

Forms of Bankruptcy Relief

Liquidation and rehabilitation are the two basic types of bankruptcy proceedings. Liquidation is pursued under Chapter 7 of the law and involves the bankruptcy trustee collecting all of the debtor's nonexempt property, converting it into cash and distributing the proceeds among the debtor's creditors. In return, the debtor obtains a discharge of all debts outstanding at the time the petition was filed which releases the debtor from all liability for those pre-bankruptcy debts.

Rehabilitation (sometimes known as reorganization) is effected through Chapter 11 or Chapter 13 of the law and in essence provides that creditors' claims are satisfied not via liquidation of the obligor's assets but rather from future earnings. That is, debtors are allowed to retain their assets but their obligations are restructured and a plan is implemented whereby creditors may be paid.

Chapter 11 bankruptcy is available to all debtors, whether individuals, corporations or partnerships. Chapter 13 (sometimes referred to as the "wage earner plan"), on the other hand, may be used only by individuals with regular incomes and when their unsecured debts are under $100,000 and secured debts less than $350,000. The aforementioned rehabilitation plan is essentially a contract between the debtor and the creditors. Before the plan may be confirmed, the bankruptcy court must find it has been proposed in good faith and that creditors will receive an amount at least equal to what would be received in a Chapter 7 proceeding. In Chapter 11 reorganization, all creditors are entitled to vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, only secured creditors are so entitled. A majority vote binds the minority to the plan, provided the latter will receive pursuant to the plan at least the amount they would have received in a straight liquidation. The plan is fashioned so that it may be carried out in three years although the court may extend this to five years.

Most cases in bankruptcy courts are Chapter 7 proceedings, but reorganization cases are increasingly common. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. Nonetheless, the fact that reorganization plans are tailored to the facts and circumstances applicable to each bankrupt situation means that they vary considerably and the amount recovered by the creditor may similarly vary from nominal to virtually complete recovery.

Functions of Bankruptcy Trustees

Trustees are selected by the borrower's creditors and are responsible for administering the affairs of the bankrupt debtor's estate. The bankrupt's property may be viewed as a trust for the benefit of the creditors, consequently it follows the latter should, through their elected representatives, exercise substantial control over this property.

Voluntary and Involuntary Bankruptcy

When a debtor files a bankruptcy petition with the court, the case is described as a voluntary one. It is not necessary the individual or organization be insolvent in order to file a voluntary case. Creditors may also file a petition, in which case the proceeding is known as an involuntary bankruptcy. However, this alternative applies only to Chapter 7 cases and the debtor generally must be insolvent, i.e., unable to pay debts as they mature, in order for an involuntary bankruptcy to be filed.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to stop or "stay" further action to collect their claims or enforce their liens or judgements. Actions to accelerate, set off or otherwise collect the debt are prohibited once the petition is filed, as are post- bankruptcy contacts with the obligor. The stay remains in effect until the debtor's property is released from the estate, the bankruptcy case is dismissed, the debtor obtains or is denied a discharge, or the bankruptcy court approves a creditor's request for termination of the stay. Two of the more important grounds applicable to secured creditors under which they may request termination are as follows: (1) The debtor has no equity in the encumbered property, and the property is not necessary to an effective rehabilitation plan; or (2) The creditor's interest in the secured property is not adequately protected. In the latter case, the law provides three methods by which the creditor's interests may be adequately protected: the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; an additional or substitute lien on other property may be obtained; or some other protection is arranged (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in the secured creditor being adequately protected, relief from the automatic stay will not be granted. If relief from the stay is obtained, creditors may continue to press their claims upon the bankrupt's property free from interference by the debtor or the bankruptcy court.

Property of the Estate

When a borrower files a bankruptcy petition, an "estate" is created and, under Chapter 7 of the law, the property of the estate is passed to the trustee for distribution to the creditors. Certain of the debtor's property is exempt from distribution under all provisions of the law (not just Chapter 7), as follows: homeowner's equity up to $7,500; automobile equity and household items up to $1,200; jewelry up to $500; cash surrender value of life insurance up to $4,000; Social Security benefits (unlimited); and miscellaneous items up to $400 plus any unused portion of the homeowner's equity. The bankruptcy code recognizes a greater amount of exemptions may be available under state law and, if state law is silent or unless it provides to the contrary, the debtor is given the option of electing either the federal or state exemptions. Examiners should note that some liens on exempt property which would otherwise be enforceable are rendered unenforceable by the bankruptcy. A secured lender may thus become unsecured with respect to the exempt property. The basic rule in these situations is that the debtor can render unenforceable judicial liens on any exempt property and security interests that are both nonpurchase money and nonpossessory on certain household goods, tools of the trade and health aids.

Discharge and Objections to Discharge

The discharge, as mentioned previously, protects the debtor from further liability on the debts discharged. Sometimes, however, a debtor is not discharged at all (i.e., the creditor has successfully obtained an "objection to discharge") or is discharged only as regards to a specific creditor(s) and a specific debt(s) (an action known as "exception to discharge"). The borrower obviously remains liable for all obligations not discharged, and creditors may pursue customary collection procedures with respect thereto. Grounds for an "objection to discharge" include the following actions or inactions by the bankrupt debtor (this is not an all-inclusive list): fraudulent conveyance within 12 months of filing the petition; unjustifiable failure to keep or preserve financial records; false oath or account or presentation of a false claim in the bankruptcy case and estate, respectively; withholding of books or records from the trustee; failure to satisfactorily explain any loss or deficiency of assets; refusal to testify when legally required to do so; and receiving a discharge in bankruptcy within the last six full years. Some of the bases upon which creditors may file "exceptions to discharge" are: nonpayment of income taxes for the three years preceding the bankruptcy; money, property or services obtained through fraud, false pretenses or false representation; debts not scheduled on the bankruptcy petition and which the creditor had no notice; alimony or child support payments (this exception may be asserted only by the debtor's spouse or children, property settlements are dischargeable); and submission of false or incomplete financial statements. If an institution attempts to seek an exception on the basis of false financial information, it must prove the written financial statement was materially false, it reasonably relied on the statement, and the debtor intended to deceive the institution. These assertions can be difficult to prove. Discharges are unavailable to corporations or partnerships. Therefore, after a bankruptcy, corporations and partnerships often dissolve or become defunct.

Reaffirmation

Debtors sometimes promise their creditors after a bankruptcy discharge that they will repay a discharged debt. An example wherein a debtor may be so motivated involves the home mortgage. To keep the home and discourage the mortgagee from foreclosing, a debtor may reaffirm this obligation. This process of reaffirmation is an agreement enforceable through the judicial system. The law sets forth these basic limitations on reaffirmations: the agreement must be signed before the discharge is granted; a hearing is held and the bankruptcy judge informs the borrower there is no requirement to reaffirm; and the debtor has the right to rescind the reaffirmation if such action is taken within 30 days.

Classes of Creditors

The first class of creditors is known as priority creditors. As the name implies, these creditors are entitled to receive payment prior to any others. Priority payments include administrative expenses of the debtor's estate, unsecured claims for wages and salaries up to $2,000 per person, unsecured claims for employee benefit plans, unsecured claims of individuals up to $900 each for deposits in conjunction with rental or lease of property, unsecured claims of governmental units and certain tax liabilities. Secured creditors are only secured up to the extent of the value of their collateral. They become unsecured in the amount by which collateral is insufficient to satisfy the claim. Unsecured creditors are of course the last class in terms of priority.

Preferences

Certain actions taken by a creditor before or during bankruptcy proceedings may be invalidated by the trustee if they result in some creditors receiving more than their share of the debtor's estate. These actions are called "transfers" and fall into two categories. The first involves absolute transfers, such as payments received by a creditor; the trustee may invalidate this action and require the payment be returned and made the property of the bankrupt estate. A transfer of security, such as the granting of a mortgage, may also be invalidated by the trustee. Hence, the trustee may require previously encumbered property be made unencumbered, in which case the secured party becomes an unsecured creditor. This has obvious implications as regards loan collectibility.

Preferences are a potentially troublesome area for banks and examiners should have an understanding of basic principles applicable to them. Some of the more important of these are listed here.

- A preference may be invalidated (also known as "avoided") if it has all of these elements: the transfer was to or for the benefit of a creditor; the transfer was made for or on account of a debt already outstanding; the transfer has the effect of increasing the amount a creditor would receive in Chapter 7 proceedings; the transfer was made within 90 days of the bankruptcy filing, or within one year if the transfer was to an insider who had reasonable cause to believe the debtor was insolvent at the time of transfer; and the debtor was insolvent at the time of the transfer. Under bankruptcy law, borrowers are presumed insolvent for 90 days prior to filing the bankruptcy petition.
- Payment to a fully secured creditor is not a preference because such a transfer would not have the effect of increasing the amount the creditor would otherwise receive in a Chapter 7 proceeding. Payment to a partially secured creditor does, however, have the effect of increasing the creditor's share and is thus deemed a preference which the trustee may avoid.
- Preference rules also apply to a transfer of a lien to secure past debts, if the transfer has all five elements set forth under the first point.
- There are certain situations wherein a debtor has given a preference to a creditor but the trustee is not permitted to invalidate it. A common example concerns floating liens on inventory under the Uniform Commercial Code. These matters are subject to complex rules, however, and consultation with the regional office may be advisable when this issue arises.

Setoffs

Setoffs occur when a party is both a creditor and a debtor of another; amounts which a party owes are netted against amounts which are owed to that party. If an institution exercises its right of setoff properly and before the bankruptcy filing, the action is generally upheld in the bankruptcy proceedings. Setoffs made after the bankruptcy may also be valid but certain requirements must be met of which the following are especially important: First, the debts must be between the same parties in the same right and capacity. For example, it would be improper for the institution to setoff the debtor's loan against a checking account of the estate of the obligor's father, of which the debtor is executor. Second, both the debt and the deposit must precede the bankruptcy petition filing. Third, the setoff may be disallowed if funds were deposited in the institution within 90 days of the bankruptcy filing and for the purpose of creating or increasing the amount to be set off.

Transfers Not Timely Perfected or Recorded

Under most circumstances, an institution which has not recorded its mortgage or otherwise fails to perfect its security interest in a proper timely manner runs great risk of losing its security. This is a complex area of the law but prudence clearly dictates that liens be properly obtained and promptly filed so that the possibility of losing the protection provided by collateral is eliminated.

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SYNDICATED LENDING

Overview

Syndicated loans often represent a substantial portion of the commercial and industrial loan portfolios of large banks. A syndicated loan involves two or more banks contracting with a borrower, typically a large or middle market corporation, to provide funds at specified terms under the same credit facility. The average commercial syndicated credit is in excess of $100 million. Syndicated credits differ from participation loans in that lenders participate jointly in the origination process, as opposed to one originator selling undivided participation interests to third parties. In a syndicated transaction, each financial institution receives a pro rata share of the income based on the level of participation in the credit. Additionally, one or more lenders take on the role of *lead* or *agent* (co-agents in the case of more than one) of the credit and assume responsibility of administering the loan for the other lenders. The agent may retain varying percentages of the credit, which is commonly referred to as the hold *level*.

The syndicated-lending market formed to meet basic needs of lenders and borrowers, such as:

- Raising large amounts of money,
- Enabling geographic diversification,
- Obtaining working capital quickly and efficiently,
- Diversifying credit risk among banks, and
- Gaining attractive pricing advantages.

In times of excess liquidity in the marketplace, spreads typically are quite narrow for investment-grade facilities, thus making it a borrower's market. This may be accompanied by an easing of the structuring and covenants. In spite of tightening margins, commercial banks are motivated to compete regarding pricing in order to retain other business as well as generate fee income.

Relaxing covenants and pricing may result in lenders relying heavily on market valuations, or so-called "enterprise values" in arriving at credit decisions. These values are derived by applying a current-period multiple to cash flows (which uses data from comparable companies within the same industry), or discounting projected cash flows over several years (which typically uses an average cost of capital as the discount rate). This value represents the intangible business value of a company as a going concern, which often exceeds its underlying hard assets.

Many deals involve merger and acquisition financing. While the primary originators of the syndicated loans are commercial banks, most of the volume is sold and held by other investors.

A subset of syndicated lending is leveraged lending which refers to borrowers with an elevated level of debt and debt service compared with cash flow. By their very nature, these instruments are of higher risk.

Syndication Process

There are four phases in loan syndications: Pre-Launch, Launch, Post-Launch, and Post-Closing.

The Pre-Launch Process - During this phase, the syndicators identify the borrower's needs and perform their initial due diligence. Industry information is gathered and analyzed, and background checks may be performed. Potential pricing and structure of the transaction takes shape. Formal credit write-ups are sent to credit officers for review and to senior members of the syndication group for pricing approval. Competitive bids are sent to the borrower. The group then prepares for the launch.

An information memorandum is prepared by the agent. This memorandum is a formal and confidential document that should address all principal credit issues relating to the borrower and to the project being financed. It typically contains an overview of the transaction including a term sheet, an overview of the borrower's business, and quarterly and annual certified financial statements. This document acts as both the marketing tool and as the source of information for the syndication.

The Launch Phase - The transaction is launched into the market when banks are sent the information memoranda mentioned above. Legal counsel commences to prepare the documentation. Negotiations take place between the banks and the borrower over pricing, collateral, covenants, and other terms. Often there is an institution meeting so potential participants can discuss the company's business and industry both with the lead agent and with the company.

Post-Launch Phase - Typically there is a two-week period for potential participants to evaluate the transaction and to decide whether or not to participate in the syndication. During this period, banks do their due diligence and credit approval. Often this entails running projection models, including stress tests, doing business and industry research, and presenting the transaction for the approval process once the decision is made to commit to the transaction.

After the commitment due date, participating banks receive a draft credit agreement for their comments. Depending upon the complexity of the agreement, they usually have about a week to make comments. The final credit agreement is then negotiated based on the comments and the loan would then close two to five days after the credit agreement is finalized.

Post-Closing Phase - Post-Closing, there usually is an ongoing dialogue with the borrower about financial/operating performance as well as quarterly credit agreement covenant compliance checks. Annually, a full credit analysis typically is done as well as annual meetings of the participants for updates on financial and operating performance. Both the agent institution and the participants need to assess the loan protection level by analyzing the business risk as well as the financial risk. Each industry has particular dominant risks to be assessed.

Loan Covenants

Loan covenants are special conditions included in a loan agreement that the borrower is required to fulfill in order for the loan agreement to remain valid. Typically, covenants cover several domains but can broadly be divided into financial and non-financial categories. Effective financial covenants establish an operating framework using conditions defined in absolute amounts or ratios. If exceeded by the borrower, the covenants provide lenders the opportunity to further strengthen collateral controls or adjust interest rates. Some examples are:

Net Worth test: restricts the total amount of debt a borrower can incur, expressed as a percentage of net worth.

Current Ratio/ Quick Ratio test: measures liquidity.

Interest, Debt Service or Fixed Charge Coverage test: assures that some level of cash flow is generated by a company above its interest expense and other fixed obligations. The proxy for cash flow is usually EBITDA (earnings before interest, taxes, depreciation and amortization).

Capital Expenditure Limitations: generally set according to the company's business plan and then measured accordingly.

Borrowing Base Limitations: lending formula typically based on eligible accounts receivable and inventory. At times, the formula may also include real estate or other non-current assets.

Leverage test: actual leverage covenant levels vary by industry segment. Typical ratios include Total Debt divided by EBITDA, Senior Debt divided by EBITDA and Net Debt (subtracts cash) divided by EBITDA.

Non-financial covenants may include restrictions on other matters such as management changes, provisions of information, guarantees, disposal of assets, etc.

Credit Rating Agencies

The large credit rating agencies (Standard and Poor's, Moody's, and Fitch Investor Services) provide coverage of many syndicated loans at origination and periodically during the life of the loan. Credit ratings issued by these agencies reflect a qualitative and quantitative evaluation of financial and other information of the prospective borrower, including information provided by the borrower and other non-public information.

Credit ratings may represent the overall corporate credit rating of a borrower or reflect analysis of a borrower's specific financial instruments, such as their syndicated loans. Credit ratings for each financial instrument reflect the general credit risk of the borrower, their ability to repay the debt, and the probability of the borrower defaulting on the instrument in question. Some credit rating agencies also provide separate ratings that consider the financial loss the holder of a financial instrument such as a syndicated loan may incur if a borrower defaults.

Overview of the Shared National Credit (SNC) Program

The Shared National Credit (SNC) Program is an interagency initiative administered jointly by the FDIC, Federal Reserve Board, and the Office of the Comptroller of the Currency. The program was established in the 1970's for the purpose of ensuring consistency among the three federal banking regulators in the classification of large syndicated credits.

Definition of a SNC

Any loan or formal loan commitment, including any asset such as other real estate, stocks, notes, bonds and debentures taken for debts previously contracted, extended to a borrower by a supervised institution, or any of its subsidiaries and affiliates, which in original amount aggregates $100 million or more and, which is shared by three or more unaffiliated institutions under a formal lending agreement; or, a portion of which is sold to two or more unaffiliated institutions, with the purchasing institution(s) assuming its pro rata share of the credit risk.

SNCs generally include:

- Loans administered by a domestic office of a supervised institution;
- Domestic commercial and real estate loans and all international loans to borrowers in the private sector; and
- Acceptances, commercial letters of credit, standby letters of credit or similar bonds or guarantees, note issuance facilities, revolving underwriting facilities, Eurodollar facilities, syndications, and similar extensions or commitments, and lease financing receivables.

SNCs do not include:

- Credits shared solely between affiliated supervised institutions;
- Private sector credits that are 100 percent guaranteed by a sovereign entity;
- International credits or commitments administered in a foreign office; or
- Direct credits to sovereign borrowers.

SNC Review and Rating Process

Teams of interagency examiners review and risk rate a sample of credits at agent banks during the first and third quarters of each year. Of note, SNC reviews occur regularly at agent banks originating a significant level of SNC credits. For agent banks with smaller SNC portfolios, credits are only reviewed through the program on an ad hoc basis. The SNC review sample is based on internal rating, industry, size, and the number of regulated participants. The regulatory rating assigned by an interagency team of examiners is reported to all participating banks shortly after the conclusion of the on-site review voting period. Ratings remain active on a rolling two review basis (approximately 1 year), thus avoiding duplicate reviews of the same loan and ensuring consistent treatment with regard to regulatory credit ratings. Examiners should not change SNC ratings during risk management examinations. Any material change in a borrower's condition should be reported to the national SNC coordinator.

The SNC rating process includes risk rating, accrual and TDR status. Impairment measurement and ALLL treatment are not addressed in the SNC rating and should be reviewed at each participant institution. Current and historical SNC ratings can be accessed through the FDIC's internal systems. Designated SNC credits not reviewed in the current SNC sample will be listed as "Not Rated." These credits may be reviewed separately at the participant institution if significant to the examination scope or an examiner believes that the credit may carry an adverse rating.

The FDIC's SNC office can provide examiners with additional information to facilitate the review of "Not Rated" credits or copies of line sheets used in the interagency SNC review to help examiners explain rating rationales to participant banks. In those situations where a "Not Rated" credit is reviewed at the participant institution and an adverse rating is assigned, examiners should communicate their findings to the national SNC coordinator.

SNC Rating Communication and Distribution Process

At the conclusion of each semi-annual SNC review, electronic reports are generated, and notifications are sent via email to participant institution contacts. They are provided a link to retrieve a summary of ratings, applicable loan write-ups, cover letter and a list of agent institution contacts. These reports are available to examiners upon request and can be retransmitted to the participant institution contact if needed. The notification email also marks the beginning of a 14 day window for banks to file an appeal.

Appeals Process

Agent and participant banks may appeal any preliminary rating. Agent and participant banks have 14 days from the electronic distribution of preliminary results to submit an appeal. The written appeal details the reasons why the institution is disputing the classification and includes documentation supporting the institution's position. The written appeal is sent to the applicable agency of the agent institution for the credit in question. An interagency appeals panel reviews the appeal, determines the final disposition of the credit, and informs the institution of its decision in writing. Ratings changed by the appeals process are communicated electronically to all affected participant banks.

Additional Risks Associated with Syndicated Loan Participations

An institution that purchases a participation interest in large loan syndications faces the same risks as an institution purchasing an ordinary loan participation from another institution. Examiners should reference the manual section on *Loan Participations* for a more in depth discussion of related risks. As discussed in that section, an institution purchasing a participation loan is expected to perform the same degree of independent credit analysis on the loan as if it were the originator. The same holds true for banks purchasing participation interests in large syndications. Institutions that lack the resources or skill sets to perform an independent credit analysis on a complex loan syndication generally refrain from participating in such a transaction.

In some cases, an institution may enter into a sub-participation agreement in which the institution purchases a piece of a participation from another syndicated loan participant rather than directly from the agent institution. As a result, the sub-participant may not be registered with or known to the agent institution and may not receive timely notification of risk ratings or adverse credit actions from either the agent institution or the SNC system. Additionally, sub-participants may not have the same legal rights or remedies as participants of record in the syndicate, which may give rise to other transactional and operational risk concerns.

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CREDIT SCORING

Automated credit scoring systems allow institutions to underwrite and price loans more quickly than was possible in the past. This efficiency has enabled some banks to expand their lending into national markets and originate loan volumes once considered infeasible. Scoring also reduces unit-underwriting costs, while yielding a more consistent loan portfolio that is easily securitized. These benefits have been the primary motivation for the proliferation of credit scoring systems among both large and small institutions.

Credit scoring systems identify specific characteristics that help define predictive variables for acceptable performance (delinquency, amount owed on accounts, length of credit history, home ownership, occupation, income, etc.) and assign point values relative to their overall importance. These values are then totaled to calculate a credit score, which helps institutions to rank order risk for a given population. Generally, an individual with a higher score will perform better relative to an individual with a lower credit score.

Few, if any, institutions have an automated underwriting system where the credit score is used exclusively to make the credit decision. Some level of human review is usually present to provide the flexibility needed to address individual circumstances. Institutions typically establish a minimum cut-off score below which applicants are denied and a second cutoff score above which applicants are approved. However, there is usually a range, or “gray area,” in between the two cut-off scores where credits are manually reviewed and credit decisions are judgmentally determined.

Most, if not all, systems also provide for overrides of established cut-off scores. If the institution’s scoring system effectively predicts loss rates and reflects management’s risk parameters, excessive overrides will negate the benefits of an automated scoring system. Therefore, it is critical for management to monitor and control overrides. Institutions typically develop acceptable override limits and prepare monthly override reports that provide comparisons over time and against the institution’s parameters. Override reports also typically identify the approving officer and include the reason for the override.

Although banks often use more than one type of credit scoring methodology in their underwriting and account management practices, many systems incorporate credit bureau scores. Credit bureau scores are updated periodically and validated on an ongoing basis against performance in credit bureau files. Scores are designed to be comparable across the major credit bureaus; however, the ability of any score to estimate performance outcome probabilities depends on the quality, quantity, and timely submission of lender data to the various credit bureaus. Often, the depth and thoroughness of data available to each credit bureau varies, and as a consequence, the quality of scores varies.

As a precaution, institutions that rely on credit bureau scores often sample and compare credit bureau reports to determine which credit bureau most effectively captures data for the market(s) in which the institution does business. For institutions that acquire credit from multiple regions, use of multiple scorecards may be appropriate, depending on apparent regional credit bureau strength. In some instances, it may be worthwhile for institutions to pull scores from each of the major credit bureaus and establish rules for selecting an average value. By tracking credit bureau scores over time and capturing performance data to differentiate which score seems to best indicate probable performance outcome, institutions can select the best score for any given market. Documenting such efforts to differentiate and select the best credit bureau score supports a deliberative decision process.

Although some institutions develop their own scoring models, most are built by outside vendors and subsequently maintained by the institution. Vendors build scoring models based upon specific information and parameters provided by institution management. Therefore, management must clearly communicate with the vendor and ensure that the scorecard developer clearly understands the institution's objectives. Bank management that adheres closely to vendor manual specifications for system maintenance and management, particularly those that provide guidance for periodically assessing performance of the system, achieve the most reliable results.

Scoring models generally become less predictive as time passes. Certain characteristics about an applicant, such as income, job stability, and age change over time, as do overall demographics. One-by-one, these changes will result in significant shifts in the profile of the population. Once a fundamental change in the profile occurs, the model is less able to identify potentially good and bad applicants. As these changes continue, the model loses its ability to rank order risk. Thus, for the best results, institutions must periodically validate the system's predictability, refine scoring characteristics when necessary, and document these efforts.

Institutions initially used credit scoring for consumer lending applications such as credit card, auto, and mortgage lending. However, credit scoring eventually gained acceptance in the small business sector. Depending on the manner in which it is implemented, credit scoring for small business lending may represent a fundamental shift in underwriting philosophy if institutions view a small business loan as more of a high-end consumer loan and, thus, grant credit more on the strength of the principals' personal credit history and less on the fundamental strength of the business. While this may be appropriate in some cases, it is important to remember that the income from small business remains the primary source of repayment for most loans. Institutions that do not analyze business financial statements or periodically review their lines of credit may lose an opportunity for early detection of credit problems.

The effectiveness of any scoring system directly depends on the policies and procedures established to guide and enforce proper use. The most effective policies include an overview of the institution's scoring objectives and operations; the establishment of authorities and responsibilities over scoring systems; the use of a chronology log to track internal and external events that affect the scoring system; the establishment of institution officials responsible for reporting, monitoring, and reviewing overrides; as well as the provision of a scoring system maintenance program to ensure that the system continues to rank risk and to predict default and loss under the original parameters.

Examiners should refer to the Credit Card Specialty Bank Examination Guidelines and the Credit Card Activities section of the Examination Modules for additional information on credit scoring systems.

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SUBPRIME LENDING

Introduction

There is no universal definition of a subprime loan in the industry, but subprime lending is generally characterized as a lending program or strategy that targets borrowers who pose a significantly higher risk of default than traditional retail banking customers. Institutions often refer to subprime lending by other names such as the nonprime, nonconforming, high coupon, or alternative lending market.

Well-managed subprime lending can be a profitable business line; however, it is a high-risk lending activity. Successful subprime lenders carefully control the elevated credit, operating, compliance, legal, market, and other risks as well as the higher overhead costs associated with more labor-intensive underwriting, servicing, and collections. Subprime lending should only be conducted by institutions that have a clear understanding of the business and its inherent risks, and have determined these risks to be acceptable and controllable given the institution's staff, financial condition, size, and level of capital support. In addition, subprime lending should only be conducted within a comprehensive lending program that employs strong risk management practices to identify, measure, monitor, and control the elevated risks that are inherent in this activity. Finally, subprime lenders need to retain capital support that is consistent with the volume and nature of the additional risks assumed. If the risks associated with this activity are not properly controlled, subprime lending may be considered an unsafe and unsound banking practice.

The term, subprime, refers to the credit characteristics of the borrower at the loan's origination, rather than the type of credit or collateral considerations. Subprime borrowers typically have weakened credit histories that may include a combination of payment delinquencies, charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria. 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 5 years;
- Relatively high default probability as evidenced by, for example, a Fair Isaac and Co. risk score (FICO) of 660 or below (depending on the product/collateral), or other bureau or proprietary scores with an equivalent default probability likelihood; and
- 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.

This list is illustrative rather than exhaustive and is not meant to define specific parameters for all subprime borrowers. Additionally, this definition may not match all market or institution-specific subprime definitions, but should be viewed as a starting point from which examiners should expand their review of the institution's lending program.

Subprime lenders typically use the criteria above to segment prospects into subcategories such as, for example, A, B, C, and D. However, subprime subcategories can vary significantly among lenders based on the credit grading criteria. What may be an "A" grade definition at one institution may be a "B" grade at another institution, but generally each grade represents a different level of credit risk.

While the industry often includes borrowers with limited or no credit histories in the subprime category, these borrowers can represent a substantially different risk profile than those with a derogatory credit history and are not inherently considered subprime. Rather, consideration should be given to underwriting criteria and portfolio performance when determining whether a portfolio of loans to borrowers with limited credit histories should be treated as subprime for examination purposes.

Subprime lending typically refers to a lending program that targets subprime borrowers. Institutions engaging in subprime lending generally have knowingly and purposefully focused on subprime lending through planned business strategies, tailored products, and explicit borrower targeting. An institution's underwriting guidelines and target markets should provide a basis for determining whether it should be considered a subprime lender. The average credit risk profile of subprime loan programs will exhibit the credit risk characteristics listed above, and will likely display significantly higher delinquency and/or loss rates than prime portfolios. High interest rates and fees are a common and relatively easily identifiable characteristic of subprime lending. However, high interest rates and fees by themselves do not constitute subprime lending.

Subprime lending does not include traditional consumer lending that has historically been the mainstay of community banking, nor does it include making loans to subprime borrowers as discretionary exceptions to the institution's prime retail lending policy. In addition, subprime lending does not refer to: prime loans that develop credit problems after acquisition; loans initially extended in subprime programs that are later upgraded, as a result of their performance, to programs targeted to prime borrowers; or community development loans as defined in the CRA regulations.

For supervisory purposes, a subprime lender is defined as an insured institution or institution subsidiary that has a subprime lending program with an aggregate credit exposure greater than or equal to 25 percent of Tier 1 capital plus ALLL. Aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual assets relating to securitized subprime loans.

Capitalization

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than exist in subprime loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime lending activities, and for fully documenting the methodology and analysis supporting the amount specified.

Examiners will evaluate the capital adequacy of subprime lenders on a case-by-case basis, considering, among other factors, the institution's own documented analysis of the capital needed to support its subprime lending activities. Capital levels are typically risk sensitive, that is, allocated capital should reflect the level and variability of loss estimates within reasonably conservative parameters. Institutions generally specify a direct link between the estimated loss rates used to determine an appropriate ALLL, and the unexpected loss estimates used to determine capital.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime lending activities and consider the following elements:

- Portfolio growth rates;
- Trends in the level and volatility of expected losses;
- The level of subprime loan losses incurred over one or more economic downturns, if such data/analyses are available;

- The impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets;
- Any deterioration in the average credit quality over time due to adverse selection or retention;
- The amount, quality, and liquidity of collateral securing the individual loans;
- Any asset, income, or funding source concentrations;
- The degree of concentration of subprime credits;
- The extent to which current capitalization consists of residual assets or other potentially volatile components;
- The degree of legal and other risks associated with the subprime business line(s) pursued; and
- The amount of capital necessary to support the institution's other risks and activities.

Given the higher risk inherent in subprime lending programs, examiners should reasonably expect, as a starting point, that an institution 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. Refinements typically depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and the amount, quality, and liquidity of collateral securing the loans. Institutions with significant subprime programs generally have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared to prime loans, and may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding depending on the level and volatility of risk. Because of the higher inherent risk levels and the increased impact that subprime portfolios may have on an institution's overall capital, examiners should document and reference each institution's subprime capital evaluation in their comments and conclusions regarding capital adequacy.

Stress Testing

An institution's capital adequacy analysis typically includes stress testing as a tool for estimating unexpected losses in its subprime lending pools. Institutions may project the performance of their subprime loan pools under conservative stress test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing scenarios may include "shock" testing of basic assumptions such as delinquency rates, loss rates, and recovery rates on collateral. It may also consider other potentially adverse scenarios, such as: changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit score distribution; and changes in the capital markets demand for whole loans, or asset-backed securities supported by subprime loans.

These are representative examples. Actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress test scenarios are performed manually, or through automated modeling techniques, the Regulatory Agencies will expect that:

- The process is clearly documented, rational, and easily understood by the board and senior management;
- The inputs are reliable and relate directly to the subject portfolios;
- Assumptions are well documented and conservative; and
- Any models are subject to a comprehensive validation process.

The results of the stress test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime lending without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime lending activities, examiners should consult with their regional office to determine the appropriate course of action.

Risk Management

The following items are essential components of an effective risk management program for subprime lenders.

Planning and Strategy. Prior to engaging in subprime lending, the board and management 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 establishing appropriate feedback and control systems. Appropriate risk assessment processes extend beyond credit risk and appropriately incorporate operating, compliance, market, liquidity, and legal risks.

Institutions establishing an appropriate subprime lending program 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. Strategic plan performance analysis is generally conducted frequently in order to detect adverse trends or circumstances and take appropriate action in a timely manner.

Management and Staff. Prior to engaging in subprime lending, the board typically ensures that management and staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of activity. 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 is generally not sufficient to have the same staff responsible for both subprime and prime loans. Servicing and collecting subprime loans can be very labor intensive and requires a greater volume of staff with smaller caseloads. Lenders should monitor staffing levels, staff experience, and the need for additional training as performance is assessed over time. Compensation programs should not depend primarily on volume or growth targets. Any targets used should be weighted towards factors such as portfolio quality and risk-adjusted profitability.

Lending Policies and Procedures. Lenders typically have comprehensive written policies and procedures, specific to each subprime lending product that set limits on the amount of risk that will be assumed and address how the institution will control portfolio quality and avoid excessive exposure. Prudent institutions implement policies and procedures before initiating the activity. Institutions may originate subprime loans through a variety of channels, including dealers, brokers, correspondents, and marketing firms. Regardless of the source, it is critical that underwriting policies and procedures incorporate the risk tolerances established by the board and management and explicitly define underwriting criteria and exception processes. Subprime lending policies and procedures typically address the items outlined in the loan reference module of the ED Modules for subprime lending. If the institution elects to use scoring systems for approvals or pricing, the model should be tailored to address the behavioral and credit characteristics of the subprime population targeted and the products offered. It is generally not acceptable to rely on models developed for standard risk borrowers or products. Furthermore, the models should be reviewed frequently and updated as necessary to ensure assumptions remain valid.

Given the higher credit risk associated with the subprime borrower, effective subprime lenders use mitigating underwriting guidelines and risk-based pricing to reduce the overall risk of the loan. These guidelines include lower loan-to-value ratio requirements and lower maximum loan amounts relative to each risk grade within the portfolio. Given the high-risk nature of subprime lending, the need for thorough analysis and documentation is heightened relative to prime lending. Compromises in analysis or documentation can substantially increase the risk and severity of loss. In addition, successful subprime lenders develop criteria for limiting the risk profile of borrowers selected, giving consideration to factors such as the frequency, recentness, and severity of delinquencies and derogatory items; length of time with re-established credit; and reason for the poor credit history.

Since the past credit deficiencies of subprime borrowers reflect a higher risk profile, appropriate subprime loan programs are based upon the borrowers' current reasonable ability to repay and a prudent debt amortization schedule. Loan repayment should not be based upon foreclosure proceedings or collateral repossession. Institutions are to recognize the additional default risks and determine if these risks are acceptable and controllable without resorting to foreclosure or repossession that could have been predetermined by the loan structure at inception.

Profitability and Pricing. A key consideration for lenders in the subprime market is the ability to earn risk-adjusted yields that appropriately compensate the institution for the increased risk and costs assumed. Successful institutions have a comprehensive framework for pricing decisions and profitability analysis that considers all costs associated with each subprime product, including origination, administrative/servicing, expected charge-offs, funding, and capital. In addition, such pricing frameworks allow for fluctuations in the economic cycle. Fees often comprise a significant portion of revenue in subprime lending. Consideration should be given to the portion of revenues derived from fees and the extent to which the fees are a recurring and viable source of revenue. Profitability projections typically are incorporated into the business plan. Also, effective management teams track actual performance against projections regularly and have a process for addressing variances.

Loan Review and Monitoring. Consistent with the safety and soundness standards prescribed in Appendix A to Part 364 of the FDIC Rules and Regulations, institutions must have comprehensive analysis and information systems that identify, measure, monitor and control the risks associated with subprime lending. Such analysis promotes understanding of the portfolio and early identification of adverse quality/performance trends. Systems employed must possess the level of detail necessary to properly evaluate subprime activity. Examples of portfolio segmentation and trend analyses are discussed in the subprime lending loan reference module of the ED Modules.

Comprehensive analysis considers the effects of portfolio growth and seasoning, which can mask true performance by distorting delinquency and loss ratios. Vintage, lagged delinquency, and lagged loss analysis methods are sometimes used to account for growth, seasoning, and changes in underwriting. Analysis should also take into account the effect of cure programs on portfolio performance. Refer to the glossary of the Credit Card Specialty Bank Examination Guidelines for definitions of vintage, roll rate, and migration analysis.

Servicing and Collections. Defaults occur sooner and in greater volume than in prime lending; thus a well-developed servicing and collections function is essential for the effective management of subprime lending. Strong procedures and controls are necessary throughout the servicing process; however, particular attention is warranted in the areas of new loan setup and collections to ensure the early intervention necessary to properly manage higher risk borrowers. Prudent lenders also have well-defined written collection policies and procedures that address default management (e.g., cure programs and repossessions), collateral disposition, and strategies to minimize delinquencies and losses. This aspect of subprime lending is very labor intensive but critical to the program's success.

Cure programs include practices such as loan restructuring, re-aging, renewal, extension, or consumer credit counseling. Cure programs typically are used only when the institution has substantiated the customer's renewed willingness and ability to pay. Appropriate controls help ensure cure programs do not mask poor initial credit risk selection or defer losses. Effective subprime lenders may use short-term loan restructure programs to assist borrowers in bringing loans current when warranted, but will often continue to report past due status on a contractual basis. Cure programs that alter the contractual past due status may mask actual portfolio performance and inhibit the ability of management to understand and monitor the true credit quality of the portfolio.

Repossession and resale programs are integral to the subprime business model. Policies and procedures for foreclosure and repossession activities typically specifically address the types of cost/benefit analysis to be performed before pursuing collateral, including valuation methods employed; timing of foreclosure or repossession; and accounting and legal requirements. Effective policies clearly outline whether the institution will finance the sale of the repossessed collateral, and if so, the limitations that apply. Institutions that track the performance of such loans are able to assess the adequacy of these policies.

Compliance and Legal Risks. Subprime lenders generally run a greater risk of incurring legal action given the higher fees, interest rates, and profits; targeting customers who have little experience with credit or damaged credit records; and aggressive collection efforts. Because the risk is dependent, in part, upon the public perception of a lender's practices, the nature of these risks is inherently unpredictable. Institutions that engage in subprime lending must take special care to avoid violating consumer protection laws. An adequate compliance management program must identify, monitor and control the consumer protection hazards associated with subprime lending. The institution should have a process in place to handle the potential for heightened legal action. In addition, management should have a system in place to monitor consumer complaints for recurring issues and ensure appropriate action is taken to resolve legitimate disputes.

Audit. The institution's audit scope should provide for comprehensive independent reviews of subprime activities. Appropriate audit procedures include, among other things, a sample of a sufficient volume of accounts to verify the integrity of the records, particularly with respect to payments processing.

Third Parties. Subprime lenders may use third parties for a number of functions from origination to collections. In dealing with high credit-risk products, effective management teams take steps to ensure that exposures from third-party practices or financial instability are minimized. This includes proper due diligence performed prior to contracting with a third party vendor and on an ongoing basis. Appropriate contracts provide the institution with the ability to control and monitor third party activities (e.g. growth restrictions, underwriting guidelines, outside audits, etc.) and discontinue relationships that prove detrimental to the institution.

Special care must be taken when purchasing loans from third party originators. Some originators who sell subprime loans charge borrowers high up-front fees, which may be financed into the loan. These fees provide incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. These fees also increase the likelihood that the originator will attempt to refinance the loans. Appropriate contracts restrict the originator from the churning of customers. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation. Effective management also ensures that third party conflicts of interest are avoided. For example, if a loan originator provides recourse for poorly performing loans purchased by the institution, the originator or related interest thereof should not also be responsible for processing and determining the past due status of the loans.

Securitizations. Securitizing subprime loans carries inherent risks, including interim credit, liquidity, interest rate, and other risks, that are potentially greater than those for securitizing prime loans. The subprime loan secondary market can be volatile, resulting in significant liquidity risk 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 may be forced to sell loan 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 typically develop a contingency plan that addresses back-up purchasers of the securities, whole loans, or the attendant servicing functions, alternate funding sources, and measures for raising additional capital. An institution’s liquidity and funding structure should not be overly dependent upon the sale of subprime loans.

Given some of the unique characteristics of subprime lending, accounting for the securitization process requires assumptions that can be difficult to quantify reliably, and erroneous assumptions can lead to the significant overstatement of an institution's assets. Prudent institutions take a conservative approach when accounting for these transactions and ensure compliance with existing regulatory guidance. Refer to outstanding examination instructions for further information regarding securitizations.

Classification

The Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy) governs the evaluation of consumer loans. This policy establishes general classification thresholds based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. An examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient. Given the high-risk nature of subprime portfolios and their greater potential for loan losses, the delinquency thresholds for classification set forth in the Retail Classification Policy should be considered minimums. Well-managed subprime lenders recognize the heightened risk-of-loss characteristics in their portfolios and, if warranted, internally classify their delinquent accounts well before the timeframes outlined in the interagency policy. If examination classifications are more severe than the Retail Classification Policy suggests, the examination report should explain the weaknesses in the portfolio and fully document the methodology used to determine adverse classifications.

ALLL Analysis

An institution’s appropriately documented ALLL analysis identifies subprime loans as a specific risk exposure separate from the prime portfolio. In addition, the analysis segments the subprime lending portfolios by risk exposure such as specific product, vintage, origination channel, risk grade, loan to value ratio, or other grouping deemed relevant.

Adversely classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an appropriate allowance should be established consistent with accounting requirements. For subprime loans that are not adversely classified, the ALLL should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. To the extent that the historical net charge-off rate is used to estimate credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account management practices, and current economic or business conditions that may alter such experience.

Subprime Auto Lending

Underwriting. Subprime auto lenders use risk-based pricing of loans in addition to more stringent advance rates, discounting, and dealer reserves than those typically used for prime auto loans to mitigate the increased credit risk. As credit risk increases, advance rates on collateral decrease while interest rates, dealer paper discounts, and dealer reserves increase. In addition to lower advance rates, collateral values are typically based on the wholesale value of the car. Lenders will typically treat a new dealer with greater caution, using higher discounts and/or purchasing the dealer’s higher quality paper until a database and working relationship is developed.

Servicing and Collections. Repossession is quick, generally ranging between 30 to 60 days past due and sometimes earlier. The capacity of a repossession and resale operation operated by a prime lender could easily be overwhelmed if the lender begins targeting subprime borrowers, leaving the lender unable to dispose of cars quickly. Resale methods include wholesale auction, retail lot sale, and/or maintaining a database of retail contacts. While retail sale will command a greater price, subprime lenders may consider limiting the time allocated to retail sales before sending cars to auction in order to ensure adequate cash flow and avoid excessive inventory build-up. Refinancing resales are usually limited and tightly controlled, as this practice can mask losses. Lenders typically implement a system for tracking the location of the collateral.

Subprime Residential Real Estate Lending

Underwriting. To mitigate the increased risk, subprime residential real estate lenders use risk-based pricing in addition to more conservative LTV ratio requirements and cash-out restrictions than those typically used for prime mortgage loans. As the credit risk of the borrower increases, the interest rate increases and the loan-to-value ratio and cash-out limit decreases. Prudent loan-to-value ratios are an essential risk mitigant in subprime real estate lending and generally range anywhere from 85 percent to 90 percent for A- loans, to 65 percent for lower grades. High loan-to-value (HLTV) loans are generally not considered prudent in subprime lending. HLTV loans should be targeted at individuals who warrant large unsecured debt, and then only in accordance with outstanding regulatory guidance. The appraisal process takes on increased importance given the greater emphasis on collateral. Prepayment penalties are sometimes used on subprime real estate loans, where allowed by law, given that prepayment rates are generally higher and more volatile for subprime real estate loans. Government Sponsored entities, Fannie Mae and Freddie Mac, have participated in the subprime mortgage market to a limited degree through purchases of subprime loans and guarantees of subprime securitizations.

Servicing and Collections. Collection calls begin early, generally within the first 10 days of delinquency, within the framework of existing laws. Lenders generally send written correspondence of intent to foreclosure or initiate other legal action early, often as early as 31 days delinquent. The foreclosure process is generally initiated as soon as allowed by law. Updated collateral valuations are typically obtained early in the collections process to assist in determining appropriate collection efforts. Frequent collateral inspections are often used by lenders to monitor the condition of the collateral.

Subprime Credit Card Lending

Underwriting. Subprime credit card lenders use risk-based pricing as well as tightly controlled credit limits to mitigate the increased credit risk. In addition, lenders may require full or partial collateral coverage, typically in the form of a deposit account at the institution, for the higher-risk segments of the subprime market. Initial credit lines are set at low levels, such as $300 to $1,000, and subsequent line increases are typically smaller than for prime credit card accounts. Increases in credit lines should be subject to stringent underwriting criteria similar to that required at origination.

Underwriting for subprime credit cards is typically based upon credit scores generated by sophisticated scoring models. These scoring models use a substantial number of attributes, including the frequency, severity, and recency of previous delinquencies and major, derogatory items, to determine the probability of loss for a potential borrower. Subprime lenders typically target particular subprime populations through prescreening models, such as individuals who have recently emerged from bankruptcy. Review of the attributes in these models often reveals the nature of the institution’s target population.

Servicing and Collections. Lenders continually monitor customer behavior and credit quality and take proactive measures to avert potential problems, such as decreasing or freezing credit lines or providing consumer counseling, before the problems become severe or in some instances before the loans become delinquent. Lenders often use sophisticated scoring systems to assist in monitoring credit quality and frequently re-score customers. Collection calls on delinquent loans begin early, generally within the first 10 days delinquent, and sometimes as early as 1-day delinquent, within the framework of existing laws. Lenders generally send written correspondence within the first 30 days in addition to calling. Account suspensions occur early, generally within the first 45 days of delinquency or immediately upon a negative event such as refusal to pay. Accounts over 90 days past due are generally subject to account closure and charge-off. In addition, account closures based upon a borrower’s action, such as repeated refusal to pay or broken promises to bring the account current within a specified time frame, may occur at any time in the collection process. Account closure practices are generally more aggressive for relatively new credit card accounts, such as those originated in the last six months.

Payday Lending

Payday lending is a subset of subprime lending. Payday loans are usually priced at a fixed dollar fee per $100 borrowed, which represents the finance charge. Because these loans have such short terms to maturity, usually ranging from 14 to 45 days, the cost of borrowing, expressed as an annual percentage rate may be high.

In return for the loan, the borrower usually provides the lender with a debit authorization for the amount of the loan plus the fee. Repayment is often provided through an electronic payment of the fee and the advance with the next direct deposit. In addition, lenders allow payment by mail or other means rather than electronic transfer, and may charge a lower fee/finance charge for consumers that choose to pay electronically. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced through payment of another fee.

General

The examination instructions described in this section apply to banks with payday lending programs that the bank administers directly or through a third party that partners with the bank to offer payday loans to consumers. These instructions **do not** apply to situations where a bank makes occasional small-dollar loans as an accommodation to borrowers that do not fall within the definition of payday loans above nor do they apply to banks offering products and services, such as deposit accounts and extensions of credit, to non-bank payday lenders. These instructions apply regardless of whether an institution is a subprime lender, as described in the section above.

Due to the heightened safety and soundness risks posed by payday lending, concurrent risk management and consumer protection examinations should be conducted absent overriding resource or scheduling problems. In all cases, a review of each discipline's examinations and workpapers should be part of the examination planning process. Relevant state examinations also should be reviewed. The subprime lending loan reference module of the ED Modules provides procedures to assist examiners in evaluating a payday lending program.

Examiners may conduct targeted examinations of a third party bank partner where appropriate. Authority to conduct examinations of third parties may be established under several circumstances, including through the bank's written agreement with the third party, section 7 of the Bank Service Company Act, or through powers granted under section 10 of the Federal Deposit Insurance Act. Third party examination activities would typically include, but not be limited to, a review of compensation and staffing practices; marketing and pricing policies; management information systems; and compliance with bank policy as well as applicable laws and regulations. Third party reviews should also include testing of individual loans for compliance with underwriting and loan administration guidelines, and appropriate treatment under delinquency, and re-aging and cure programs.

Underwriting

Institutions making payday loans may use a variety of underwriting techniques, such as scoring systems, review of current pay stub or proof of a regular income source and evidence that the customer has a checking account, consultation of nationwide databases that track bounced checks and persons with outstanding payday loans, among others. As described above, the *Interagency Guidelines Establishing Standards for Safety and Soundness (Guidelines)* set out the safety and soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The Loan Documentation prong of the Guidelines addresses assessing the ability of the borrower to repay the indebtedness in a timely manner and ensuring that any claim against a borrower is legally enforceable. The Credit Underwriting prong addresses providing for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed. Institutions that choose to offer payday loans with strong risk management frameworks might adopt the following controls, among others, to demonstrate their conformance with these prongs of the Guidelines:

- Consideration of the consumer’s overall short-term debt obligations relative to resources;
- Consideration of the total length of time a consumer has had payday loan debt outstanding as an indication of the customer’s ability to repay the payday loan according to its term without reborrowing; and
- Consideration of any applicable laws and regulations.

Payday Lending Through Third Parties

Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans. Institutions also may rely on the third party to provide additional services that the institution might otherwise provide, including collections, advertising and soliciting applications. The existence of third party arrangements when not properly managed, can increase institutions’ transaction and legal risks.

The use of third parties in no way diminishes the responsibility of the board of directors and management to ensure that the activity performed on behalf of the bank is conducted in a safe and sound manner that complies with applicable consumer protection laws. Appropriate corrective actions, including enforcement actions, may be pursued for deficiencies related to a third-party relationship that poses safety and soundness issues or compliance with consumer protection laws.

The FDIC's principal concern relating to third parties is whether effective risk controls are implemented. Examiners should assess the institution's risk management program for third-party payday lending relationships. An assessment of third-party relationships should include an evaluation of the bank's risk assessment and strategic planning, as well as the bank's due diligence process for selecting a competent and qualified third party provider. Examiners should determine whether arrangements with third parties are guided by a written contract and approved by the institution's board. Appropriate arrangements typically:

- Describe the duties and responsibilities of each party, including the scope of the arrangement;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the institution;
- Authorize the institution and the appropriate banking agency to have access to such records of the third party and conduct onsite transaction testing and operational reviews at the third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Effective bank management sufficiently monitors the third party with respect to its activities and performance. This includes dedicating sufficient staff with the necessary expertise to oversee the third party. An appropriate oversight program also includes monitoring the third party's financial condition, internal controls, and the quality of its service and support, including the resolution of consumer complaints if handled by the third party. Oversight programs that are documented sufficiently facilitate the monitoring and management of the risks associated with third-party relationships.

Concentrations

Given the potential risk of payday lending, concentrations of credit in this line of business pose a significant safety and soundness concern. In the context of payday lending, a concentration would be defined as a volume of payday loans totaling 25 percent or more of an institution's common equity tier 1 capital plus the ALLL or the ACL for loans and leases, as applicable. Appropriate supervisory action may be necessary to address concentrations, including directing the institution to reduce its loans to an appropriate level, or raising additional capital.

Capital Adequacy

The minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles and that are subject to more stringent underwriting procedures than exist in payday lending programs. Therefore, minimum capital requirements may not be sufficient to offset the risks associated with payday lending. Institutions that underwrite payday loans may need to maintain capital levels as high as one hundred percent of the loans outstanding (i.e. dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining the appropriate amount of capital include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. The degree of legal risk associated with payday lending should also be considered, especially as it relates to third party agreements.

Allowance for Loan and Lease Losses

As with other loan types, institutions should maintain an ALLL or an ACL for loans and leases as applicable, that is appropriate to absorb estimated credit losses with the payday portfolio. Although the contractual term of each payday loan may be short, institutions' methodologies for estimating credit losses on these loans should take into account if payday loans remain outstanding for longer periods because of renewals and rollovers. In addition, examiners should evaluate the institution's assessment of the collectibility of accrued fees and finance charges on payday loans and whether the institution employs appropriate methods to ensure that income is accurately measured.

Examiners should determine that institutions engaged in payday lending have methodologies and analyses in place that demonstrate and document that the level of the ALLL or the ACL for payday loans is appropriate. The application of historical loss rates to the payday loan portfolio, adjusted for the current environmental factors, including reasonable and supportable forecast for institutions that have adopted CECL, is one way to determine the ALLL or ACL needed for these loans. Environmental factors include levels of and trends in delinquencies and charge-offs, trends in loan volume, effects of changes in risk selection and underwriting standards and in account management practices, and current economic conditions. Examiners should be mindful that for institutions that do not have loss experience of their own, it may be appropriate to reference the payday loan loss experience of other institutions with payday loan portfolios with similar attributes. Other methods, such as loss estimation models, are acceptable if they estimate losses in accordance with generally accepted accounting principles. Examiners should review documentation to determine that institutions' loss estimates and allowance methodologies reflect consideration of the principles discussed in the 2001 and 2006 Interagency policy statements on ALLL, or if the institution has adopted CECL, the 2020 Interagency Policy Statement on Allowances for Credit Losses.

Classifications

The Retail Classification Policy addresses general classification thresholds for consumer loans based on delinquency, but also discusses examiners' discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status. Examiners also may classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account management practices that are deficient.

Payday loans may have well-defined weaknesses that may jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios can be characterized by a marked proportion of obligors whose paying capacity is questionable, and such Payday loans are typically classified as Substandard. Payday loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement are not classified.

Payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Short-term Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge-off may be appropriate (e.g., the institution does not renew beyond the first payday and the borrower is unable to pay, the institution closes an account). The institution's policies regarding consecutive advances also should be considered when determining Loss classifications. Where the economic substance of consecutive advances is substantially similar to "rollovers" – without intervening "cooling off" or waiting periods – examiners should treat these loans as continuous advances and classify accordingly.

Renewals/Rewrites

The Retail Classification Policy provides guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite are typically expected by institutions to exhibit a renewed willingness and ability to repay the loan. Institutions can refer to the Retail Classification Policy principles that address the use of extensions, deferrals, renewals, or rewrites of payday loans. In consideration of the Retail Classification Policy, institutions typically:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

Accrued Fees and Finance Charges

Examiners should determine whether institutions evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. (For more guidance on accounting for delinquency fees, refer to ASC Section 310-10-25, Receivables – Overall - Recognition.) Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, examiners should assess whether the institution employs 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. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

Recovery Practices

After a loan is charged off, institutions must properly report any subsequent collections on the loan (refer to ASC Section 310-10-25, Receivables – Overall - Recognition.) Typically, some or all of such collections are reported as recoveries to the ALLL or ACL for loans and leases. In some instances, the total amount credited to the ALLL or ACL for loans and leases as recoveries on an individual loan (which may have included principal, finance charges, and fees) may exceed the amount previously charged off against the ALLL or ACL 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.

Consistent with regulatory reporting instructions, recoveries represent collections on amounts that were previously charged off against the ALLL or ACL for loans and leases. Accordingly, institutions must ensure that the total amount credited to the ALLL or ACL as recoveries on a loan is limited to the amount previously charged off on that loan. Any amounts collected in excess of this limit should be recognized as income.

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GOVERNMENT GUARANTEED LENDING AND GOVERNMENT INSURED MORTGAGE LENDING

Overview

Government-guaranteed lending and government-insured mortgage lending (collectively, "GGL") involve programs administered by various Federal agencies[2] ("agency", or "agencies") to support the needs of individuals, businesses, and communities that may not qualify for conventional loans, or to support the economic interests of the United States (U.S.).

The agencies that administer GGL programs may extend loans directly or provide guarantees for loans originated by financial institutions ("institutions") and other eligible lenders. GGL programs typically provide funding for commercial, agricultural, residential, disaster relief, and educational purposes. Other agencies such as the Federal Housing Administration (FHA) offer programs that insure mortgage loans to protect lenders from borrower default. Loan guarantees and mortgage insurance, which are backed by the full faith and credit of the U.S. Government, serve as protection against credit risk, and provide incentives for institutions to extend loans to individuals and businesses that may not otherwise be eligible for conventional financing.[3] GGL borrowers must be creditworthy, but generally present greater credit risk than conventional borrowers as they may lack adequate credit history, have weak collateral, or have lower equity.

In addition to the credit enhancement provided by the guarantee or insurance, there are a number of reasons why institutions engage in GGL activities. Some institutions originate and hold the loans to maturity in order to provide a long-term source of interest income (originate-to-hold), while others sell the guaranteed portions of loans in the secondary market to free up funds for additional lending or investing activities, and to generate income from sales premiums and servicing fees (originate-to-sell).

Institutions may also engage in GGL to provide borrowers with more flexible repayment terms; manage loan concentrations; or, reduce credit or interest rate risk. Typically, the guaranteed or insured portion of the loan is not included in legal lending limit calculations; however, examiners should confirm by referencing the applicable state lending laws. Institutions may also get credit under the Community Reinvestment Act for GGL activities.

Risks in GGL

While a government-guarantee is an attractive loan feature, an institution's participation in GGL programs is not without risk. With limited exceptions, the guarantee is *conditional,* meaning the institution must comply with certain conditions in order to fully collect upon the guarantee.[4] Conditions vary by agency, but often require that loans are prudently underwritten, approved, documented, closed, administered, serviced, and liquidated in accordance with the agency's regulations and program requirements. Noncompliance with guarantee conditions may permit the agency to revoke the guarantee and restrict the institution's ability to participate in the program.

The specific agency's regulations and program requirements help to ensure that the mission of the agency is being met and to the extent possible that associated risks to the agency and the lender are limited. For example, common requirements among the agencies are that loans are made only to borrowers who otherwise would not be able to secure credit on reasonable terms from another source (commonly referred to as the "credit elsewhere" requirement), and that funds can only be used for certain purposes (e.g. working capital, farm production).

The agencies also typically require their lenders to maintain an appropriate control environment, including adequate written policies for loan origination, underwriting, servicing, quality control, and fraud prevention. They also expect their lenders to maintain a well-trained staff that remains informed of agency program updates, avoids

[2] For example, Small Business Administration (SBA); U.S. Department of Agriculture (USDA), Farm Service Agency (FSA) and Rural Development (RD); U.S. Department of Housing and Urban Development (HUD), FHA; Veterans Administration (VA); Export-Import Institution of the U.S. (EXIM)

[3] Refer to https://www.fdic.gov/resources/consumers/small-business-topics/sba.html and https://www.fdic.gov/resources/bankers/affordable-mortgage-lending-center/products.html for links to information on Federal Agencies and Government Sponsored Enterprises Programs & Products.

[4] As of March 29, 2024, EXIM is the only agency whose guarantee to the institution for certain loans (e.g. EXIM Medium-term loan program) is unconditional and transferable.

conflicts of interest, and complies with all applicable laws and regulations.

When an institution engages in GGL activities without fully understanding or complying with applicable regulations and program conditions, its participation can introduce increased risks to the institution, as discussed below.

- **Operational risk** - An institution that does not have staff with the requisite knowledge and familiarity with a GGL program or an adequate risk management framework may be exposed to loss of all or a portion of the guarantee due to staff's inability to perform within the agency's regulations and program requirements.
- **Compliance risk** - An institution that fails to comply with the GGL program requirements and applicable laws and regulations (e.g. Anti-Money Laundering and Countering the Financing of Terrorism, Equal Credit Opportunity Act) may be suspended by the agency and/or lose all or a portion of the guarantee. Depending on the law or regulation, severity of non-compliance, or if there was consumer harm, the institution could face civil money penalties or be required to pay restitution.
- **Credit Risk** - Credit risk is mitigated in the guaranteed portion of the loan, but only if the institution complies with agency regulations and program requirements. The institution assumes full credit risk on the unguaranteed portion of the loan.
- **Strategic risk** - An institution whose business model centers on GGL activities may realize reduced profitability and liquidity impacts due to decreased demand, increased competition, loss of delegated authority, or suspension by the agency to participate in the program.
- **Third-Party Risk** - Due to complexities involved with GGL program requirements, institutions may contract with third parties to provide some or all functions related to GGL activities. Institutions that do not have adequate oversight and controls for managing relationships with third-parties, may realize loss of guarantee, financial loss, and legal impacts.
- **Fraud Risk** - GGL programs may be susceptible to fraud, defalcation, and other operational losses, including by institution insiders, customers, and third parties, especially when risk management and internal controls are inadequate.

In addition to the above, institutions that engage in the originate-to-sell business model are exposed to off-balance sheet risk, and liquidity and price risks associated with originating, funding, and managing a pipeline of loans to be sold, as discussed below.

- **Off-Balance Sheet/Servicing Risk** - An institution that originates and sells government-guaranteed loans subject to certain representations and warranties and/or subject to a servicing agreement, and breaches those representations and warranties, or servicing agreement, may need to establish a recourse liability.
- **Liquidity and Price Risk -** Institutions that have an originate-to-sell model and rely on GGL loan sales for liquidity and/or profitability may be negatively impacted by reduced market demand, required repurchases, adverse movements in interest rates, or suspension by the agency for material non-compliance with agency regulations or program requirements. Pricing risk increases when demand for loans declines resulting in lower premium and servicing income (earnings impact), or longer holding periods (liquidity impact).
- **Operational Risk/Execution Risk -** Institutions that have an originate-to-sell model are subject to disruption or unexpected developments due to loan modifications and restructurings in the serviced portfolio. For example, the SBA is required to repurchase the guaranteed portion of a loan after 60 days of non-payment. The secondary market would generally prefer the loan be repurchased than concede interest income for an extended period of time as a result of a restructuring involving a reduction in the loan's stated interest rate. The institution faces operational and execution risk if it is not able to facilitate the loan restructuring or loan modification, and/or have the funds available to timely execute the repurchase, if necessary.
- **Credit/Concentration Risk** - When an institution originates large volumes of guaranteed loans to sell, and retains only the unguaranteed portion, the institution may develop a concentration in assets with elevated credit risk. The institution may be exposed to loss if these risks are not properly controlled or mitigated. In addition, lower demand for government-guaranteed loans in the secondary market could make the activity no longer economical, as the benefits may not justify the risk in the retained unguaranteed portion.
- **Compliance Risk/Strategic Risk** - The originate-to-sell model may become overly reliant on sales volume to reach internal origination and premium income goals. As a result, lenders may feel pressure to relax underwriting standards or link employee performance reviews and compensation to a targeted loan volume without adequately considering risk. Pressure to reach income targets and compensation practices that do not sufficiently value prudent risk management increases the risk of noncompliance with GGL program requirements and the institution's own lending policies, as well as nonconformance with the credit administration, underwriting, and compensation

provisions of the Interagency Guidelines Establishing Standards for Safety and Soundness Standards.[5] Furthermore, an institution that fails to comply with the agencies' program requirements and applicable laws and regulations may have to repurchase loans from investors, and/or may lose all or a portion of the guarantee.

In summary, GGL programs provide an avenue to allow institutions to lend to customers without exposing the institution to excessive credit or other risk, as long as the institution does so prudently, follows the GGL agencies' regulations, policies and program guidelines, and complies with all other applicable laws and regulations.

Examiners should familiarize themselves with applicable GGL program requirements and assess whether the institution is effectively measuring, monitoring, and controlling the risks from engaging in GGL activities. The scope of review of GGL activities should be risk focused and commensurate with the institution's participation in the program, as well as the institution's business model, risk profile and complexity.

Delegated Authority Lender

Some agencies require pre-approval of certain loans, particularly those that are larger or more complex.[6] Most agencies also have delegated authority lender programs, status lender programs, or similar programs that grant lenders expedited processing benefits. Having this designation generally gives the institution authorization to make certain credit determinations and/or servicing decisions without prior review and approval by the agency. Agency criteria for approval varies, and may consider factors such as loss rate and loan production volume.

Having delegated authority helps to expedite the lending process; however, operational, compliance, credit and other risks to the institution may increase as the agency is not reviewing each credit decision. In addition, for institutions that rely heavily on GGL, the loss of delegated authority could have adverse strategic and financial impacts. Prudent institutions that participate in delegated authority lender programs have sufficient controls in place to ensure compliance with the agency's requirements, including those related to maintaining its delegated authority lender status, and a contingency plan should the institution unexpectedly lose its status.

Agency Audit or Reviews

As a condition of being an approved lender, some agencies conduct reviews or audits to assess areas such as portfolio performance, management and operations, credit administration, and/or compliance. Some agencies assign risk ratings,[7] while others outline findings in a report or letter at the conclusion of the examination or audit. Loan performance reports, statistical reports, or concerns with the institutions lending or servicing activities may also be furnished through a web-based portal.

If deficiencies are identified, such as non-compliance with program requirements, institutions are required to implement corrective actions. The agencies may also suspend, revoke or terminate an institution's ability to participate in the program or delegated authority to originate government-guaranteed loans without prior agency approval. The agencies may also issue enforcement actions against an institution depending on the severity or frequency of the offenses.

Agency reviews are not a substitute for an institution's independent audit coverage of GGL activities. Examiners may consider agency reviews in their assessment of GGL activities, in conjunction with independent audit reports, if the information is timely and relevant to the activities being reviewed. Access to agency reviews or audit reports may be governed by agency disclosure regulations. However, findings and discussion of any such reviews should be reflected in the relevant board or committee minutes of the institution. If this information is not available through the normal examination process, and may have a bearing on the examiners' assessment of the GGL activities, a request for the audit/review report from the agency should be considered.

Guarantee Purchase/ Loss Claim Payment

Before an institution is able to collect on the guarantee, the agency conducts a review of the institution's compliance with the agency's regulations and program requirements. This is sometimes referred to as the guarantee purchase or loss claims review process. The process varies by agency; however, most have guidelines on when a lender can request payment on a guarantee, such as a minimum of 60-day uncured delinquency. Agencies generally expect institutions to make reasonable efforts to work with borrowers before considering liquidation of collateral, and require the institution or servicer to prepare a detailed

[5] Refer to Appendix A to Part 364 of the FDIC's Rules and Regulations

[6] For example, EXIM loans typically require prior approval from the agency, although the agency does have a delegated authority lender program.

[7] For example, the SBA has developed "PARRiS," lender risk rating system; Refer to https://www.federalregister.gov/documents/2021/02/16/2021-03053/sba-lender-risk-rating-system).

liquidation plan for the agencies' approval as part of the guarantee claims process.

The agency assesses an institution's guarantee claim package and reaches a decision with three possible outcomes: (1) full purchase or payment of guarantee, (2) reduced payment amount of guarantee, or "repair," or (3) denial of payment of guarantee. A repair is often viewed as a fine or penalty, lowering the dollar amount of the guarantee payment (not a change in the percentage of the guarantee) due to a material deficiency that occurred during origination, closing, servicing, and/or liquidation. A denial of liability or payment is more severe than a repair as the agency determined the institution's action or inaction was severe enough to negate the guarantee.

For example, in the case of an SBA loan, if an institution fails to file a lien on equipment, the SBA may reduce the amount of the guarantee by the value of the equipment during the guarantee claim process. However, if the borrower's business fails because of a fire and the hazard insurance coverage had expired, the SBA may deny the entire claim. An institution is often able to provide additional documentation to the agency to cure a deficiency before a final determination on the guarantee claim is made. Common reasons to deny or reduce loss claims include incorrect loan eligibility determination, ineligible use of proceeds, negligent loan origination or servicing (e.g. lack of prior approval) and, failure to obtain, perfect, or maintain the collateral or lien position.

If a loan has been sold to an investor, the agency may require the institution to repurchase the defaulted loan, or the agency may repurchase it directly from the investor. If the agency repurchases the loan and finds that the institution that originated the loan was deficient in terms of underwriting and servicing of the loan, the agency may be able to request indemnification from the institution for any losses realized on the credit.

Loan Sales

Institutions with an originate-to-sell model typically sell the guaranteed portions of loans in order to provide liquidity for additional lending or investing, and to generate income from sales premiums and servicing fees. In the secondary market, government-guaranteed loans are readily marketable and generally can be sold at a premium.[8] Investors buy these loans because the interest rates are relatively high compared to the risk, as the only risk the investor incurs is prepayment risk. Loans with longer terms and higher yields realize higher premiums.

The requirements and processes for selling government-guaranteed loans vary by agency. For example, institutions that originate loans guaranteed by the SBA and USDA are able to sell the guaranteed portion of the loan in the secondary market, but are required to retain some or all of the unguaranteed portion of the loan and servicing rights to ensure the institution remains responsible and committed throughout the life of the loan.

Institutions that sell government-guaranteed loans must comply with Financial Accounting Standards Board (FASB) and Call Report Instructions regarding sales treatment, income recognition, fair value measurement, and contingent liabilities, as applicable. Under Generally Accepted Accounting Principles (GAAP), a transfer of the guaranteed portion of a government-guaranteed loan must be accounted for in accordance with Accounting Standards Codification (ASC) Topic 860 and Call Report Instructions.[9] ASC Topic 860 provides that, in order for a transfer of a portion of an entire financial asset to qualify for sale accounting, the portion must meet the definition of a "participating interest" and must meet all of the sales conditions set forth in this topic. If the guaranteed portion of the loan is transferred at a premium, the transferred guaranteed portion and the retained unguaranteed portion of the loan should normally meet the definition of a "participating interest" on the transfer date.[10]

When an institution sells a government-guaranteed loan, and retains servicing, the institution receives a certain percentage as a minimum servicing fee. For example, for a $1 million loan originated with a 75 percent guarantee, a hypothetical 10 percent premium, and a typical servicing fee of 1 percent, the income generated from this origination would be based on the $750,000 guaranteed portion. Specifically, the servicing fee would be $7,500 annually based on 1 percent of the $750,000 guaranteed portion of the loan. It is important to note that this assumes that the loan does not amortize and principal remains constant. In most cases, the unpaid principal amount would decline as the loan is repaid, so in the first year the servicing fee would be less than $7,500. Additionally, the premium recognized would be $75,000 based on a 10 percent premium of the $750,000 guaranteed portion of the loan. Overall, the institution would hypothetically recognize $82,500 in income in the first year and $7,500 in each subsequent year until the loan matures.

When an institution sells a GGL and retains servicing, the selling institution records a servicing asset representing its right to service the portion of the loan sold. For example, the selling institution typically receives a servicing fee of 1

[8] For the purposes of loan sales, transfers of guaranteed portions of GGLs are presumed to be at a price in excess of par (i.e., at a premium) and qualify for sale accounting as of the transfer date.

[9] Refer to Call Report Glossary entry for "Transfers of Financial Assets."

[10] Refer to ASC topic 860 and Call Report Glossary entry for "Transfers of Assets" for discussion of loans sold at par.

percent and if the current industry practice is to receive 40 basis points for servicing compensation, the present value of the remaining 60 basis points would be recorded as a servicing asset at its fair value at the transfer date.[11] When the benefits of servicing are expected to more than adequately compensate the selling institution for performing servicing, the selling institution also records an intangible servicing asset and is required to periodically value the servicing asset.

Risk Management Framework

A well-informed Board and management team develops a sound understanding of GGL activities, including applicable regulations, policies, and program requirements prior to engaging in such activities. An appropriate risk assessment process serves as the basis for establishing risk controls and includes the lending program, scope of activities, (e.g. underwriting, servicing, selling and/or purchasing loans), and relevant risks. Proposed activities should be consistent with a sound business strategy and the board's risk appetite and should be supported by an appropriate risk management framework.

A sound risk control framework includes appropriate policies and procedures, personnel, and systems to identify, measure, monitor, and control the associated risks. Appropriate internal controls include, as applicable, quality assurance processes, loan review, credit risk rating systems, pipeline management, concentration risk management, portfolio servicing controls, internal and external audit, and GGL monitoring and reporting systems. The content and timing of reporting should be commensurate with the nature of GGL activities, and may include GGL exposures and performance, pipeline activity, material servicing actions, compliance with risk limits, status tracking of any guarantee claims or guarantee purchase activities, and agency/investor reporting.

Policies and Procedures

Appropriate GGL policies and procedures typically address the areas that are present in any type of lending with more specific coverage of areas specific to the GGL program. Depending on the nature and scope of activities, GGL policies may specifically address the following, as applicable.

- Approved GGL lending programs and portfolio risk limit framework;
- Credit underwriting and administration standards that, among other things, define the agency's unique program requirements, including but not limited to borrower eligibility, credit analysis criteria, credit file documentation (including authentication of borrower representations), and monitoring and collateral maintenance;
- Quality controls and assurance processes which test for and ensure compliance with GGL program rules and regulations;
- Policy exception approval (institution and agency), tracking, and reporting;
- Procedures for ensuring risks of GGL activities are appropriately reflected in the ACL and capital adequacy analyses, including stress testing, if applicable;
- Concentration risk management practices, including stress testing or sensitivity analysis as applicable, that adequately measure, monitor and control related risk;
- Guidelines for secondary market activities, as applicable,
  - Guidelines for selling, and purchasing loans in the secondary market, including effective quality control programs;
  - Pipeline management processes and controls to limit price and liquidity risk, as well as contingency planning to handle unplanned liquidity or operational stresses stemming from pipeline activities, changes in market conditions, or agency participation restrictions;
  - Servicing agreement controls, including processes for prior approval of material servicing actions and reporting requirements (agency or investors); and
- Guidelines for use and oversight of third parties in GGL activities.

Management and Personnel

Well run institutions engaging in GGL activities ensure that management and staff possess sufficient expertise to manage the risks in GGL and that staffing levels are adequate for the planned volume of activity. GGL often requires specialized knowledge and skills that financial institutions may not possess. Marketing, origination, and collections strategies and techniques often differ from those employed for conventional credit. In addition, servicing and collecting government-guaranteed loans can be labor intensive and may require a greater number of staff. Effective management monitors staffing levels, staff experience and training needs, and engages in prudent compensation practices. Prudent incentive compensation arrangements balance employee financial rewards with the long-term health of the institution.[12]

[11] Refer to ASC Topic 860 and Call Report Glossary entry for "Servicing Assets and Liabilities."

[12] For further discussion of compensation considerations, see Section 4.1 – Management, Appendix A to Part 364, and the Interagency Guidance on Sound Incentive Compensation Policies.

Institutions may use third-party service providers to assist in facilitating GGL activities, depending on, and subject to agency program requirements. For example, the SBA requires approval of arrangements with third parties engaged in conducting certain SBA activities.[13] However, overreliance on third parties can further elevate operational and compliance risk. Effective third-party risk management practices help to ensure proper oversight and controls over third parties that are engaged to assist institutions in administering GGL activities. For example, when a third party service provider fails to maintain an institution's compliance or risk controls, examiners should determine that that an adequate process to escalate and remediate the failure is in place.

Concentrations

If an institution holds a concentration in government-guaranteed loans that share common risk characteristics or have heighted sensitivity to similar economic, financial, or other risk factors, a single economic event or adverse market conditions could disproportionally affect asset quality, earnings, or capital. Concentrations may be segregated by industry (agriculture, housing), commodity (cattle, dairy), geographic region, large borrower(s), lending program, counterparty, or affiliated and interdependent loans.

Examiners should consider the risk profile of the GGL concentration when assessing concentration risk, including whether the guarantee is conditional or unconditional; the varying risks presented by the guaranteed and unguaranteed portions; and, whether the risk management framework is adequate to measure, monitor and control associated risks.
Examiners should assess whether concentration risk management practices, including risk limits and other risk mitigants, are adequate and commensurate with the nature and volume of GGL exposures. For example, concentrations with higher levels of inherent risk, such as unguaranteed loans typically warrant robust limits and risk mitigants. Institutions may also establish sub-limits for the guaranteed portions of loans, both retained and sold, to mitigate credit, liquidity and repurchase or off-balance sheet risk should the guarantee not be honored due to noncompliance with agency regulations and/or program requirements. Sub-limits may also be used to control pipeline exposures with elevated interest rate and, if applicable, default risk.
Proper oversight of concentrations include monitoring and reporting of risk limits to the board, and reevaluation of risk limits when conditions, activities or risks change. For example, an internal audit finding that reflected concerns with the institution's compliance with agency documentation standards may warrant a reevaluation of risk limits and controls. Controls must be sufficient to allow for effective management of concentrations. Institutions with excessive or unmonitored exposures require heightened scrutiny during the examination. Refer to the Report of Examination (ROE) Instructions for guidance in identifying and listing concentrations in the ROE.

Allowance for Credit Losses (ACL)

As with other loan types, institutions should maintain an ACL for loans and leases that is appropriate to absorb expected credit losses within the GGL portfolio. An institution's appropriately documented ACL analysis identifies GGL loans as a specific risk exposure, giving consideration to the differences in credit risk between the guaranteed and unguaranteed portions of government guaranteed loans, and the differences between conditional and unconditional guarantees.

When reviewing the appropriateness of the institution's methodology, examiners consider factors such as the performance of GGL loans, including the number of historical issues with the guarantee claims and the loss rates for the overall GGL segments and other factors as appropriate. Consideration should also be given to the quality of the institution's underwriting and credit administration, or third party risk management practices (if applicable), as well as the institution's record of compliance with the agency's regulations and program requirements.

Examiners should be aware that ASC Subtopic 326-20 does not require measurement of expected credit losses on a financial asset, or group of financial assets, for which the expectation of nonpayment of the amortized cost basis is *zero*. A loan that is fully secured by cash or cash equivalents, such as certificates of deposit issued by the lending institution, would likely have zero credit loss expectations. Similarly, the guaranteed portion of government guaranteed loans would likely have zero credit loss expectations if these financial assets are *unconditionally guaranteed* by the U.S. government. In these instances, zero credit loss estimates would typically be supported with historical experience, such as the institution's favorable claims history. If there is evidence of noncompliance or lack of full guarantee repayment, adjustments may be warranted.

Credit Risk Rating and Loan Classifications

Government-guaranteed loans are typically provided to creditworthy borrowers that do not qualify for traditional financing. The credit enhancement provided by the government-guarantee or insurance is an inducement to institutions to provide credit to borrowers that generally

[13] Refer to SBA SOP 50 10 6, part 2, section A, chapter 5, paragraph D.

present greater credit risk than conventional borrowers. Institutions have frequently over relied on the guarantee when risk rating loans. When assigning risk ratings, repayment capacity should be assessed relative to the guaranteed and unguaranteed portion of the loan. Consideration should be given to the primary source of repayment, such as cash flow from operations or conversion of assets, and secondary sources of repayment, such as the ability of the guarantors to repay, collateral support, or the government guarantee. Consideration should also be given to the nature (conditional or unconditional) and extent of the protection provided by the government guarantee.

When reviewing government-guaranteed lending, examiners should review the institution's risk rating and classification process. If a loan is unconditionally guaranteed by the U.S. Government, then that portion of the loan should generally receive a pass rating. However, if a loan is conditionally guaranteed by the U.S. Government, then consideration should be given to the quality of the institution's underwriting and credit administration, or third party risk management practices (if applicable), as well as the institution's record of compliance with the agency's regulations and program requirements when assigning the risk rating. For example, if there are well-defined weaknesses or weaknesses that jeopardize the liquidation of the debt, and there are no deficiencies identified with underwriting, administration, servicing or other agency program compliance, adverse classification will generally be limited to the unguaranteed portion. However, if deficiencies are identified, the guarantee may be at risk for reduction or denial by the agency, and examiners should consider adversely classifying the full loan amount.

As with assessment of any loan, the facts and circumstances of each loan should be considered, as the presence of deficiencies alone is not conclusive evidence that the agency will not honor its guarantee. A review of the institution's purchase guarantee and loss claims process with the agency provide insight in this regard. If a loan is not in default, but there are credit administration weaknesses or other negative characteristics noted, examiners should discuss with bank management and consider whether a Special Mention designation is warranted.

Similar to non-government-guaranteed loans, examiners may evaluate contingent liabilities associated with GGL loans for credit risk and if appropriate, list contingent liabilities for Special Mention or adverse classification. However, this only applies to Category I contingent liabilities (e.g. unfunded loan commitments), which are liabilities that will give rise to a corresponding increase in institution assets if the contingencies convert into actual liabilities. This examination treatment does not apply to Category II contingent liabilities, where there will be no equivalent increase in assets if a contingency becomes a direct liability. Refer to section 16.1 of this manual for instructions for the report treatment of Category II contingent liabilities.