

Real estate lending is a major function of some branches. However, the composition of real estate loan portfolios will vary from branch to branch because of differences in strategic direction, asset size, lending experience, market conditions, and location. This section of the manual deals with the permanent financing of residential and commercial real estate. Also included in this section are discussions on real estate appraisals and environmental liability. Real estate construction lending is discussed separately in the following section of this manual.

Due to the differences in individual state banking laws, this section of the manual provides a general overview of the supervisory and regulatory requirements for a safe and sound real estate lending program. For information on lending limitations and restrictions, refer to the applicable banking laws and regulations that govern federally-insured and state-licensed branches.

### REAL ESTATE LENDING POLICY

The branch's real estate lending policy is a broad statement of the standards, guidelines, and limitations that senior branch management and lending officers are expected to adhere to in the process of making a real estate loan. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the branch's management of the real estate lending function.

The policies governing a branch's real estate lending activities must include prudent underwriting standards that are periodically reviewed by head office management and clearly communicated to the branch's management and lending staff. The branch should also have credit risk control procedures that include, for example, prudent internal limits on exposure and an effective credit review and problem loan identification process. The complexity and scope of these policies and procedures should be appropriate to the size of the branch and the nature of the branch's activities, and should be consistent with prudent banking practices and relevant regulatory requirements. As part of the analysis of a branch's real estate loan portfolio, examiners should review lending policies, loan admin-

istration procedures, and credit risk control procedures as well as the branch's compliance with its policy.

On March 19, 1993, a uniform rule on real estate lending by insured depository institutions promulgated by the federal banking agencies became effective. Although the rule does not directly apply to uninsured branches, it should be used as a general supervisory guide when reviewing loan portfolios, procedures, and practices at all branches. The rule requires each insured depository institution to adopt and maintain comprehensive written real estate lending policies that are consistent with safe and sound banking practices, are appropriate to the size of the institution, and the nature and scope of its operations. The policies must establish loan-to-value limits; loan administration procedures; portfolio diversification standards; and documentation, approval, and reporting requirements. The policies adopted by the branch should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies established by the federal banking agencies. In addition to the requirements of the uniform rule, a branch's real estate lending policy should include principal amortization terms acceptable for each type of real estate loan that the branch underwrites. Branch management should also ensure that loans are granted with the reasonable expectation that the borrowers will be able and willing to meet the repayment terms. Any loan that does not follow this principle should be regarded as an unsound banking practice, regardless of the collateral value and favorable ratio of collateral value to the outstanding loan. While there is no single lending policy appropriate for all branches, there are basic elements that a branch should consider in formulating its policy, including:

- Allocation of funds (i.e., maximum exposure) for real estate lending;
- Definition of acceptable loans that the branch would consider making and the minimum terms that are acceptable to the branch (i.e., amortization rates and cash flow coverage ratio by loan type);
- Geographic area in which the branch will consider lending;
- Minimum standards for credit analysis and loan documentation, including real estate appraisal and evaluation policies;

- Minimum credit criteria that a borrower must meet for the credit to be considered by the branch;
- Maximum loan amounts and loan maturities that can be extended on a given property type;
- Maximum aggregate loan amounts that may be extended for a given category of real estate loans and for all other real estate loans;
- Required pricing structure for each type of loan;
- Definition of lending authorities and loan approval process;
- Structure and procedures for administering the disbursement and servicing of the branch's real estate loan portfolio;
- System for monitoring troubled loans;
- Regular review of procedures and practices to ensure compliance with the branch's lending policy and safe and sound lending practices; and
- Procedures for originating and purchasing loans with loan-to-value ratios in excess of those limits discussed in the Interagency Guidelines for Real Estate Lending Policies, based on the support provided by other credit factors.

## REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (i.e., construction loans) and permanent financing (e.g., a 30-year residential mortgage or 10-year balloon mortgage on an existing commercial office building). Each type of lending carries with it unique underwriting risks and common risks associated with any type of lending. In all cases, the branch should understand the credit risks and structure of the proposed transaction, even if it is not the originating lender. This policy includes, at a minimum, evaluating the financial strength of the borrower to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long-term in nature and presents a funding risk because a branch's source of funds is generally of a shorter maturity. Accordingly, branch management should be aware of the source for funding this lending activity. While matching the maturity structures of assets to liabilities is particularly important for a branch's overall loan portfolio management, the importance of

this task is even more evident in real estate lending activity. Many institutions reduce their funding risk by entering into loan participations and sales with other institutions and asset securitization transactions.<sup>1</sup>

For a detailed discussion on short-term financing, see the manual section on Real Estate Construction Loans.

## UN SOUND LENDING PRACTICES

Some institutions have adversely affected their financial condition and performance by granting loans based on ill-conceived real estate projects. Apart from losses due to unforeseen economic downturns, these losses have generally been the result of poor or lax underwriting standards and improper management of the institution's overall real estate loan portfolio.

A principal indication of an unsound lending practice is an improper relationship between the loan amount and the market value of the property; for example, a high loan-to-value ratio in relation to normal lending practice for a similar type of property. Other unsafe and unsound lending practices include the failure of the institution to examine the borrower's debt service ability, or inappropriate loan structure such as capitalizing interest on a term loan, not requiring principal amortization, or "ever-green" lending—i.e. extending a short-term loan for long-term purposes. For a commercial real estate loan, sound underwriting practices are critical to the detection of problems in the project's plans, such as unrealistic income assumptions, substandard project design, potential construction problems, and a poor marketing plan that will affect the feasibility of the project.

## REAL ESTATE LOAN PORTFOLIO CONCENTRATION RISK

A branch should have in place effective internal policies, systems, and controls to monitor and manage its real estate loan portfolio risk. An indication of improper management of a branch's portfolio is an excessive concentration in loans

1. See the section on Asset Securitization for additional information, including information on mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs).

to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the branch's designated trade area. In the case of a branch, examiners should base their initial review of asset concentrations on the total assets of the branch. (See the Credit Risk Management section for further information on branch concentrations.)

In identifying loan concentrations, commercial real estate loans and residential real estate loans should be viewed separately when their performance is not subject to similar economic or financial risks. However, groups or classes of real estate loans should be viewed as concentrations when there are significant common characteristics and the loans are affected by similar adverse economic, financial, or business developments. Institutions with asset concentrations should have effective internal policies, systems, and controls in place to monitor and manage this risk.

Concentrations that involve excessive or undue risks require close scrutiny by the branch and head office management, and should be reduced over a reasonable period of time. To reduce this risk, the branch should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans.

## LOAN ADMINISTRATION AND SERVICING

Real estate loan administration is responsible for certain aspects of loan monitoring. While the administration may be segregated by property type, such as residential or commercial real estate loans, the functions of the servicing department may be divided into the following categories (although the organization will vary among institutions):

*Loan closing and disbursement*—preparing the legal documents verifying the transaction, recording the appropriate documents in the public land records, and disbursing funds in accordance with the loan agreement.

*Payment processing*—collecting and applying the loan payments.

*Escrow administration*—collecting insurance premiums and property taxes from the borrower

and remitting the funds to the insurance company and taxing authority.

*Collateral administration*—maintaining documents to reflect the status of the branch's lien on the collateral (i.e., mortgage/deed of trust and title policy/attorney's opinion), the value of the collateral (i.e., real estate appraisal or evaluation and verification of senior lien, if in existence), and the protection of the collateral (i.e., hazard/liability insurance and tax payments).

*Loan pay-offs*—determining the pay-off amount, preparing the borrower release or assumption documents, confirming the receipt of funds, and recording the appropriate lien-release documents in the public land records.

*Collections and foreclosure*—monitoring the payment performance of the borrower and pursuing collection of past-due amounts in accordance with branch policy on delinquencies.

*Claims processing*—seeking recoveries on defaulted loans that are covered by a government guarantee or insurance program or a private mortgage insurance company.

The branch should have adequate procedures to ensure segregation of duties for disbursal and receipt of funds control purposes. Additionally, the procedures should address the need for document control because of the importance of the timely recording of the branch's security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the branch will have the additional responsibility of remitting funds on a timely basis to the other institutions, in accordance with a servicing agreement. The servicing agreement sets forth the servicer's duties, reporting requirements, time frame for remitting funds, and fee structure. If one institution relies upon another institution for servicing, the branch should have adequate control and audit procedures to verify the performance of the servicer (also see the manual section on Asset Securitization). For residential loans sold into the secondary mortgage market for which the branch has retained servicing, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation

(FHLMC), and the Government National Mortgage Corporation (GNMA) have specific standards to which the branch (i.e., seller/servicer) must adhere. Failure to meet these standards can result in the termination of the servicing agreement.

## ASSESSMENT OF THE BORROWER

While the value of the real estate collateral is an important component of the loan approval process, the branch should not place undue reliance upon the collateral value in lieu of an adequate assessment of the borrower's ability to repay the loan. These assessment factors will differ depending upon the purpose of the loan, such as single family residential loans compared to income producing commercial property loans and commercial or residential development loans (referred to as "commercial real estate lending"). The loan documentation must adequately support the branch's assessment of the borrower and contain the appropriate legal documentation to protect the branch's interests.

### Single Family Residential Loans

Some branches make single family residential loans, typically to branch employees. As with other such loans, the branch should evaluate the applicant's creditworthiness and determine whether the individual has the ability to meet monthly mortgage payments and meet all other obligations and expenses associated with home ownership. This process includes an assessment of the applicant's income, liquid assets, employment history, credit history, and existing obligations.<sup>2</sup> The branch should also consider the availability of private mortgage insurance, a government guarantee, or a government insurance program, such as loans through the FHA-insured or VA-guaranteed programs, in assessing the credit risk of a loan applicant.

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2. There are restrictions on the information that federally-insured branches can request. The Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202), details the information that may and may not be requested on a loan application and provides a model form for a residential mortgage transaction; and Regulation Z, Truth in Lending (12 CFR 226), describes the disclosure requirements to the potential borrower on the cost of financing.

If a branch delegates the loan origination function to a third party, the branch should have adequate controls to ensure that its loan policies and procedures are being followed. The controls should include a review of the third party's qualifications; a written agreement between the branch and the third-party originator to set forth the responsibilities of the third party as an agent for the branch; a periodic review of the third party's operations to ensure that the branch's policies and procedures are being followed; and development of quality controls to ensure that loans originated by the third party meet the branch's lending standards and those of the secondary mortgage market, if the branch expects to sell the mortgages.

### Secondary Residential Mortgage Market

In the secondary market, a branch (the primary mortgage originator) sells all or a portion of its interest in residential mortgages to other financial institutions (investors). Thus, the secondary mortgage market provides an avenue for a branch to liquidate a long-term asset, as the need for funds arises. The majority of the secondary mortgage market activity is supported by three government-related or controlled institutions: FNMA,<sup>3</sup> FHLMC,<sup>4</sup> and GNMA.<sup>5</sup> These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. FNMA, FHLMC, and GNMA have specific underwriting standards and loan documentation requirements for mortgages, which they purchase or guarantee.

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3. Although FNMA was originally created in 1938 as an organization within the federal government, it became a federally chartered, stockholder corporation in 1968, when some of its functions were placed under the newly created GNMA. Financial institutions can either sell mortgages directly to FNMA or pool mortgages for placement in a FNMA-guaranteed mortgage-backed security.

4. FHLMC was sponsored by the Federal Home Loan Bank Board and its members in 1970. Its primary purpose is to provide a secondary market for conventional mortgages originated by thrifts.

5. GNMA, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when FNMA became a private corporation. It has several functions to assist in government housing programs, such as managing and liquidating loans acquired by the government. In the secondary market, GNMA acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

Generally, financial institutions enter into either a mandatory or a standby commitment agreement with these entities, wherein the financial institution agrees to sell loans according to certain delivery schedules, terms, and performance penalties.

## Commercial Real Estate Loans

As with other types of lending activities, the extent of commercial real estate lending activity should be contingent upon the lender's expertise and the branch's experience. In considering an application for a commercial real estate loan, a branch should understand the relationship of the actual borrower to the project being financed. The form of business ownership varies for commercial real estate projects and can affect the financial resources available for the completion of the project and the management and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the branch assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the branch should closely review the project's feasibility study. The study should provide sensitivity and risk analyses of the potential impact of changes in key economic variables, such as interest rates, vacancy rates, or operating expenses. The branch should also conduct credit checks of the borrower and of all principals involved in the transaction to verify relationships with contractors, suppliers, and business associates.

Finally, the branch should assess the borrower's financial strength to determine if the principals of the project have the necessary working capital and financial resources to support the project until it reaches stabilization. As with any type of lending on income-producing properties,<sup>6</sup> the branch should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any guarantees or other collateral that may be available as a source of loan repayment.

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6. Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels.

## ASSESSMENT OF THE REAL ESTATE COLLATERAL

Branches should obtain an appraisal or evaluation, as required by any applicable federal or state laws or regulations, for all real estate-related financial transactions, before making the final credit or other decision. (Refer to the Real Estate Appraisals and Evaluations part of this section for additional information.) The appraisal section explains the standards for appraisals, indicates which transactions should have an appraisal or an evaluation, provides guidelines on qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches for a Complete Appraisal.

Management is responsible for determining whether the assumptions and conclusions of the appraisal or evaluation are reasonable. In addition, management's rationale for accepting and relying upon the appraisal or evaluation should be documented in writing. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the branch may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation.

## Single Family Residential Loans

The assessment of the residential property's market value is critical to the branch's estimate of loan-to-value ratio. This assessment provides the branch with an estimate of the borrower's equity in the property and the branch's potential credit risk, if the borrower should default on the loan. While transactions under \$250,000 may not require an appraisal, a branch is expected to perform an appropriate evaluation of the underlying real estate collateral. Additionally, state laws for appraisals may differ from federal regulatory or internal requirements.

## Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is no uniformly

accepted format for valuing commercial properties as there is for valuing one-to-four family residential properties. A branch relies upon outside appraisers or, in some instances, in-house expertise to prepare appraisals. For the most part, appraisals on commercial real estate projects are presented in a narrative format with supporting schedules. As the complexity of a commercial project increases, the detail of the appraisal report or evaluation should also increase to fully support the analysis.

When estimating the value of income-producing real estate, the appraiser generally relies on the income approach to valuation to a greater degree than on the comparable sales approach or the cost approach. The income approach converts all expected future net operating income into present value terms using different analytical methods. One method, known as the direct capitalization method, estimates the present value of a property by discounting its stabilized net operating income at an appropriate capitalization rate (commonly referred to as a cap rate). Stabilized net operating income is the net cash flow derived from a property when market conditions are stable and no unusual patterns of future rents and occupancy are expected. To approximate stabilized net operating income, the appraiser or branch may need to adjust the current net operating income of a property either up or down to reflect current market conditions. The direct capitalization method is appropriate only for use in valuing stabilized properties.

Another method, known as the discounted cash flow method, requires the discounting of expected future cash flows, at an appropriate discount rate, to determine the net present value of a property. This method is appropriate for use in estimating the values of new properties that have not yet stabilized or for troubled properties that are experiencing fluctuations in income.

The discount rates and cap rates, used in estimating property values, should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used in the appraisal. The appraiser should not use exaggerated, imprudent, or unsustainably high or low discount rates, cap rates, or income projections.

In assessing the reasonableness of the facts and assumptions associated with the valuation

of commercial real estate, the branch should consider:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- The project's feasibility study and market survey to determine support for the assumptions concerning future supply and demand factors;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property compared to budget projections; and,
- Discount rates and direct capitalization rates.

Because the income approach is generally relied upon to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the branch must use judgment in determining the time it will take for a property to achieve stabilized occupancy and rental rates. The analysis of collateral values should not be based on a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions.

The capacity of a property to generate cash flow to service a loan is evaluated on the basis of rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy, rental rates, and net operating income should be based on an analysis of current and reasonably expected market conditions, taking into consideration historical levels, when appropriate.

## EARLY INDICATIONS OF TROUBLED COMMERCIAL REAL ESTATE LOANS

### Market Related

To evaluate the collectibility of their commercial real estate portfolio, branches should be alert for economic indicators of weakness in their real estate markets and for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators, which may be useful in evaluating the

condition of the local real estate market, include permits for and the value of new construction, absorption rates, employment trends, vacancy rates, and tenant lease incentives. Weaknesses disclosed by these types of statistics may signify that a real estate market is experiencing difficulties that may cause cash flow problems for individual real estate projects, declining real estate values and ultimately, troubled real estate loans.

## Project Related

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

- An excess supply of similar projects under construction in the same trade area;
- The lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions;
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions);
- Rent concessions or sales discounts, resulting in cash flow below the level projected in the original feasibility study, appraisal or evaluation;
- Concessions on finishing tenant space, moving expenses, and lease buyouts;
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan;
- Delinquent lease payments from major tenants;
- Land values that assume future rezoning;
- Tax arrearages; and,
- Environmental hazards and liability for cleanup.

As the problems associated with a commercial real estate loan become more pronounced, the borrower/guarantor may experience a reduction in cash flow to service related debts, which could result in delinquent interest and principal payments.

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

- Loans on speculative, undeveloped property where the borrower's only source of repayment is the sale of the developed property;
- Loans based on land values that have been driven up by rapid turnover of ownership but without any corresponding improvements to the property or supportable income projections to justify an increase in value;
- Additional advances to service an existing loan without evidence that the loan will be repaid in full;
- Loans to borrowers with no development plans or noncurrent development plans;
- Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule<sup>7</sup>;
- Evergreen loans—short-term, interest-only loans that are renewed annually with no provision for repayment. Although structured as a short-term loan, these loans are intended for long-term purposes such as for the acquisition or development of real estate;
- Loans that continue to capitalize interest after construction is completed because of slower than anticipated lease-up;
- Loans with no meaningful principal amortization, instead relying on price appreciation and the sale of property for repayment; and,
- Loans that are funded before zoning is obtained, water rights acquired, or an environmental study is performed.

## EXAMINER REVIEW OF COLLATERAL VALUE

The focus of an examiner's review of a real estate loan is on the ability of the loan to be repaid. The principal factors that bear on this review are the income-producing potential of the underlying collateral and the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms. In evaluating the overall risk associated with a real estate loan, examiners should consider a number of factors, including

7. As discussed more fully in the section on Asset Quality Classifications, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

the borrower's character, overall financial condition and resources, and payment history; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.<sup>8</sup> As the borrower's and guarantor's ability to repay a troubled real estate loan decreases, the importance of the collateral value of the loan increases commensurately.

An examiner's analysis of the collateral value is based on the branch's most recent appraisal or evaluation and includes a review of the major facts, assumptions and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal or evaluation.

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

Assumptions should be given a reasonable amount of deference when recently made by qualified appraisers or qualified evaluators and when consistent with the discussion above. Examiners should not challenge the underlying assumptions, including discount rates and cap rates used in appraisals or evaluations, that differ only in a limited way from norms that would generally be associated with the property under review. However, the estimated value of the underlying collateral may be adjusted for

credit analysis purposes when the examiner can establish that underlying facts or assumptions are inappropriate and can support alternative assumptions.

## CLASSIFICATION GUIDELINES

As with other types of loans, real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. In analyzing loans, the examiner should focus on the ability of the borrower, guarantor, or the collateral to provide the necessary cash flow to adequately service the loan. However, the fact that the underlying collateral value equals or exceeds the current loan balance, does not preclude the loan from classification if other factors jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.

Similarly, loans to sound borrowers that are refinanced or renewed according to prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or categorized as special mention, unless well-defined weaknesses exist that jeopardize repayment. A branch should not be criticized for working with borrowers whose loans are classified or categorized as special mention, as long as the branch has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage the level of these loans.

In evaluating real estate credits for possible classification, examiners should apply the standard classification definitions as set forth in the Classification of Credits section of the manual. In determining the appropriate classification, examiners should consider all important information regarding repayment prospects, including information on the borrower's creditworthiness, the value of and cash flow provided by all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's performance history to date is important and must be considered by the examiner. As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a

8. The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees. However, examiners should also consider the support provided by any guarantees when determining the appropriate classification treatment for a troubled loan. The treatment of guarantees in the classification process is discussed in the Asset Quality Classifications section of this manual.

performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.<sup>9</sup>

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

### Troubled Project-Dependent Commercial Real Estate Loans

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral and there are no other available and reliable sources of repayment. As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral and that can be clearly identified as uncollectible, should be classified “loss.” The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified doubtful when the potential for full 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. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. However, this methodology would occur infrequently.

9. Another issue that arises in the review of commercial real estate loans is its accrual or nonaccrual treatment for reporting purposes. The federal banking agencies, under the auspices of the FFIEC, have provided guidance on nonaccrual status in the instructions for the Report of Assets and Liabilities (call report) and in related supervisory guidance of the banking regulatory agencies. This guidance is summarized in the Credit Risk Management section of this manual.

### Partially Charged-Off Loans

An evaluation based upon consideration of all relevant factors may indicate that a credit has well-defined weaknesses that jeopardize collection in full, although a portion of the loan may be reasonably certain of collection. When a charge-off has been taken in an amount sufficient to ensure that the remaining recorded balance of the loan (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

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

### Formally Restructured Loans

The classification treatment previously discussed for a partially charged-off loan would also generally be appropriate for a formally restructured loan, when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner’s analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.<sup>10</sup> Troubled commercial real estate loans, whose terms have been restructured, should be identified in the institution’s

10. An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a “cash flow” mortgage, which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

internal credit review system and closely monitored by management.

## REAL ESTATE APPRAISALS AND EVALUATIONS

Bank regulators have a long-standing policy on real estate appraisals that emphasizes the importance of sound appraisal policies and procedures. In December 1987, the federal banking agencies jointly adopted supervisory guidelines for real estate appraisal policies and review procedures (which were revised in September 1992). With the passage of Title XI of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, in August 1990, the federal banking agencies adopted regulations regarding the performance and utilization of appraisals by federally regulated financial institutions.

The intent of Title XI of FIRREA is to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. Title XI requires that real estate appraisals be performed in writing in accordance with uniform standards and by individuals with demonstrated competency and whose professional conduct is subject to effective supervision. In this regard, Title XI required each state to establish a program for certifying and licensing real estate appraisers, who are qualified to perform appraisals in connection with federally-related transactions (which are defined later in this section). Additionally, Title XI designated the Appraisal Foundation, a non-profit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. However, Title XI left to the states the authority to establish qualification standards for licensing. Title XI established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council to monitor the requirements established to meet the intent of Title XI.

### Applicability of Title XI of FIRREA to Branches

The requirements of the appraisal regulations adopted by each of the federal banking agencies

pursuant to Title XI of FIRREA are discussed in the remainder of this section. The appraisal regulations are directly applicable only to FDIC-insured branches. In uninsured branches, examiners may use the regulations as general supervisory guidance when reviewing appraisal practices. As such, while an examiner in an uninsured branch may not cite the branch as being in violation of law or regulation for appraisal practices not consistent with the standards set forth in Title XI and the implementing appraisal regulations, the examiner may criticize such practices in the report of examination if considered appropriate from a risk management basis.

### Effective Date

Appraisals performed in connection with federally-related transactions after the effective date of August 9, 1990, are to comply with the regulations. Appraisals for real estate-related financial transactions entered into before August 9, 1990, do not have to comply with the regulations. However, the branch would have had to adhere to the Federal Reserve Board's supervisory guidelines, issued in 1987, for such real estate appraisals. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform, before the effective date.

The requirement to use a state-certified or -licensed appraiser had a separate effective date of no later than December 31, 1992. However, states had the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within their state. Financial institutions doing business in a state that had an effective date for mandatory use of certified or licensed appraiser earlier than the federally-mandated effective date would have had to abide by any state laws in this regard.

### Branch Appraisal and Evaluation Policy

Branch and head office management is responsible for adopting policies and procedures that establish effective real estate appraisal and

evaluation programs for the branch. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan approval process, undue reliance should not be placed upon the collateral value in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that branches have sound appraisal policies and procedures as a method of controlling risk.

### *Appraisal and Evaluation Programs*

The appraisal and evaluation programs of a branch should be tailored to the branch's size, location, and the nature of its real estate market and attendant real estate-related activity. Such programs should establish prudent standards and procedures that ensure written appraisals or evaluations are obtained and analyzed for real estate-related financial transactions before the branch makes its final credit decision.

The branch's appraisal and evaluation programs should also establish the manner in which it selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. The key elements of the branch's programs should ensure that individuals possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license, if applicable, and are capable of rendering a high quality, written appraisal or evaluation.

### *Compliance Procedures*

To ensure the branch's compliance with applicable supervisory guidelines, the branch should have established regulatory compliance procedures for all appraisals and evaluations. Additionally, a branch should critique selected appraisals and evaluations for adequacy and relevance of the data before making final credit decisions. The critique should consider the appropriateness of the methods and approaches used, and assess the reasonableness of the analyses, opinions, and conclusions. The branch

should maintain formal documentation or evidence of the critique to support the compliance review. An individual performing critiques, either an employee of the branch or an outside consultant, should have real estate-related training or experience and be independent of the transaction. The individual may not change the estimate of value of the appraisal or evaluation as a result of a critique.

### *Reappraisals and Reevaluations*

The program should also include a process for determining when a reappraisal and reevaluation is required on a prior transaction. In these situations, the original appraisal or evaluation will have become unreliable, e.g., the useful life of the appraisal or evaluation has ended and further circumstances dictate that the collateral should be reappraised or reevaluated. The individual who makes this determination should have real estate-related training or experience.

The decision to obtain a reappraisal or reevaluation will depend upon the condition and quality of a credit or investment and the soundness of the underlying collateral. The volatility of the local real estate market should also be considered in determining the need for a reappraisal or reevaluation. In certain situations, such as loan workouts, loan renewals, loan restructurings, or problem credits or investments, the need for a reappraisal or reevaluation should receive particularly close attention. In all cases, the information sources and analyses relied upon must sufficiently support a branch's determination of whether a reappraisal or reevaluation is required. Reappraisals should conform with appraisal regulations, and reevaluations should conform with applicable supervisory guidelines.

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 should 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 acceptances 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.

## FEDERALLY-RELATED FINANCIAL TRANSACTIONS

A federally-related transaction is defined in Title XI as a real estate-related financial transaction that a federal financial institution's regulatory agency engages in, contracts for, or regulates and that requires the services of an appraiser. Title XI further defines a real estate-related financial transaction as any transaction involving the sale, lease, purchase, investment, or exchange of real property, including interests in property or the financing thereof; the refinancing of real property or interests in real property; or the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

The federal banking agencies recognize that not all real estate-related financial transactions require the services of a certified or licensed appraiser and, therefore, would not be considered federally-related transactions. While these transactions do not require a certified or licensed appraisal, an evaluation of the underlying collateral is required under existing supervisory guidelines.

### Transaction Value

The transaction value is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered one transaction if it seems that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

### Transactions Not Requiring the Services of a Licensed or Certified Appraiser

Currently, the categories of transactions not requiring the services of an appraiser include transactions where:

- The transaction value is \$250,000 or less;
- A lien on real property has been taken as

collateral, solely through an abundance of caution and, as a consequence, the terms of the transaction have not been made more favorable than the terms would have been in the absence of a lien;

- The transaction is not secured by real estate;
- A lien on real estate has been taken for purposes other than the real estate's value;
- The transaction is a business loan that has a transaction value of \$1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- 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;
- 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 the Board's regulatory requirements for appraisals at the time of origination;
- The transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government-sponsored agency;
- The transaction either qualifies for sale to a U.S. government agency or U.S. government-sponsored agency, or 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; or
- There is a subsequent transaction resulting from a maturing extension of credit, provided that:
  - The borrower has performed satisfactorily, according to the original terms;
  - No new monies have been advanced, other than as previously agreed;
  - The credit standing of the borrower has not deteriorated; and
  - There has been no obvious and material deterioration in market conditions or physical aspects of the property, which would threaten the branch's collateral protection; or
  - A branch purchases a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property

interest met the requirements of the appraisal regulation.

When a real estate-related financial transaction does not require a certified or licensed appraiser, the U.S. regulator may still require an appropriate evaluation of the real property that is consistent with the guidelines for real estate appraisal and evaluation programs.

## Obtaining an Appraisal

The branch or its agent is responsible for engaging the appraiser and must have sufficient time to analyze the appraisal as part of the decision process to enter into the transaction. A branch may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. However, an appraisal prepared for one federally-regulated financial institution may be used by the branch, so long as the branch has established procedures for reviewing appraisals, the review indicates that the appraisal meets the regulation, and the review is documented in writing.

## When to Obtain an Appraisal

The branch should obtain the appraisal in sufficient time to be analyzed before the branch makes its final credit or other decision. In certain circumstances, when a branch acts to prudently protect its interest by modifying the terms and conditions of an existing extension of credit to facilitate orderly collection and thereby reduce its risk of loss, an appraisal or evaluation may be obtained after the branch makes its decision concerning the extension of credit.

The determination of when a federally-related transaction has occurred may be difficult to define in existing credits or in established lending arrangements. A new federally-related transaction is generally considered to have occurred when there is a potential change in the branch's exposure to risk. This includes, but is not limited to the following situations.

*Phased Developments*—The appraisal of an earlier phase cannot be used for a new phase. However, if the original appraisal was prepared for all phases of the project, the branch may use the project appraisal, provided that the appraisal

is still valid at the time the branch extends the additional credit for the new phase.

*Cross-Collateralization*—In cases where multiple loans are secured by separate parcels of real estate and are collateralized by the real estate pledged to other loans, the branch would not necessarily be required to reappraise all real estate collateral if an extension or renewal is granted on one of the loans. However, if the branch is relying on the excess collateral of the other loans to support the loan in question, the branch would have to have a valid appraisal on all real estate collateral.

*Loan Assumptions*—If a new borrower is substituted for the original borrower and the original borrower is released from any future obligation on the loan, the branch would be required to have a valid appraisal.

*Loan Restructuring and Workouts*—A branch would have to have a valid appraisal if the transaction is a refinancing.

*Foreclosures*—At the time title to foreclosed real estate passes to the branch, a branch needs to have a valid appraisal. It is recommended that the individual who performed the appraisal for the original credit decision should normally not perform the appraisal for this subsequent transaction.

*Sale of Other Real Estate Owned (OREO)*—A branch is required to have a valid appraisal when the sale occurs. The appraisal prepared for the foreclosure may be used, if that appraisal remains valid.

## Useful Life of Appraisals or Evaluations

The useful life of an appraisal or evaluation will vary depending upon the circumstances surrounding the property and the marketplace. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a branch should determine if there has been any material change to the underlying assumptions, which would affect the original estimate of value.

Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the

availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; change in zoning; or environmental contamination. The branch should document its information sources and analyses used to determine that an existing appraisal or evaluation remains valid and that the branch will use that appraisal or evaluation in a subsequent transaction.

## Updated Appraisal

An updated appraisal is currently not acceptable as an appraisal under the Board of Governors' regulation. However, a branch may use an updated appraisal in the following cases:

- To evaluate real estate when a federally-related transaction has not occurred; or
- To assess the useful life of an appraisal.

## APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation, if applicable, and the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms completed in compliance with the rule and USPAP are also acceptable.

## Appraisal Options

A branch may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraisal 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. Departure from standards designed as binding requirements is not permitted.

A branch 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 branch or agency or other intended users of the appraisal report. The banking regulators do not prohibit the use of a Limited Appraisal for a federally related transaction, but the bank regulators believe that branches 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 capsulized report with the supporting details maintained in the appraiser's files.

The banking 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 a branch's real estate transactions and under other circumstances when a branch's program requires an evaluation.

Moreover, since a branch 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 branch'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 branch's expectations and delineated each party's responsibilities, especially for large, complex, or out-of-area properties.

## Appraisal Standards

Title XI mandated that the minimum standards for Complete appraisals performed in connection with federally-related transactions are standards set forth in USPAP together with any other standards that the federal banking agencies deem necessary. In summary, an appraisal must:

- Be performed by a qualified, independent staff or fee-paid appraiser, selected by the branch, who is competent and knowledgeable of relevant markets. The appraiser must also hold the proper state certification or license as required under the appraisal regulations. An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property;
- Result in a market value that is defined as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably and the price is not affected by any undue stimulus;
- State the market value in terms of the cash equivalent value, which reflects the value of the property without the influence of special or creative financing or seller concessions;
- Follow a reasonable valuation method, which addresses cost, income, and direct sales comparison approaches to determine market value, unless the appraiser fully explains and documents the elimination of an approach;
- Support the current valuation of the real estate. All assumptions and projections should be supportable by current market conditions and expectations of current market trends. In the case of income property, the capitalization rate, discount rate, net income and/or loss projections, cash flow, financing terms, and absorption rate should be reasonable and supportable by current market conditions;
- Document and explain how the discount and capitalization rates used in generating present value estimates were derived;
- Render the "as is" value, which reflects the value of the property in its current physical condition and subject to the zoning in effect as of the appraisal date. Appropriate deductions and discounts should be made for proposed development projects to reflect holding costs, marketing expenses, and entrepreneurial profit, which are based on stabilized occupancy for commercial projects or a retail sales program for residential projects;
- Report the sales history on the appraised property for one year for 1-to-4 family residential properties and three years for all other types of properties;
- Address a proposed project's marketability and feasibility prospects. Studies prepared by a party other than the appraiser must be verified to the extent assumptions are utilized. The appraiser's acceptance or rejection of the third party study and its impact on value must be fully explained;
- State the marketing period for the appraised property, the effective date of the appraisal, and the date the appraisal was rendered;
- Include a legal description of the subject property;
- Identify and separately value any personal property, fixtures, and intangible items that are not real property but are included in the appraisal, and discuss the impact of their inclusion or exclusion on the estimate of market value of the real property;
- Contain an appraiser's certification statement in which the appraiser attests to the accuracy of the data, the disclosure of assumptions, and independence from the transaction; states whether an inspection of the property was made; discloses any professional assistance received from another appraiser; and certifies that a fee, contingent on the value rendered, was not received; and
- The appraisal regulations and USPAP provide a complete listing of the appraisal standards.

## Appraisal Valuation Approaches

There are three basic approaches used in appraising the market value of real estate in a Complete Appraisal:

- Cost Approach;
- Market Data or Direct Comparable Sales Approach; and
- Capitalization of Income Approach.

All three approaches have particular merits depending upon the type of real estate being appraised. For single family residential property, the cost and comparable sales approaches are most frequently used because the common use of the property is the personal residence of the owner. However, if a single family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach and the cost and comparable sales approaches. For special use commercial properties, the appraiser may have difficulty in obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approach. If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

## Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that judgment must be exercised in analyzing the results and determining the estimate of market value.

## Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any depreciation, i.e., disadvantages or deficiencies of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as

though vacant; (2) estimate the current cost of reproducing the existing improvements; (3) estimate depreciation and deduct from the reproduction cost estimate; and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

## Market Data or Direct Sales Comparison Approach

The essence of this approach is to determine the price at which similar properties have sold for recently on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The market approach to value estimation is essential in nearly every appraisal of real property and is based on the following assumptions:

- Market value is the highest price for which a property is deemed most likely to sell in a competitive market;
- A reasonable time is allowed for exposure of the property in the open market;
- Payment is to be made in cash or on terms reasonably equivalent to cash or on typical financing terms available at the time of the appraisal;
- Both the buyer and seller are typically motivated and the price is not affected by undue stimulus; and
- Both buyer and seller act prudently and knowledgeably and have reasonable knowledge of the various uses to which the property may be put.

The application of this approach produces an estimate of value of a property by comparing it with similar properties that have been sold recently. The process used in determining the degree of comparability of two or more properties involves judgment as to their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range in which the value of the subject property lies.

## Capitalization of Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach typically is used to determine the market value of income producing properties, such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash flow techniques to arrive at a market value. These techniques include band-of-investments method, mortgage equity method, annuity method, and land residual technique. The use of a particular technique will depend upon whether there is project financing, whether there are long-term leases with fixed level payments and whether the value is being rendered for a component of the project, such as land or buildings.

The accuracy of this method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and method. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This information provides gross rental data and the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce;
- Expense data, such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined;
- Time frame for achieving a "stabilized" or normal occupancy and rent levels (also referred to as holding period); and
- An appropriate capitalization rate and valuation technique are selected and applied to net income to establish a value estimate.

Basically, 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 used to value income

properties. This method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated in terms of current income.

The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

For special use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this 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 the 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.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. For further discussion, refer to the section of this manual on Real Estate Loans.

## Other Definitions of Value

An appraisal for a federally-related transaction must reflect a market value as defined in the

regulations. The regulations also require that, for development projects, the appraisal contain the “as is” value as of the date of the appraisal. However, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include:

**Fair Value.** This term is an accounting term that is generally defined as the amount, in cash or cash equivalent value or other consideration, that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (i.e., selling price), that is, other than in a forced or liquidation sale. According to accounting literature, fair value is generally used in valuing assets in troubled debt restructuring, quasi-reorganizations, nonmonetary transactions, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

**Investment Value.** This term is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor’s criteria and objectives are often substantially different than participants in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

**Liquidation Value.** This term assumes that there is little or no current demand for the property and that the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

**Going-Concern Value.** This term is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record with the assumption that the business will continue to operate.

**Assessed Value.** This term represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

**Net Realizable Value (NRV).** This term is recognized under generally accepted accounting prin-

ciples (GAAP) as “the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal.” The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner’s costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

The appraiser should state the definition of value reported in the appraisal, and, for federally-related transactions, the value must meet the market value definition as defined in the regulations. This value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably and the price is not affected by undue stimulus. Other presentations of value, in addition to market value, are allowed and may be included in the appraisal at the request of the branch.

## EVALUATION REQUIREMENTS

The appraisal regulations identify certain real estate-related financial transactions that do not require the services of an appraiser (i.e., do not need an appraisal). In the context of Title XI of FIRREA, an appraisal means the kind of specialized opinion as to the value of real estate containing certain formal elements recognized by appraisal industry practices and standards. For transactions that do not require an appraisal by a licensed or certified appraiser under the appraisal regulations, the branch should establish an evaluation program and perform an appropriate evaluation of the real estate for these transactions as a prudent banking practice. The evaluation should result in a determination of value that will assist the branch in assessing the soundness of the transaction and that will protect the branch’s interest in the transaction. Further, the evaluation need not meet all of the detailed requirements of an appraisal as set forth in the appraisal regulations.

Bank regulators’ appraisal regulations allow an institution to use an appropriate evaluation of

real estate rather than an appraisal when the transaction:

- Has a value of \$250,000 or less;
- Is a business loan of \$1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
- Involves an existing extension of credit at the lending branch, provided that: (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the branch'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.

The branch is not precluded from obtaining an appraisal that conforms to the regulation for any real estate-related financial transaction. If a branch makes loans that may be sold into the secondary market at a later date, the branch may need to ensure that they meet the secondary mortgage market requirements.

## Form and Content of Evaluations

The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the evaluator's analysis and assumptions. There is no requirement that the evaluator use a particular form or valuation approach but the analysis should be applicable to the type of property and fully explain the value rendered.

An evaluation, at a minimum, should:

- 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 individual who conducts an evaluation should have real estate-related training or expe-

rience relevant to the type of property but does not have to be a state-licensed or -certified appraiser. Prudent practices generally require that, as the branch's exposure in a real estate-related financial transaction increases, a more detailed evaluation should be performed, whether or not specifically subject to appraisal regulations.

An evaluation for a transaction that needs a more detailed analysis should fully describe the property and discuss its use, especially for nonresidential property. An evaluation report should include 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 evaluation for a transaction that requires a less detailed analysis may be based upon information, such as comparable property sales information from sales data services, for example, the multiple listing service or current tax assessed value in appropriate situations. Further, the branch's own real estate loan portfolio experience and value estimates, which were prepared for recent loans on comparable properties where appraisals meeting the requirements of the regulation were obtained, may be used. Regardless of the method, the branch must document its analysis and findings in the loan file.

## Letter Updates

A branch may use letter updates to an appraisal as an evaluation even though such updates do not conform to the appraisal regulations and would not be acceptable for the initial credit decision for federally-related transactions. For example, an existing appraisal for a first mortgage might be updated for a subsequent home equity line of credit where the extension of credit is below the threshold amount.

## QUALIFICATIONS CRITERIA FOR APPRAISERS AND EVALUATORS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the

individual performing the appraisal or evaluation and the expertise of the appraiser or evaluator at developing and interpreting pertinent data for the subject property. Appraisers and evaluators should have adequate training, experience, and knowledge of the local real estate market to make sound judgments concerning the value of a particular property. The level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, appraisers and evaluators should be independent of the credit decision, have no interest in the property being appraised, and have no affiliations or associations with the potential borrower.

## Appraiser Qualifications

Under Title XI of FIRREA, two classifications of appraisers were identified to be used in federally-related transactions: “state-certified appraiser” and “state-licensed appraiser.” For a certified appraiser, Title XI contemplated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. These standards set forth minimum educational, testing, experience, and continuing education requirements. For a licensed appraiser, the states have some latitude in establishing qualification standards provided that the criteria are adequate to protect federal financial and public policy interests.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring the states for compliance with Title XI. The federal banking agencies also have the authority to impose additional certification and licensing requirements to those adopted by a given state.

## Selection of an Appraiser

In selecting an appraiser for an appraisal assignment, a branch is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a par-

ticular designation from an appraisal association, organization, or society.

In that regard, branches should treat all appraisers fairly and equitably in determining whether to use the services of a particular appraiser. Generally, financial institutions have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of pre-approving appraisers for on-going appraisal work and maintaining an approved appraiser list is acceptable as long as all appraisers are required to follow the same approval process. However, a branch that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of certain appraisal organizations—would be viewed as having a questionable selection process.

## APPRAISALS PERFORMED BY CERTIFIED OR LICENSED APPRAISERS

In summary, a federally-insured branch is required to use a Certified Appraiser for:

- All federally-related transactions over \$1 million;
- Nonresidential federally-related transactions of \$250,000 or more; and
- Complex residential federally-related transactions of \$250,000 or more.

A federally-insured branch is required to use a Licensed Appraiser for:

- All other federally-related transactions over the \$250,000 transaction value not requiring the services of a certified appraiser. These also may be performed by a certified appraiser.

Some of the states have adopted other appraiser designations, which may cause confusion on whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states have used designations such as “certified residential” appraiser and “certified general” appraiser, which leads to further confusion. Other states have no specified license designation but have

used the term “certified residential” based on the standards for licensing. For this reason, the branch needs to understand (1) the qualifications criteria set forth by the state appraiser regulatory body and (2) whether these standards are equivalent to the federal designations as accepted by the Appraisal Subcommittee.

## Other Appraiser Designations

The Appraisal Subcommittee recognized two other appraiser designations: certified residential appraiser and transitional license. For the certified residential appraiser, the minimum qualification standards are those established by the Appraiser Qualifications Board for “certified residential real estate appraiser.” Under the appraisal regulations, a certified residential appraiser would be permitted to appraise real estate in connection with a federally-related transaction designated for a “certified” appraiser as long as the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the federal banking agencies also recognized a transitional license, which allowed a state to issue a license to an appraiser provided that the individual had passed an examination and had satisfied either the education or experience requirement. A transitional licensed appraiser was permitted to appraise real estate collateral in connection with a federally-related transaction as if licensed. The transitionally-licensed appraiser was expected to complete the missing requirement within a set time frame or the license would expire. The recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from the establishment of a new regulatory program. The Appraisal Subcommittee advised the states that the use of the transitional license should be phased out over time once the appraiser regulatory program is fully established. As a result, the use of the transitional license and the applicable time frame varies from state to state.

## Qualifications of Individuals Who Can Perform Evaluations

Evaluations can be performed by a competent person who has experience in real estate-related

activities, including but not limited to appraisals, real estate lending experience, real estate consulting, and real estate sales. An individual performing an evaluation need not be licensed or certified. The branch’s evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and confirming their qualifications and independence to perform an evaluation for a particular transaction.

## Supervisory Policy and Evaluations

A branch’s appraisal and evaluation policies and procedures should be reviewed as part of the examination of its overall real estate-related activities to ensure compliance with regulations, if a federally-insured branch, and to evaluate risk management techniques as appropriate. This process would include a review of the procedures for selecting an appraiser for a particular appraisal assignment and confirming that the appraiser is qualified, independent, and licensed/certified to undertake the assignment. If a branch maintains a list of qualified real estate appraisers acceptable for the branch’s use, the examiner should ascertain whether senior management of the branch has periodically reviewed and approved the list.

When analyzing individual credits, examiners should analyze appraisals or evaluations to determine that the methods, assumptions, findings, and conclusions are reasonable and in compliance with any applicable appraisal regulations and supervisory guidelines. Examiners should not challenge the underlying assumptions, including discount rates and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Additionally, an examiner is not bound to accept the results of the appraisal or evaluation, regardless of whether a new appraisal or evaluation was requested during the examination. If an examiner concludes that an appraisal or evaluation is deficient for any reason, that fact will be taken into account in reaching a judgment on the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, the examiner may adjust the estimated value of the property for credit analysis purposes. It is

important to emphasize that an examiner's overall analysis and classification of a credit may be based upon other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation. Further discussion on the examiner's assessment of value for loan classification can be found in sections in this manual on Classification of Credits.

Significant failures to meet applicable standards and procedures as outlined previously should be criticized and corrective action should be required. Furthermore, inadequate appraisal and evaluation procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the branch's financial condition. In this situation, formal corrective measures will be pursued as appropriate.

The appraisal regulation and guidelines require that federally-insured financial institutions use the services of qualified, independent, certified or licensed appraisers to perform appraisals. A branch that knowingly uses the services of an individual to perform an appraisal in connection with a federally-related transaction who is not properly certified or licensed is in violation of Section 1120(a)(1) of Title XI of FIRREA. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of Title XI should be reported to the branch's appropriate federal and/or state regulators for referral to the state appraiser regulatory agency for investigation.

## ENVIRONMENTAL LIABILITY

In connection with any real estate lending activity, a branch and its legal entity, the foreign banking organization, may be subject to liability associated with the clean-up of hazardous substance contamination pursuant to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the federal superfund statute. CERCLA was enacted in response to the growing problem of improper handling and disposal of hazardous substances. CERCLA authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the clean up from entities specified in the statute. The superfund statute is the primary federal law dealing with hazardous substance contamination. However, there are numerous other federal

and state statutes that establish environmental liability that could place banking organizations at risk. For example, underground storage tanks are also covered by separate federal legislation.<sup>11</sup>

While the superfund statute was enacted in 1980, it has been only since the mid-1980s that court actions have resulted in some banking organizations being held liable for the clean-up of hazardous substance contamination. These early court decisions had a wide array of interpretations as to whether banking organizations are owners or operators of contaminated facilities and thereby liable under the superfund statute for clean-up costs. These decisions led to uncertainty on the part of banking organizations as to how best to protect themselves from environmental liability.

The relevant provisions of CERCLA, the so-called "superfund" statute as it pertains to banking organizations indicate which persons or entities are subject to liability for clean-up costs of hazardous substance contamination. These include "the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed."<sup>12</sup> A person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination under the superfund statute.

The liability imposed by the superfund statute is strict liability, which means the government does not have to prove that the owners or operators had knowledge of or caused the hazardous substance contamination. Moreover, liability is joint and several, which allows the government to seek recovery of the entire cost of the clean up from any individual party that is liable for those clean-up costs under CERCLA. In this connection, CERCLA does not limit the bringing of such actions to the EPA but permits such actions to be brought by third parties.

CERCLA provides a secured creditor exemption in the definition of "owner and operator" by stating that these terms do not include "a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security

11. Resource Conservation and Recovery Act of 1987 (RCRA).

12. CERCLA, Section 107(a).

interest in the vessel or facility.”<sup>13</sup> However, this exception has not provided banking organizations with an effective “safe harbor” because early court decisions worked to limit the application of this exemption. Specifically, courts held that actions by lenders to protect their security interests may result in the banking organization “participating in the management” of a vessel or facility, thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the banking organization, courts held that the exemption no longer applies and that the banking organization is liable under the superfund statute as an “owner” of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without the knowledge of pre-existing conditions (the so-called “innocent landowner defense”). However, the courts applied a stringent standard to qualify for this defense. Because little guidance is provided by the statute as to what constitutes the appropriate timing and degree of “due diligence” to successfully employ this defense, banking organizations should exercise caution before relying on it.

## Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences resulting from having generated or handled hazardous substances or otherwise having been associated with the aftermath of subsequent contamination. The following discussion highlights some common environmental hazards but by no means covers all environmental hazards.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals or solvents in the manufacturing process or as waste products. For years, these types of hazardous substances were disposed of in land fills or just dumped on industrial sites. Hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of potential hazardous substance contamination, which should be of concern to banking organizations.

- Farmers and ranchers (use of fuel, fertilizers, herbicides, insecticides, and feedlot runoff).

- Dry cleaners (various cleaning solvents).
- Service station and convenience store operators (underground storage tanks).
- Fertilizer and chemical dealers and applicators (storage and transportation of chemicals).
- Lawn care businesses (application of lawn chemicals).
- Trucking firms (local and long haul transporters of hazardous substances, such as fuel or chemicals).
- The real estate industry has taken the brunt of the adverse affects of hazardous waste contamination. In addition to having land contaminated with toxic substances, construction methods for major construction projects, such as commercial buildings, have utilized materials that have been subsequently determined to be hazardous resulting in significant declines in their value. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos was found to be a health hazard and now must meet certain federal and, in many instances, state requirements for costly removal or abatement (enclosing or otherwise sealing off).
- Another common source of hazardous substance contamination is underground storage tanks. Leaks in these tanks not only contaminate the surrounding ground but often flow into ground water and travel far away from the original contamination site. As contamination spreads to other sites, clean-up costs escalate.

## Impact on Banking Organization

Banking organizations may encounter losses arising from environmental liability in several ways. The greatest risk to banks resulting from the superfund statute and other environmental liability statutes is the possibility of being held solely liable for costly environmental clean ups, such as hazardous substance contamination. If a bank is found to be a responsible party under CERCLA, it may find itself responsible for cleaning up a contaminated site at a cost that far exceeds any outstanding loan balance. This risk of loss results from an interpretation of the superfund statute as providing for joint and several liability. Any responsible party, including a branch and the foreign banking organization or FBO, as the branch’s legal entity, could be forced to pay the full cost of any clean up. Of course, the branch or FBO may attempt to

13. CERCLA, Section 101(20)(A).

recover such costs from the borrower, or from the owner, if different than the borrower, provided that the borrower or owner continues in existence and is solvent. Banking organizations may be held liable for the clean up of hazardous substance contaminations in situations where it:

- Takes title to property pursuant to foreclosure;
- Involves the banking organization's personnel or contractors engaged by the bank in day-to-day management of the facility;
- Takes actions designed to make the contaminated property salable, possibly resulting in further contamination;
- Acts in a fiduciary capacity, including management involvement in the day-to-day operations of industrial or commercial concerns and purchasing or selling contaminated property;
- Owns or acquires (by merger or acquisition), subsidiaries involved in activities that might result in a finding of environmental liability; or
- Owns or acquires, for future expansion, premises that have been previously contaminated by hazardous substances. For example, site contamination at a branch office where a service station with underground storage tanks once operated. Premises or other real estate owned could also be contaminated by asbestos requiring costly clean up or abatement.

A more common situation encountered by banking organizations has been where real property collateral is found to be contaminated by hazardous substances. The value of contaminated real property collateral can decline dramatically depending on the degree of contamination. As the projected clean-up costs increase, the borrower may not be able to provide the necessary funds to remove contaminated materials. In making its determination whether to foreclose, the lender must estimate the potential clean-up costs. In many cases, this estimated cost has been found to be well in excess of the outstanding loan balance and the lender has elected to abandon its security interest in the property and write-off the loan. This situation occurs, regardless of the fact that the superfund statute provides a secured creditor exemption. Some courts have not extended this exemption to situations where lenders have taken title to a property pursuant to foreclosure. These rulings have been based on a strict reading of the statute that provides the exemption to "security interests" only.

Risk of credit losses can also arise where the credit quality of individual borrowers (operators, generators, or transporters of hazardous substances) deteriorates markedly as a result of being required to clean up hazardous substance contamination. Banking organizations must be aware that significant clean-up costs borne by the borrower could threaten the borrower's solvency and jeopardize the lender's ultimate collection of outstanding loans to that borrower regardless of the fact that no real property collateral is involved. Therefore, ultimate collection of loans to fund operations or to acquire manufacturing or transportation equipment can be jeopardized by the borrower's generating or handling of hazardous substances in an improper manner. Further, some bankruptcy courts have required clean up of hazardous substance contamination before distribution of a debtor's estate to secured creditors.

Borrowers may have existing subsidiaries or may be involved in merger and acquisition activity that may place the borrower at risk for the activities of others that result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court imposed clean-up costs. Additionally, borrowers can be held liable for contamination that occurred before they owned or used real estate.

## Protection Against Environmental Liability

Lenders have numerous ways to identify and minimize their exposure to environmental liability. Because environmental liability is relatively recent, procedures used to safeguard against such liability are evolving. Generally, however, banking organizations should have in place adequate safeguards and controls to limit their exposure to potential environmental liability. Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests and existing loans. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be held

to a more stringent due diligence investigation than borrowers in low-risk industries or localities.

In addition to establishing procedures for granting credit, procedures should be developed and applied to portfolio analysis, credit monitoring, loan workout situations, and—before taking title to real property—foreclosures. Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability.

At the same time, banking organizations must be careful that any lending policies and procedures, especially those undertaken to assess and control environmental liability, cannot be construed as taking an active role in participating in the management or day-to-day operations of the borrower's business. Activities that could be considered active participation in the management of the borrower's business and therefore subject the banking organization to potential liability, include but are not limited to:

- Having branch or FBO employees serve as members of the borrower's board of directors or actively participating in board decisions;
- Assisting in day-to-day management and operating decisions; or
- Actively determining management changes.

These considerations are especially important when the banking organization is actively involved in loan workouts or debt restructuring.

The first step in identifying and minimizing environmental risk is for banks to perform environmental reviews. Such reviews may be performed by loan officers or others and typically identify past practices and uses of the facility and property, evaluate regulatory compliance, if applicable, and identify potential future problems. This review is accomplished by interviewing persons familiar with past and present uses of the facility and property, reviewing relevant records and documents, and visiting and inspecting the site.

Where the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough review and inspection of the facility and property. Environmental audits differ markedly from environmental assessments in that independent environmental engineers are employed to

investigate, in greater detail, those factors listed previously and actually test for hazardous substance contamination. Such testing might require collecting and analyzing air samples, surface soil samples, and subsurface soil samples and drilling wells to sample ground water.

Other measures used by some banking organizations to assist in identifying and minimizing environmental liability include obtaining indemnities from borrowers for any clean-up costs incurred by the bank and including affirmative covenants in loan agreements (and attendant default provisions) requiring the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, they are not a substitute for environmental reviews, assessments, and audits because their effectiveness is dependent upon the financial strength of the borrower.

The foregoing discussion provides general guidance on environmental liability. Because of continuing legal and regulatory changes and court decisions in this area, all policies, practices, and procedures should be periodically reviewed by legal counsel to ensure that they are adequate and up-to-date.

## Conclusion

Potential environmental liability can touch on a great number of loans to borrowers in many industries or localities. Moreover, nonlending activities and affiliations can lead to environmental liability depending upon the nature of these activities and the degree of participation that the banking organization, whether domestic or foreign, exercises in its U.S. operations. Such liability can result in losses arising from hazardous substance contamination because banking organizations are held directly liable for costly court ordered clean ups. Additionally, the banking organization's ability to collect the loans it makes may be hampered by significant declines in collateral value or the inability of a borrower to meet debt payments, after paying for costly clean-ups of hazardous substance contamination.

Banking organizations must understand the nature of environmental liability arising from hazardous substance contamination. Additionally, they should take prudential steps to identify and minimize their potential environmental

liability. Indeed, the common thread to environmental liability is the existence of hazardous substances, not types of borrowers, lines of business, or real property.

# Real Estate Loans

## Examination Objectives

Effective date July 1997

## Section 3100.2

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1. To determine if policies, practices, procedures, and internal controls regarding real estate lending activities and appraisals are adequate.
2. To determine if branch officers are operating in conformance with established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine that appraisals performed in connection with federally-related transactions comply with the minimum standards of the appraisal regulations and the Uniform Standards of Professional Appraisal Practice.
5. To determine whether adequate safeguards and controls have been established to limit exposure to potential environmental liability.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Real Estate Loans Examination Procedures

Effective date July 1997

## Section 3100.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of real estate lending activities. However, if the branch engages in significant real estate lending activities, and additional information is needed, the examiner should perform the following examination procedures.

1. If selected for implementation, complete or update the Internal Control Questionnaire.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
3. Review the following information for selected real estate loans:
  - a. Determine the primary source of repayment and evaluate its adequacy.
  - b. Assess the quality of any secondary collateral afforded by the loan guarantors or partners.
  - c. Compare collateral values to outstanding debt and determine whether the loan's LTV ratio is in excess of the suggested supervisory LTV limits.
  - d. Assess the adequacy of the appraisal or evaluation.
  - e. Determine if the loan complies with branch policy.
  - f. Identify deficiencies in the loan's credit files or the collateral records.
  - g. Review the borrower's compliance with loan covenants, and payment performance.
  - h. Determine if any problems exist that may jeopardize the repayment of the loan.
  - i. If the loan was classified during the preceding examination and has subsequently been paid off, determine the source of funds for repayment (e.g. another loan, a sale to another institution, or repossession of the property.)
  - j. If the loan is to a firm or to individuals who provided professional services to the branch, such as attorneys, accountants, or appraisers, determine if the borrower received preferential treatment.
4. Evaluate the branch's real estate lending activities, taking into account the following items:

- a. The adequacy of the policies, procedures, and internal controls.
- b. The adherence to policies and procedures, and accuracy and completeness of the branch's records.
- c. The competency of management and loan officers.
- d. The adequacy of systems to monitor both favorable and adverse trends in the overall real estate industry.
- e. The quality of the real estate loan portfolio, including the level and trends of classified and criticized loans, and delinquent and nonaccrual loans. Ascertain if management is aware of the causes of existing problems.
- f. Loans lacking current and complete financial information or documentation. Address deficiencies related to items such as appraisals, feasibility studies, the environmental impact study, takeout commitment, title policy, deeds of trust, and mortgage notes.
- g. Compliance with laws, regulations, and applicable regulatory policy.
- h. Independent verification of collateral values.

### APPRAISALS

5. Review the branch's appraisal and evaluation program, making sure it includes guidelines for obtaining appraisals from third party appraisers and evaluating appraisals in-house.
6. Evaluate the adequacy and integrity of the appraisal and evaluation process, considering:
  - a. The appropriateness of the methods, assumptions, and techniques used, and compliance with interagency real estate appraisal and evaluation guidelines.
  - b. Other appraisal deficiencies such as:
    - Misrepresentation of data,
    - Inadequate analysis,
    - Use of dissimilar comparables,
    - Underestimation of factors, such as construction cost, construction period, lease-up period, and rent concessions,

- Use of best case assumptions for the income approach, or
  - Overly optimistic assumptions, such as a high absorption rate in an overbuilt market.
9. Review loan agreements to determine if warranties, representations, and indemnifications have been included in loan agreements designed to protect the branch from losses stemming from hazardous substance contamination. (Although such provisions provide some protection for the lender, these agreements are not binding against the government or third parties. Such contractual protections are only as secure as the borrower's financial strength.)

## ENVIRONMENTAL LIABILITY

7. Determine if policies, procedures, and other safeguards and controls have been established to avoid or mitigate potential environmental liability.
8. Determine whether appropriate periodic analysis of potential environmental liability is conducted.
10. Update workpapers with any information that will facilitate future examinations.

# Real Estate Loans

## Internal Control Questionnaire

Effective date July 1997

## Section 3100.4

Refer to the Credit Risk Management Internal Control Questionnaire, section 3010.4, for a general review of the branch's internal controls, policies, practices, and procedures. If the branch engages in significant real estate lending activities, and additional information is needed, the examiner should complete the following ICQ. For audit procedures, refer to the Credit Risk Management section 3010.5.

1. Has branch and head office management adopted written real estate lending policies that define:
  - a. Target market?
  - b. Acceptable collateral?
  - c. Prudent, clear, and measurable underwriting standards for each type of property such as:
    - Maximum loan amount and maturity?
    - Repayment terms?
    - Pricing structure?
    - Loan-to-value (LTV) limits?
  - d. Approval procedures and authority limits?
  - e. Loan administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
  - f. Minimum loan documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
  - g. Appraisals and evaluations?
  - h. Reporting requirements to the head office relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are policies and procedures appropriate to the size and sophistication of the branch, and are they reviewed annually to ensure they are compatible with changing market conditions?
3. Has someone been assigned the responsibility for maintaining the document files?
4. Are notes and other original documents properly safeguarded?
5. Is a tickler system or a check sheet used to ensure that required documents are received and on file?
6. Are loan files reviewed after closing to determine if all documents are properly

drawn, executed, recorded, and filed within the loan files?

7. Is there a procedure for monitoring escrow accounts to determine that private mortgage insurance premiums and hazard insurance premiums are current?
8. Do hazard insurance policies include a loss payable clause to the branch?
9. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?
10. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
11. Does the branch have adequate collection procedures to monitor delinquencies and pursue foreclosure?
12. Are "in-substance foreclosure" properties appropriately identified?
13. Are properties to which the branch has obtained title appropriately transferred to other real estate owned (OREO)? Refer to the Other Real Estate Owned section in this manual for requirements.

## APPRAISALS AND EVALUATIONS

14. Do appraisal policies include:
  - a. Guidelines for selecting, evaluating, and monitoring the individuals performing appraisals or evaluations, whether third party or in-house?
  - b. Procedures for when to obtain appraisals and evaluations on new loans, as well as reappraisals or reevaluations on existing loans?
  - c. Review procedures to determine that appraisals and evaluations comply with supervisory guidelines?
15. If appropriate, does the appraisal meet the minimum standards of the appraisal regulations and the Uniform Standards of Professional Appraisal Practice, including:
  - a. Purpose?
  - b. Market value?
  - c. Effective date?
  - d. Marketing period?
  - e. Sales history of subject property?

- f. Reflect the valuation using the cost, income, and comparable sales approaches?
  - g. Evaluate and correlate the three approaches into a final value estimate, based on the appraiser's judgment?
  - h. Explain why an approach is inappropriate and not used in the appraisal?
  - i. Fully support the assumptions and the value rendered through adequate documentation?
16. Are staff appraisers independent of the lending, investment, and collection functions?
  17. Are fee appraisers engaged directly by the branch and do they have no direct or indirect interest, financial or otherwise, in the property or transaction?
  18. Are fee appraisers paid the same fee whether or not the loan is granted?
  19. If the transaction is outside the local geographic market of the branch, does the branch engage an appraiser with knowledge of the market where the real estate collateral is located?

## ENVIRONMENTAL LIABILITY

20. Do loan applicants provide information on environmental matters pertaining to their business facilities?
21. If the branch acquires a loan, either by purchase or participation, does it ensure that
  - adequate due diligence regarding environmental risk matters has been performed by the lead lender?

22. Do loans receive a Phase I Environmental Risk Report if the collateral is deemed to have a higher environmental risk potential than other types of real property?
23. Has senior management designated a specific "environmental risk analyst" who receives special training on environmental risk?
24. Are potential environmental problems noted in an environmental risk report considered by senior management prior to loan approval?
25. Are procedures established for reviewing collateral prior to foreclosure to ensure environmental risk has been addressed?
26. Are training programs conducted so that lending personnel are aware of environmental liability issues and are able to identify borrowers with potential problems?

## CONCLUSION

27. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
28. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

### INTRODUCTION

A construction loan is used to finance the construction of a particular project within a specified period of time and is funded by supervised disbursements of a predetermined amount over the construction period. When properly controlled, a branch can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent upon the borrower either obtaining permanent financing or finding a buyer with sufficient funds to purchase the completed project. Because many borrowers anticipate retaining ownership after construction, the cost and availability of funds from permanent financing is a primary factor to be considered by the branch in assessing the risk of a construction loan.

A construction loan is generally secured by a first mortgage or deed of trust on the land and improvements, which is often backed by a purchase agreement from a financially sound investor or by a takeout financing agreement from a responsible permanent lender. A long-term mortgage loan (permanent financing) is typically obtained prior to or simultaneous with the construction loan and is made to refinance the short-term construction loan. Additionally, the bank may require a borrower to provide secondary collateral in the form of a junior interest in another real estate project or a personal guarantee.

### LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of branch involvement. The branch's lending policies should reflect prudent lending standards and set forth pricing guidelines, limits on loan-to-value ratios and debt-coverage ratios, and yield requirements. Such policies should also address procedures relative to controlling disbursements in a manner that is commensurate with the construction progress.

### Lending Limits

A branch should establish well-controlled construction lending limits that are within the acceptable standards of state banking regulations. State banking statutes governing construction lending may contain minimum standards of prudence without specifying actual loan terms.

The branch's internal limits should not exceed the supervisory loan-to-value (LTV) limits set forth in the Interagency Guidelines for Real Estate Lending Policies, as required by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and included as appendix C of the Federal Reserve's Regulation H. These guidelines, and the accompanying LTV limits, are discussed in the Real Estate Loans section of this manual. Generally, the LTV ratio should not exceed the following supervisory guidance limits:

- 65 percent for raw land loans;
- 75 percent for land development and improved land loans;
- 80 percent for commercial, multifamily, and other nonresidential construction loans; and
- 85 percent for one- to four-family residential construction loans.

The foregoing limits apply only to domestic banks, not to FBOs; however, these guidelines are provided for reference.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project.

### Lending Risks

Construction loans are vulnerable to a wide variety of risks. Critical to the evaluation of any construction loan is the analysis of the project's feasibility study to ascertain the developer's risk, which affects the lender's risk. The major portion of the risk is attributable to the need to complete a project within specified cost and time limits. Examples of difficulties that may arise include:

- Completion of a project after takeout dates, which voids permanent funding commitments.
- Cost overruns, which may exceed takeout

commitments or sale prices.

- The possibility that the completed project will be an economic failure.
- The diversion of progress payments resulting in nonpayment of material bills or subcontractors.
- A financial collapse of or the failure of the contractors, subcontractors, or suppliers to perform before the completion date.
- Increased material or labor costs.
- The destruction of improvements from unexpected natural causes.
- An improper or lax monitoring of funds advanced by the branch.

## TYPES OF CONSTRUCTION LOANS

The basic types of construction loans are unsecured front money, land development, residential construction, and commercial construction loans. It is not uncommon for a branch to provide the acquisition, development, and construction loans for a particular project.

### Unsecured Front Money Loans

Front money loans are considered very risky and should not be undertaken unless the branch has the expertise to evaluate the credit risk. These loans may represent working capital advances to a borrower who may be engaged in a new and unproven venture. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and meet minimum working capital requirements established by construction lenders. Because repayment often comes from the first draw against construction financing, many construction loan agreements prohibit the use of the first advance to repay nonconstruction costs. Unsecured front money loans used as a developer's equity investment in a project or to cover initial cost overruns are symptomatic of an undercapitalized or possibly an inexperienced or inept builder.

### Land Development Loans

Land development or off-site improvement loans are intended to be secured-purchase loans or unsecured advances to creditworthy borrowers.

A development loan involves the purchase of land and lot development in anticipation of further construction or sale of the property. In addition to funding the acquisition of the land, a development loan may be used to fund the preparation of the land for future construction, including the grading of land, installation of utilities, and construction of streets.

Effective administration of a land development loan begins with a plan defining each step of the development. The development plan should incorporate cost budgets, including legal expenses for building and zoning permits, environmental impact statements, costs of installing utilities, and all other projected costs of the development. Branch management's review of the plan and related cost breakdowns should provide the basis for determining the size, terms, and restrictions for the development loan. Refer to the subsection below on the assessment of real estate collateral for further discussion.

The LTV ratio should provide for sufficient margin to protect the branch from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the branch's collateral position or repayment prospects. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised and any collateral should be released in a manner that maintains a reasonable margin. The repayment program should be structured to follow the sales or development program. Control over development loans can be best established when the branch finances both the development and the construction or sale phases of the project.

In the case of an unsecured land development loan, it is essential to analyze the borrower's financial statements to determine the source of loan repayment. In establishing the repayment program, the branch should review sales projections to ensure that they are not overly optimistic. Additionally, branches should avoid granting loans to illiquid borrowers or guarantors who provide the primary support for a borrower (project).

### Residential Construction Loans

Residential construction loans are made either on a speculative basis, where homes are built to be sold later in the general market, or for a

specific buyer with prearranged permanent financing. Loans financing residential projects that do not have prearranged home buyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. It is important to ensure that the home buyer has arranged permanent financing before the branch finances the construction; otherwise, the branch may find itself without a source of repayment. Construction loans without permanent takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds the designated percentage of total assets. For further guidance in this area, examiners should consult with their respective agencies.

Proposals to finance speculative construction projects should be evaluated according to predetermined policies that are compatible with the institution's size, the technical competence of its management, and the housing needs of its service area. The prospective borrower's experience and financial condition should also be reviewed to assess the likelihood of completing the proposed project. Until the project is completed, the actual value of the real estate is questionable. Thus, the marketability of the project should be substantiated in a feasibility study, reflecting a realistic assessment of current favorable and unfavorable local housing market conditions. As in any real estate loan, the branch must also obtain an appraisal or evaluation for the project. The appraisal or evaluation and the feasibility study are important tools to be used by lenders in evaluating project risks. For projects located out of area, the lender may lack market expertise, which makes evaluating the reasonableness of the marketing plan and feasibility study more difficult, and therefore makes the loan inherently riskier.

A branch dealing with speculative builders should have control procedures tailored to the individual project. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the builder's capacity. The construction lender should receive current inspection reports indicating the project's progress. In some instances, the construction lender is also the permanent mortgagor. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing as part of the construction loan.

## Commercial Construction Loans

A branch's commercial construction lending activity can encompass a wide range of projects—apartments, condominiums, office buildings, shopping centers, and hotels—with each requiring a special set of skills and expertise to successfully manage, construct, and market.

Commercial construction loan agreements should normally require the borrower to have a precommitted extended-term loan to “takeout” the construction lender. Takeout financing agreements, however, are usually voidable if construction is not completed by the final funding date, if the project does not receive occupancy permits, or if the preleasing or occupancy rate does not meet an agreed-upon level. A branch can also enter into an “open-end” construction loan where there is no precommitted source to repay the construction loan. Such loans pose an added risk because the branch may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the branch should consider whether the completed project will be able to attract extended-term financing, supported by the projected net operating income.

The risk of commercial construction requires a complete assessment of the real estate collateral, borrower's financial resources, source of the extended-term financing, and construction plans. As in any real estate loan, the branch must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's Regulation H. Additionally, the borrower should provide a feasibility study for the project that details the project's marketing plan, as well as an analysis of the supply-and-demand factors affecting the projected absorption rate. For an open-end construction loan, the feasibility study is particularly important to the branch's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The branch also needs to assess the borrower's development expertise, that is, whether the borrower can complete the project within budget and according to the construction plans. The financial risk of the project is contingent on the borrower's development expertise because the source of the extended-term loan may be predicated upon a set date for project completion.

Until the project is completed, the actual value of the real estate is questionable.

A branch may reduce its financial risk by funding the construction loan after the borrower has funded its share of the project equity (for example, by paying for the feasibility study and land acquisition and development costs). An alternative approach would require the borrower to inject its own funds into the project at agreed-upon intervals during the project's management, construction, and marketing phases to coincide with the construction lender's contributions. In larger projects, equity injections can be provided by equity partners or joint ventures. These can take the form of equity syndications, with contributions injected in the project in phases. A branch should assess the likelihood of the syndication being able to raise the necessary equity.

## BRANCH ASSESSMENT OF THE BORROWER

The term "borrower" can refer to different types of entities. These forms can range from an entity whose sole asset is the project being financed to an entity that has other assets available to support the debt in addition to the project being financed (a multi-asset entity).

Although the value of the real estate collateral is an important component of the loan approval process, the branch should not place undue reliance on the collateral value in lieu of an adequate analysis of the borrower's ability to repay the loan. The analytical factors differ depending on the purpose of the loan, such as residential construction versus the various types of commercial construction loans.

The branch's analysis is contained in its documentation files, which should include background information on the borrower and partner/guarantor concerning their character and credit history, expertise, and financial statements (preferably audited) for the most recent fiscal years. Background information regarding a borrower's and partner's/guarantor's character and credit history is based upon their work experience and previous repayment practices, both relative to trade creditors and financial institutions. The documentation files should indicate whether the borrower has demonstrated the ability to successfully complete the type of project to be undertaken. The financial statements should be

analyzed to ensure that the loan can be repaid in the event that a takeout does not occur.

The degree of analysis depends on whether the borrower is a single-asset entity or a multi-asset entity. A loan to a single-asset entity is often predicated upon the strength of the partners/guarantors. Accordingly, understanding their financial strength, which frequently is made up of various partnership interests, is key to assessing the project's strength. In this example, it would be necessary to obtain financial information on the partner's/guarantor's other projects, even those not financed by the branch, to understand their overall financial condition. This is necessary because other unsuccessful projects may cause financial trouble for the partner/guarantor, despite a successful sales program by the branch's borrower. Issues to be considered, in addition to those raised in the preceding paragraph, include the vacancy rates of the various projects, break-even points, and rent rolls.

A loan to a multi-asset entity has similar characteristics to those found in the single-asset entity, in that it is necessary to evaluate all of the assets contained therein to ascertain the actual financial strength. In both cases, assessment of the project under construction would include preleasing requirements. For a loan with a takeout commitment, the financial strength and repayment history of the permanent lender should be analyzed. For a loan without a takeout commitment, or one where the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. Refer to the Real Estate Loans section in this manual, on the branch's assessment of the borrower, for additional factors to be considered.

In instances where approval for the loan is predicated upon the strength of entities other than the borrower (partner/guarantor), the branch should obtain information on their financial condition, income, liquidity, cash flow, contingent liabilities, and any other relevant factors that exist to demonstrate their financial capacity to fulfill the obligation in the event that the borrower defaults.

Partners/guarantors generally have investments in other projects included as assets on their financial statements. The value of these investments frequently represents the partner's/guarantor's own estimate of the investment's worth, as opposed to a value based upon the investment's financial statements. As a result, it

is necessary to obtain detailed financial statements for each investment to understand the partner's/guarantor's complete financial picture and capacity to support the loan. The statements should include detailed current and accurate cash flow information since cash flow is often the source of repayment.

It is also important to consider the number and amount of the guarantees currently extended by a partner/guarantor to determine if they have the financial capacity to fulfill the contingent claims that exist. Furthermore, the branch should review the prior performance of the partner/guarantor to voluntarily honor the guarantee as well as the marketability of the assets collateralizing the guarantee. Since the guarantee can be limited to development and construction phases of a project, the branch should closely monitor the project before issuing a release to the partner/guarantor.

## BRANCH ASSESSMENT OF REAL ESTATE COLLATERAL

Branches should obtain an appraisal or evaluation, as appropriate, for all real estate-related financial transactions prior to making the final credit or other decision. Refer to the Real Estate Appraisals and Evaluations section of this manual for a description of the related requirements a branch must satisfy for real estate-related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications necessary for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal methods.

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The aggregate principal amount of the loan should be based on an appraisal or evaluation that provides, at a minimum, the "as is" market value of the property. Additionally, the branch will normally request the appraiser to report the "as completed" value. Projections should be accompanied by a feasibility study explaining the effect of projected property improvements on the market value of the land. The feasibility study may be a separate report or incorporated into the appraisal report. If the appraiser uses the feasibility study,

the appraiser's acceptance or rejection of the study and its effect on the value should be fully explained in the appraisal.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale in accepting and relying upon the appraisal or evaluation should be documented in writing and made a part of loan documentation. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the branch may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation. Since the approval of the loan is based upon the value of the project after the construction is completed, insofar as the value component of the loan-to-value ratio is concerned, it is important for the branch to closely monitor the project's progress and value during the construction period. Refer to the Real Estate Loans section of the manual for additional information relative to the real estate collateral assessment.

## LOAN DOCUMENTATION

The loan documentation should provide information on the essential details of the loan transaction, the security interest in the real estate collateral, and the takeout loan commitment, if any. The necessary documentation before the start of construction generally includes:

- Financial and background information on the borrower to substantiate the borrower's expertise and financial strength to complete the project.
- The construction loan agreement, which sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or the mortgage.
- A recorded mortgage or deed of trust, which can be used to foreclose and to obtain title to the collateral.
- A title insurance binder or policy, usually issued by a recognized title insurance company

or, in some states, an attorney's opinion. The title should be updated with each advance of funds to provide additional collateral protection.

- Insurance policies and proof of payment as evidence that the builder has adequate and enforceable coverage for liability, fire and other hazards, and vandalism and malicious mischief losses.
- An appropriate appraisal or evaluation showing the value of the land and improvements to date or, possibly, a master appraisal based on specifications for a multi-phase development.
- Project plans, a feasibility study, and a construction budget showing the development plans, project costs, marketing plans, and equity contributions. A detailed cost breakdown of land and "hard" construction costs, as well as indirect or "soft" costs for construction loan interest, organizational and administrative cost, and architectural, engineering, and legal fees should be included.
- Property surveys, easements, an environmental impact report, and soil reports that indicate construction is feasible on the selected development site. The branch should also obtain the architect's certification of the plan's compliance with all applicable building codes and zoning, environmental protection, and other government regulations, as well as the engineer's report on compliance with building codes and standards. If internal expertise is not available, a branch may need to retain an independent construction expert to review these documents to assess the reasonableness and appropriateness of the construction plans and costs.
- The takeout commitment from the permanent lender, if applicable, and the terms of the loan. The branch should verify the financial strength of the permanent lender to fund the takeout commitment.
- A completion or performance bond signed by the borrower that guarantees that the borrower will apply the loan proceeds to the project being financed.
- An owners' affidavit or a borrowing resolution empowering the borrower or its representative to enter into the loan agreement.
- Evidence that property taxes have been paid to date.

These documents furnish evidence that the lending officer is obtaining the information nec-

essary for processing and servicing the loan and protect the branch in the event of default.

## Documentation for Residential Construction Loans on Subdivisions

The documents mentioned above are usually available for residential construction loans on subdivisions (tracts). Documentation of tract loans frequently includes a master note in the gross amount of the entire project, and a master deed of trust covering all of the land involved in the project. In addition to an appraisal or evaluation for each type of house to be constructed, the branch should also obtain a master appraisal including a feasibility study for the entire development. The feasibility study compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. This analysis should indicate whether there will be sufficient demand for the developer's homes given the project's location, type of homes, and unit sales price.

## Documentation for Takeout Commitment

Most construction lenders require the developer to have an arrangement for permanent financing for each house to be constructed. Exceptions include model homes, typically one for each style of home offered, and a limited number of housing starts ahead of sales (speculative building). The starts ahead of sales, however, contain additional risk. If the branch finances too many houses without purchase contracts, and housing sales decline rapidly, it may have to foreclose on the unsold houses and sell them for less than their loan value. A takeout of this type is usually an arrangement between the developer and a permanent mortgage lender, but construction lenders may also finance the permanent mortgages.

The essential information required for a commercial real estate takeout to proceed includes the floor and ceiling rental rates and minimum occupancy requirements; details of the project being financed; expiration date; standby fee requirement; assignment of rents; and, generally, a requirement that the construction loan be fully disbursed and not in any way be in default at the time settlement occurs.

The commitment agreement, referred to as a buy/sell contract or a tri-party agreement, is signed by the borrower, the construction lender, and the permanent lender. The purpose of this agreement is to permit the permanent lender to buy the loan directly from the construction lender upon completion of the construction, with the stipulation that all contingencies have been satisfied. Examples of contingencies include project completion by the required date, clear title to the property, and minimum lease-up requirements. A commitment agreement also protects the construction lender against unforeseen possibilities, such as the death of a principal, before the permanent loan documents are signed.

## LOAN ADMINISTRATION

The branch and the borrower must effectively cooperate as partners if controls relative to construction progress are to be maintained. The loan agreement specifies the performance of each party during the entire course of construction. Any changes in construction plans should be approved by both the construction lender and the takeout lender. Construction changes can result in increased costs, which may not necessarily increase the market value of the completed project. On the other hand, a decrease in costs may not indicate a savings but may suggest the use of lesser quality materials or workmanship, which could affect the marketability of the project.

### Disbursement of Loan Funds

Loan funds are generally disbursed through either a stage payment plan or a progress payment plan. Regardless of the method of disbursement, the amount of each construction draw should be commensurate with the improvements made to date. Funds should not be advanced unless they are used in the project being financed and as stipulated in the draw request. Therefore, the construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project.

### Stage Payment Plan

The stage payment plan, which is normally applied to residential and smaller commercial construction loans, uses a pre-established schedule for fixed disbursements to the borrower at the end of each specified stage of construction. The amount of the draw is usually based upon the stage of development because residential housing projects normally consist of houses in various stages of construction. Nevertheless, loan agreements involving tract financing typically restrict further advances in the event of an accumulation of completed and unsold houses. Disbursements are made when construction has reached the agreed-upon stages, verified by an actual inspection of the property. These typically include advances at the conclusion of various stages of construction, such as the foundation, exterior framing, the roof, interior finishing, and completion of the house. The final payment is made after the legally stipulated lien period for mechanic's liens has lapsed.

Disbursement programs of this type are usually required for each house constructed within a tract development. As each house is completed and sold, the branch makes a partial release relative to that particular house covered by its master deed of trust. The amount of the release is set forth in the loan agreement, which specifies the agreed-upon release price for each house sold with any excess over the net sales proceeds remitted to the borrower.

### Progress Payment Plan

The progress payment plan is normally used for commercial projects. Under a progress payment system, funds are released as the borrower completes certain phases of construction as agreed upon in the loan agreement. Normally, the branch retains a percentage of the funds as a hold-back (or retainage) to cover project cost overruns or outstanding bills from suppliers or subcontractors. Hold-backs occur when a developer/contractor uses a number of subcontractors and maintains possession of a portion of the amounts owed to the subcontractors during the construction period. This is done to ensure that the subcontractors finish their work before receiving the final amount owed. Accordingly, the construction lender holds back the same

funds from the developer/contractor to avert the risk of their misapplication or misappropriation.

The borrower presents a request for payment from the branch in the form of a “construction draw” request or “certification for payment,” which sets forth the funding request by construction phase and cost category for work that has been completed. This request should be accompanied by receipts for the completed work (material and labor) for which payment is being requested. The borrower also certifies that the conditions of the loan agreement have been met—that all requested funds have been used in the subject project and that suppliers and subcontractors have been paid. Additionally, the subcontractors and suppliers should provide the branch with lien waivers covering the work completed for which payment has been received. Upon review of the draw request and independent confirmation on the progress of work, the branch will disburse funds for construction costs incurred, less the hold-back. The percentage of the loan funds retained are released when a notice of the project’s completion has been filed, and after the stipulated period has elapsed under which subcontractors or suppliers can file a lien.

## Monitoring Progress of Construction and Loan Draws

It is critical that a branch has appropriate procedures and an adequate tracking system to monitor payments to ensure that the funds requested are appropriate for the given stage of development. The monitoring occurs through physical inspections of the project once it has started. The results of the inspections are then documented in the inspection reports, which are kept in the appropriate file. Depending on the complexity of the project, the inspection reports can be completed either by the lender or by an independent construction consulting firm, the latter generally staffed by architects and engineers. The reports address both the quantity and the quality of the work for which funds are being requested. They also verify that the plans are being followed and that the construction is proceeding on schedule and within budget.

The branch must be accurately informed of the progress to date in order to monitor the loan. It is also important that the branch ascertain whether draws are being taken in accordance with the predetermined disbursement schedule.

Before any draw amount is disbursed, however, the branch must obtain verification of continued title insurance. Generally, this means verifying that no liens have been filed against the title of the project since the previous draw. The title insurance insuring the construction lender’s mortgage or lien is then increased to include the new draw, which results in an increase in the title insurance commensurate with the disbursement of funds. The lender frequently examines title to the property securing the construction loan to also be certain that the borrower is not pledging it for other borrowings and to be sure that mechanic’s liens are not being filed for unpaid bills. When the project is not proceeding as anticipated, that fact should be reflected in the inspection reports.

Another important component in the process is the ongoing monitoring of general economic factors that will affect the marketing and selling of the residential or commercial properties and affect their success upon completion of the project.

## Monitoring Residential Projects

An inventory list is maintained for each tract or phase of the project. The inventory list should show each lot number, the style of house, the release price, the sale price, and the loan balance. The list should be posted daily with advances and payments indicating the balance advanced for each house, date completed, date sold, and date paid, and should age the builder’s inventory by listing the older houses completed and unsold.

Inspections (usually monthly) during the course of construction of each house should be documented in progress reports. The progress report should indicate the project’s activity during the previous month, reflecting the number of homes under construction, the number completed, and the number sold. The monthly report should indicate whether advances are being made in compliance with the loan agreement.

## Monitoring Commercial Projects

To have an effective control over its commercial construction loan program, the branch must have an established loan administration process that continually monitors each project. The

process should include monthly reporting on the work completed, the cost to date, the cost to complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be documented and reviewed by the construction consulting firm and should be approved by the branch and takeout lender. A significant number of change orders may indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget. Soft costs such as advertising and promotional expenses normally are not funded until the marketing of the project has started.

## Final Repayment

Before the final draw is made, the construction loan should be in a condition to be converted to a permanent loan. Usually the final draw includes payment of the hold-back stipulated in the loan agreement and is used to pay all remaining bills. The branch should obtain full waivers of liens (releases) from all contractors, subcontractors, and suppliers before the loan is released and the hold-back is disbursed. The branch should also obtain a final inspection report to confirm the project is completed and meets the building specifications, including confirmation of the certificate of occupancy from the governing building authority.

Sources of permanent funding for commercial projects vary greatly, depending upon the type of project. For condominium projects, the construction lender may also be providing the funding for marketing the individual units and would be releasing the loan on a unit-by-unit basis similar to a residential development construction loan. If there is a pre-committed takeout lender, the new lender could purchase the construction loan documents and assume the security interest from the construction lender. If the project is being purchased for cash, the branch would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the branch's position is protected in the event that extended-term funding is not obtained. The branch may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the branch's interests in the lease by providing for the assumption of the land-

lord's position by the branch in the event the borrower declares bankruptcy. Furthermore, to ensure that the branch has full knowledge of all provisions of the lease agreements, tenants should be required to sign an estoppel certification.

In some cases, the takeout lender may only pay off a portion of the construction loan because a conditional requirement for full funding has not been met, such as the project not attaining a certain level of occupancy. The construction lender would then have a second mortgage on the remaining balance of the construction loan. When the conditions of the takeout loan are met, the construction lender is repaid in full and the lien is released.

## Interest Reserves

A construction loan is generally an interest-only loan because of the fact that cash flow is not available from most projects until they are completed. The borrower's interest expense is therefore borrowed from the construction lender as part of the construction loan for the purpose of "paying" the lender interest on the "portion" of the loan used for actual construction. The funds advanced to pay the interest are included as part of the typical monthly draw. As a result, the balance due to the lender increases with each draw by the full amount of construction costs, plus the interest that is borrowed.

The borrower's interest cost is determined by the amount of credit extended and the length of time needed to complete the project. This interest cost is referred to as an interest reserve. This period of time should be evaluated for reasonableness relative to the project being financed. In larger projects, cash flow may be generated prior to the project's completion. In such cases, any income from the project should be applied to debt service before there is a draw on the interest reserve. The lender should closely monitor the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted to the borrower as a return of the developer's capital or for use in the developer's other projects.

## Loan Default

The inherent exposure in construction financing is that the full value of the collateral is not

realized until the project is completed. In default situations the branch must consider the alternatives available to recover its advances. For incomplete projects, the branch must decide whether it is more advantageous to complete the project or to sell on an “as is” basis. 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. Due to these factors, the construction lender may not be in the preferred position indicated by documents in the file. Therefore, the lender should take every precaution to minimize any third-party claim on the collateral. Because laws regarding the priority of certain liens may vary among states, the branch should take the necessary steps to ensure that its lien is recorded prior to the commencement of work or the delivery of materials and supplies.

## Signs of Problems

To detect signs of a borrower’s financial problems, the branch should review the borrower’s financial statements on a periodic (quarterly) basis, assessing the liquidity, debt level, and cash flow. The degree of information the financial statements provide the branch, insofar as understanding the borrower’s financial condition is concerned, depends primarily on whether the borrower is a single-asset entity or a multi-asset entity.

The financial statements of a single-asset entity only reflect the project being constructed; therefore, they are of a more limited use than statements of multi-asset entities. Nevertheless, one issue that is of importance to financial statements of both entities relates to monitoring changes in accounts and trade payables. Monitoring these payables in a detailed manner helps the branch to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a branch might choose to either contact the payables directly or request an additional credit check on the borrower. Another source of information indicating borrower problems is local publications that list lawsuits or judgments that have been filed or entered against the borrower. Additionally, the branch should also verify that the borrower is making its tax payments on time.

In a multi-asset entity, on the other hand, more potential problems could arise due to the

greater number of assets (projects/properties) that make up the borrower. As a result, it is necessary to obtain detailed financial statements of each of the assets (projects/properties) and the consolidated financial statements, as well as the consolidated financial statements. This is important because each kind of statement can provide significant insight into problems that could adversely affect the borrower’s overall financial condition.

Assessing the financial condition of the multi-asset entity includes evaluating the major sources of cash and determining whether cash flow is dependent on income generated from completed projects, the sale of real estate, or infusion of outside capital. Additionally, the branch should also review the borrower’s account receivables for the appropriateness of intercompany transactions and to guard against diversion of funds.

Depending upon the structure of the loan, it may also be desirable to obtain a partner’s/guarantor’s financial statements on a periodic basis. In such cases it is important to obtain detailed current and accurate financial statements that include cash flow information on a project-by-project basis.

Slow unit sales, or excessive inventory relative to sales, indicate the borrower may have difficulty repaying the loan. Although sometimes there are mitigating factors beyond the control of the borrower, such as delays in obtaining materials and supplies, adverse weather conditions, or unanticipated site work, the borrower may be unable to overcome these problems. Such delays usually increase project costs and could hamper the loan’s repayment.

The construction lender should be aware of funds being misused—for example, rebuilding to meet specification changes not previously disclosed, starting a new project, or possibly paying subcontractors for work performed elsewhere. The practice of “front loading,” whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon and, if not detected early on, will almost certainly result in insufficient loan funds available to complete construction in the event of a default.

## Loan Workouts

Sound workout programs begin with a full disclosure of all relevant information based on a

realistic evaluation of the borrower's ability to manage the business entity (business, technical, and financial capabilities), and the branch's ability to assist the borrower in developing and monitoring a feasible workout/repayment plan. Management should then decide on a course of action to resolve the problems, with the terms of the workout documented in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the branch should ensure that the necessary legal documents are filed to protect the branch's collateral position.

In those cases where the borrower is permitted to finish the project, additional extensions of credit for completing the project, due to cost overruns or an insufficient interest reserve, may represent the best alternative for a workout plan. At the same time, the branch should evaluate the cause of the problem(s), such as mismanagement, and determine whether it is in its best interest to allow the borrower to complete the project.

## SUPERVISORY POLICY

As a result of competitive pressures, many branches in the early 1980s made construction loans on an open-end basis, wherein the borrower did not have a commitment for longer-term or takeout financing before construction was started. Although there was sufficient demand for commercial real estate space when this practice commenced, the supply of space began to exceed demand. One symptom of the excess supply was an increase in vacancy rates,

which led to declining rental income caused by the ever greater need for rent concessions. This decline in cash flow from income-producing properties, and the uncertainty regarding future income, reduced the market value of many properties to levels considered undesirable by permanent mortgage lenders. As a result of the subsequent void created by the permanent lenders, banks in the mid- and late-1980s began to extend medium-term loans with maturities of up to seven years (also referred to as mini-perms). These mini-perms were granted with the expectation by banks that as the excess supply of space declined, the return on investment would improve, and permanent lenders would return.

As these loans mature in the 1990s, borrowers may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to roll over or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who presently may not be in a position to obtain long-term financing for the loan balance.

The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in such a manner that is consistent with sound banking principles, supervisory guidelines, and accounting practices, which would protect the branch and improve its prospects for collecting or recovering on the asset.

# Real Estate Construction Loans

## Examination Objectives

Effective date July 1997

## Section 3110.2

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1. To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
2. To determine if branch officers are operating in conformance with the branch's established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine compliance with applicable laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Real Estate Construction Loans

## Examination Procedures

Effective date July 1997

## Section 3110.3

Refer to the Real Estate Loan Examination Procedures section of this manual for examination procedures related to all types of real estate lending activity, and incorporate into this checklist those procedures applicable to the review of the real estate construction loans. The procedures in this checklist are unique to the review of a branch's construction lending activity.

1. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
2. Test real estate construction loans for compliance with policies, practices, procedures, and internal controls by performing the remaining examination procedures in this section. Also, obtain a listing of any deficiencies noted in the latest internal/external audit reviews and determine if appropriate corrections have been made. Review management's actions taken in response to prior examination comments.
3. Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
4. Evaluate the branch with respect to:
  - a. the adequacy of written policies and procedures relating to construction lending.
  - b. operating compliance with established branch policy.
  - c. favorable or adverse trends in construction lending activity.
  - d. the accuracy and completeness of the branch's records.
  - e. the adequacy of internal controls, including control of construction draws.
  - f. the adherence of lending staff to lending policies, procedures, and authority as well as the branch's adherence to the holding company's loan limits, if applicable.
  - g. compliance with laws, regulations, and Federal Reserve policy on construction lending activity, including supervisory loan-to-value (LTV) limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and prudent lending practices.
5. Select loans for examination, using an appropriate sampling technique. Analyze the performance of the loans selected for examination by transcribing the following kinds of information onto the real estate construction loan line cards, when applicable:
  - a. Collateral records and credit files, including the borrower's financial statements, review of related projects, credit report of the borrower and guarantors, appraisal or evaluation of collateral, feasibility studies, economic impact studies, and loan agreement and terms.
  - b. Loan modification or restructuring agreements to identify loans where interest or principal is not being collected according to the terms of the original loan. Examples include reduction of interest rate or principal payments, deferral of interest or principal payments, or renewal of a loan with accrued interest rolled into the principal.
  - c. The commitment agreement, buy/sell contract, or the tri-party agreement from the extended-term or permanent lender for the takeout loan.
  - d. Cash-flow projections and any revisions to projections based on cost estimates from change orders.
  - e. Estimates of the time and cost to complete construction.
  - f. Inspection reports and evaluations of the cost to complete, construction deadlines, and quality of construction.
  - g. Construction draw schedules and audits for compliance with the schedules.
  - h. Documentation on payment of insurance and property taxes.
  - i. Terms of a completion or performance bond.
  - j. Past-due/nonaccrual-related information.
  - k. Loan-specific internal problem credit analyses information.
    - l. Loans to insiders and their interests.
    - m. Loans classified during the preceding examination.

6. In analyzing the selected construction loans, the examiner should consider the following procedures, taking appropriate action if necessary:
  - a. Determine the primary source of repayment and evaluate its adequacy, including whether:
    - the permanent lender has the financial resources to meet its commitment.
    - the amount of the construction loan and its estimated completion date correspond to the amount and expiration date of the takeout commitment and/or completion bond.
    - the permanent lender and/or the bonding company have approved any modifications to the original agreement.
    - properties securing construction loans that are not supported by a takeout commitment will be marketable upon completion.
  - b. Analyze secondary support afforded by guarantors and partners.
  - c. Relate collateral values to outstanding debt by:
    - assessing the adequacy of the appraisal and evaluation.
    - ascertaining whether inspection reports support disbursements to date.
    - determining whether the amount of undisbursed loan funds is sufficient to complete the project.
    - establishing whether title records assure the primacy of the branch's liens.
    - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.
  - d. Determine whether the loan-to-value (LTV) ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
  - e. Ascertain whether the loan complies with established branch policy.
  - f. Identify any deficiencies in the loan's documentation in both the credit files and the collateral records.
  - g. Identify whether the loan is to an officer or director of the branch or to a correspondent bank, and whether an officer, director, or shareholder of the bank is a guarantor on the loan.
  - h. Review the borrower's compliance with the provisions of the loan agreement, indicating whether the loan is in default or in past-due status.
- i. Determine if there are any problems that may jeopardize the repayment of the construction loan.
- j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank or from the repossession of the property.
7. In connection with the examination of other lending activity in the branch, the examiner should check the central liability file on the borrower(s) and determine whether the total construction lending activity exceeds the lending limit to a single borrower.
8. Summarize the findings of the construction loan portfolio review and address:
  - a. the scope of the examination.
  - b. the quality of the policies, procedures, and controls.
  - c. the general level of adherence to policies and procedures.
  - d. the competency of management.
  - e. the quality of the loan portfolio.
  - f. loans not supported by current and complete financial information.
  - g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, feasibility studies, the environmental impact study, takeout commitment, title policy, construction plans, inspection reports, change orders, proof of payment for insurance and taxes, deeds of trust, and mortgage notes.
  - h. the adequacy of control over construction draws and advances.
  - i. loans to officers, directors, shareholders, or their interests.
  - j. causes of existing problems.
  - k. delinquent loans and the aggregate amount of statutory bad debts. Refer to the manual section on classification of credits for a discussion on statutory bad debts or "A" paper.
  - l. concentrations of credit.
  - m. classified loans.
  - n. violations of laws or regulations, and non-compliance with regulatory requirements.
  - o. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the branch's response to such recommendations.

### POLICIES AND OBJECTIVES

1. Has the head office and branch management adopted and written construction lending policies that:
  - a. outline construction lending objectives regarding:
    - the aggregate limit for construction loans?
    - concentrations of credit in particular types of construction projects?
  - b. establish minimum standards for documentation?
  - c. define qualified collateral and minimum margin requirements?
  - d. define the minimum equity requirement for a project?
  - e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
  - f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
  - g. delineate standards for takeout commitments?
  - h. indicate completion bonding requirements?
  - i. establish procedures for reviewing construction loan applications?
  - j. detail methods for disbursing loan proceeds?
  - k. detail project inspection requirements and progress reporting procedures?
  - l. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
2. Are construction lending policies and objectives appropriate to the size and sophistication of the branch, and are they compatible with changing market conditions?
  - public liability insurance?
  - completion insurance?
- b. the property owner's payment of real estate taxes?
4. Does the branch require that files include:
  - a. loan applications?
  - b. financial statements for the:
    - borrower?
    - builder?
    - proposed prime tenant?
    - takeout lender?
    - guarantors/partners?
  - c. credit and trade checks on the:
    - borrower?
    - builder?
    - major subcontractor?
    - proposed tenants?
  - d. a copy of plans and specifications?
  - e. a copy of the building permit?
  - f. a survey of the property?
  - g. the construction loan agreement?
  - h. an appraisal or evaluation and feasibility study?
  - i. an up-to-date title search?
  - j. the mortgage?
  - k. ground leases?
  - l. assigned tenant leases or letters of intent to lease?
  - m. a copy of the takeout commitment?
  - n. a copy of the borrower's application to the takeout lender?
  - o. the tri-party buy-and-sell agreement?
  - p. inspection reports?
  - q. disbursement authorizations?
  - r. undisbursed loan proceeds and contingency or escrow account reconcilements?
  - s. insurance policies?
5. Does the branch employ standardized checklists to control documentation for individual files and perform audit reviews for adequacy?
6. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the branch and a summary of other construction projects being financed by other banks? Does the branch analyze the status of these projects and the potential effect on the borrower's financial position?
7. Does the branch use tickler files that:
  - a. control scheduling of inspections and disbursements?

### DOCUMENTATION

3. Does the branch require and maintain the following documentation:
  - a. the contractor's payment of:
    - employee withholding taxes?
    - builder's risk insurance?
    - worker's compensation insurance?

- b. assure prompt administrative follow-up on items sent for:
  - recording?
  - attorney's opinion?
  - expert review?
- 8. Does the branch maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for:
  - a. the takeout commitment?
  - b. hazard insurance?
  - c. worker's compensation insurance?
  - d. public liability insurance?
- 16. Does the branch require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, construction engineer, or independent estimator?
- 17. Are commitment fees required on approved construction loans?

## REVIEWING LOAN APPLICATIONS

- 9. Does branch policy require a personal guarantee from the borrower on construction loans?
- 10. Does branch policy require personal completion guarantees by the property owner and/or the contractor?
- 11. Does the branch require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate the form of equity contributed.
- 12. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
- 13. Does the branch require:
  - a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
  - b. payment history information from suppliers and trade creditors on the aforementioned's previous projects?
  - c. credit reports?
  - d. detailed current and historical financial statements, including cash flow-related information?
- 14. Do the borrower's project cost estimates include:
  - a. land and construction costs?
  - b. off-site improvement expenses?
  - c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
  - d. interest, taxes, and insurance expenses?
- 15. Does the branch require an estimated cost breakdown for each stage of construction?
- 18. Is the construction loan agreement signed before an actual loan disbursement is made?
- 19. Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to:
  - a. building codes?
  - b. subdivision regulations?
  - c. zoning and ordinances?
  - d. title and/or ground lease restrictions?
  - e. health and handicap access regulations?
  - f. known or projected environmental protection considerations?
  - g. specifications required under the National Flood Insurance Program?
  - h. provisions in tenant leases?
  - i. specifications approved by the permanent lender?
  - j. specifications required by the completion or performance bonding company and/or guarantors?
- 20. Does the branch require all change orders to be approved in writing by the:
  - a. branch?
  - b. branch's counsel?
  - c. permanent lender?
  - d. architect or supervising engineer?
  - e. prime tenants bound by firm leases or letters of intent to lease?
  - f. completion bonding company?
- 21. Does the construction loan agreement set a date for project completion?
- 22. Does the construction loan agreement require that:
  - a. the contractor not start work until authorized to do so by the branch?
  - b. on-site inspections be permitted by the lending officer or an agent of the branch without prior notice?
  - c. disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving

## CONSTRUCTION LOAN AGREEMENT

- payment and that the appropriate liens are being released?
- d. the branch be allowed to withhold disbursements if work is not performed according to approved specifications?
  - e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
  - f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the branch?
  - g. the contractor carry builder's risk and worker's compensation insurance? If so, has the branch been named as mortgagee or loss payee on the builder's risk policy?
  - h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
23. In addition to the aforementioned points, does the construction loan agreement for residential tract construction loans require:
- a. branch authorization for individual tract housing starts?
  - b. periodic sales reports be submitted to the branch?
  - c. periodic reports on tract houses occupied under a rental, lease, or purchase option agreement be submitted to the branch?
  - d. limitations on the number of speculative houses and the completion of one tract prior to beginning another?
26. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
27. Does the branch have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?

## INSPECTION

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

## COLLATERAL

24. Are liens filed on non-real estate construction improvements, i.e., personal property that is movable from the project?
25. When entering into construction loans, does the branch, consistent with supervisory loan-to-value limits:
- a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
  - b. limit the loan amount to a percentage of the appraised value of the completed project when subject to the branch's own takeout commitment?
  - c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?

## DISBURSEMENTS

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

35. Does the branch obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
  36. Does the branch obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
  37. Does the branch periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
  38. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?
47. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?
    - a. issue official checks or drafts?
    - b. handle cash?
    - c. reconcile subsidiary records to general ledger controls?
  48. Are loan statements, delinquent account collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?
  49. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?
  50. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
  51. Is a delinquent accounts report generated daily?
  52. Are loans in excess of supervisory LTV limits identified in the branch's records and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
  53. Does the branch maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
  54. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

## TAKEOUT COMMITMENT

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

## COMPLETION BONDING REQUIREMENTS

43. Does the branch require completion insurance for all construction loans?
44. Has the branch established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?
45. Does counsel review completion insurance bonds for acceptability?

## LOAN RECORDS

46. Are the preparation, addition, and posting of subsidiary real estate construction loan

## LOAN INTEREST AND COMMITMENT FEES

55. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also:
  - a. issue official checks or drafts?
  - b. handle cash?
56. Are any independent interest and fee computations made and compared or adequately

tested to loan interest by persons who do not also:

- a. issue official checks or drafts?
- b. handle cash?

this area? If not, indicate any additional examination procedures deemed necessary.

58. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

## CONCLUSION

57. Is the information covered by this ICQ adequate for evaluating internal controls in

# Real Estate Construction Loans

## Audit Guidelines

Effective date July 1997

## Section 3110.5

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Refer to the Credit Risk Management, Audit Guidelines, section of this manual for items applicable to Real Estate Construction Loans.

1. Using appropriate sampling techniques, select loans from the trial balance and:
  - a. Review loan agreement provisions for hold back or retention, and determine if undisbursed loan funds and/or contingency or escrow accounts are equal to retention or holdback requirements.
  - b. If separate interest reserves are maintained, determine if debit entries to those accounts are authorized in accordance with the terms of the loan agreement and if they are supported by inspection reports, certificates of completion, individual bills, or other evidence.
  - c. Review disbursement ledgers and authorizations and determine if authorizations are signed according to the terms of the loan agreement.
  - d. Verify debits in the undisbursed loan proceeds accounts to inspection reports, individual bills, or other evidence supporting disbursements.

Some branches provide lending services to stock brokerage firms using stock of listed corporations as collateral. To promote efficiency in the pledging of collateral, the Stock Clearing Corporation, a wholly-owned subsidiary of the New York Stock Exchange, transfers stock ownership through computer book entries and thus eliminates the physical movement of the securities. The operating department of the Stock Clearing Corporation, Central Certificate Service (CCS), handles the technical aspects of that operation.

Brokerage firms deposit shares of eligible securities with CCS. The stock certificates representing those shares are registered in the name of a common nominee. CCS has physical control of the securities while they are on deposit. Loan arrangements are made between the broker and the lending branch with the broker instructing CCS, through written authorization, to debit the firm's account and credit that of the branch. CCS sends a copy of the authorization to the branch and will not reverse the entry or make partial withdrawals without written authorization from the branch. Participating financial institutions receive daily printouts, showing their position in the program by broker name and type of security. Because of adequately protected controls employed by Stock Clearing Corporation, examiners should accept the daily position printouts without further verification.

### COMMODITY LOANS

Loans to carry investments in commodities entail the same basic criteria as in all credit relation-

ships. Borrowers are typically nonproducers or nonprocessors of the commodity and include individuals, trading companies, manufacturers, or broker/dealers. The loan may represent a direct investment in the commodity or the carrying of a forward or futures position in the commodity. The commodity being purchased generally secures the borrowing. Common purposes for commodity loans include:

- The temporary holding by a trader of a commodity under contract for sale or in anticipation of sale in the near term.
- The holding of a commodity by an entity in anticipation of price appreciation for that commodity.
- The holding of a commodity by a manufacturer or fabricator awaiting transformation into some other product.

The focus of the examination of the branch's commodity lending area is on the lending policy and the control exercised over the collateral. The policy should address under what circumstances and conditions commodity loans will be made, particularly whether the branch will grant loans to finance a speculative position in a commodity. For secured loans, collateral margin requirements should be included in the policy.

Control of the collateral is important. Generally, the commodity will be held in a bonded warehouse, bank, or other depository institution. The branch should control title to the commodity. Because commodity markets can become volatile, collateral positions should be monitored frequently for compliance with the policy.

# Securities Broker and Dealer Loans

## Examination Objectives

Effective date July 1997

## Section 3120.2

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1. To determine if policies, practices, procedures, objectives, and internal controls regarding securities broker and dealer loans are adequate.
2. To determine if branch officers are operating in conformance with established guidelines.
3. To evaluate the adequacy of collateral, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Securities Broker and Dealer Loans

## Examination Procedures

Effective date July 1997

## Section 3120.3

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
2. Based on the evaluation of internal controls and of the work performed by internal/external auditors, ascertain the scope of the examination.
3. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Additionally, obtain a listing of any deficiencies noted in the latest review by internal/external auditors and determine if corrections have been accomplished.
4. Request the branch to supply:
  - a. Schedule of approved lines for each dealer, including outstanding balances.
  - b. Delinquent interest billings and date billed amount of past due interest.
5. Obtain a trial balance of all dealer accounts and:
  - a. Verify balances to departmental controls and the general ledger.
  - b. Review reconciling items for reasonableness.
6. Using an appropriate sampling technique, select borrowers to be reviewed.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards:
  - a. Total outstanding liability.
  - b. Amount of approved line.
8. Obtain from the appropriate examiner the following schedules, if applicable to this area:
  - a. Past due loans.
  - b. Loan commitments and other contingent liabilities.
  - c. Miscellaneous loan debit and credit suspense accounts.
  - d. Loans considered problem loans by management.
  - e. Each officer's current lending authority.
  - f. Current interest rate structure.
  - g. Any useful information obtained from the review of the minutes of the loan committee or any similar committee.
  - h. Reports furnished to the loan and discount committee or any similar committee.
9. Review the information received and perform the following:
  - a. For miscellaneous loan debit and credit suspense accounts:
    - Discuss with management any large or old items.
    - Perform additional procedures as deemed appropriate.
  - b. For loans classified during the previous examination, determine disposition of loans so classified by transcribing:
    - Current balances and payment status, or
    - Date loan was repaid and sources of payment.
  - c. For loan commitments and other contingent liabilities, analyze if:
    - The borrower has been advised of the contingent liability.
    - The combined amounts of the current loan balance and the commitments or contingent liabilities exceed the cutoff.
  - d. Select loans that require in-depth review based on information derived when performing the above steps.
10. For those loans selected in step 6 above and for any other loans selected while performing the above steps, transcribe the following information from the branch's collateral record onto the credit line sheets:
  - a. A list of collateral held, including date of entry and amount advanced.
  - b. A brief summary of the agreement between the branch and the dealer.
  - c. Evidence that the proper documentation is in place.
  - d. Details of any other collateral held.
11. The examiner should be aware that certain stock-secured transactions with and for brokers and dealers are exempt from the margin restrictions of Regulation U. Refer to the regulation, which can be found in the Federal Reserve Regulatory Service, for a
  - i. Reports furnished to the head office.
  - j. Loans classified during the preceding examination.
  - k. A listing of loans charged off since the preceding examination.

- complete description of such transactions that include the following:
- a. Temporary advances to finance cash transactions.
  - b. Securities in transit or transfer.
  - c. Day loans.
  - d. Temporary financing of distributions.
  - e. Arbitrage transactions.
  - f. Credit extended pursuant to hypothecation.
  - g. Emergency credit.
  - h. Loans to specialists.
  - i. Loans to odd-lot dealers.
  - j. Loans to OTC market makers.
  - k. Loans to third-market makers.
  - l. Loans to block positioners.
  - m. Loans for capital contributions.
12. At this point, the examiner needs to decide whether further examination and testing is needed. If further work is warranted, refer to the audit guidelines. After reviewing the audit guidelines, proceed to step 13.
  13. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Delinquent loans.
    - b. Loans on which collateral documentation is deficient.
    - c. Recommended corrective action when policies, practices, or procedures are deficient.
    - d. Other matters regarding the condition of the department.
  14. Prepare appropriate comments for the workpapers and the examiner-in-charge stating your findings with regard to:
    - a. The adequacy of written policies relating to securities broker and dealer loans.
    - b. The manner in which branch officers are conforming with established policy.
    - c. Schedules applicable to the department that were discovered to be incorrect or incomplete.
    - d. The competence of departmental management.
    - e. Internal control deficiencies or exceptions.
    - f. Other matters of significance.
  15. Update the workpapers with any information that will facilitate future examinations.

# Securities Broker and Dealer Loans

## Internal Control Questionnaire

Effective date July 1997

Section 3120.4

Review the branch's internal control, policies, practices, and procedures for making and servicing loans. The branch's system should be documented in a complete and concise manner and should include, *where appropriate*, narrative descriptions, flowcharts, copies of forms used, and other pertinent information.

### POLICIES

1. Has a policy been adopted specifically addressing securities broker and dealer loans that:
  - a. Establishes standards for determining broker and dealer credit lines?
  - b. Establishes minimum standards for documentation?
2. Are such loan policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Is a daily record maintained summarizing loan transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger account entries?
4. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?
5. Is an exception report produced and reviewed by operating management that encompasses extensions, renewals, or any factors that would result in a change in customer account status?
6. Do customer account records clearly indicate accounts that have been renewed or extended?

### LOAN INTEREST

7. Is the preparation and posting of interest records performed and reviewed by appropriate personnel?
8. Are any independent interest computations made and compared or adequately tested to initial interest records by appropriate personnel?

### COLLATERAL

9. Are multi-copy, prenumbered records maintained that:
  - a. Detail the complete description of collateral pledged?
  - b. Are computer generated or typed?
10. Are receipts issued to customers covering each item of negotiable collateral deposited?
11. If applicable, are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
12. Are appropriate steps with regard to Regulation T being considered in granting broker and dealer loans?
13. Concerning commodity lending:
  - a. Is control for the collateral satisfactory, i.e., stored in the branch's vault, another bank, or a bonded warehouse?
  - b. If collateral is not stored within the branch, are procedures in effect to ascertain the authenticity of the collateral?
  - c. Does the branch have a documented and recorded security interest in the proceeds of the future sale or disposition of the commodity and the existing collateral position?
  - d. Do credit files document that the financed positions are and remain fully hedged?
14. Concerning loans to commodity brokers and dealers:
  - a. Does the branch maintain a list of the major customer accounts of the brokers or dealers to whom it lends? If so, is the list updated on a periodic basis?
  - b. Is the branch aware of the broker/dealer's policy on margin requirements and the basis for valuing contracts for margin purposes, i.e., pricing spot versus future?
  - c. Does the branch attempt to ascertain whether the positions of the broker/dealer's clients that are indirectly financed by branch loans remain fully hedged?

**CONCLUSION**

15. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
16. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

# Securities Broker and Dealer Loans

## Audit Guidelines

Effective date July 1997

## Section 3120.5

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1. Verify the accuracy of the trial balance.
2. Test reconciling items to the extent considered necessary.
3. Using an appropriate sampling technique, select broker and dealer loans and:
  - a. Prepare and mail confirmation forms to dealers (information confirmed should include the loan balance and date of entry).
  - b. After a reasonable time period, mail second requests.
  - c. Follow up on any no-replies or exceptions, and resolve differences.
  - d. Obtain a list of the most recent broker and dealer interest billings and check calculation of interest report.
- e. Determine whether interest payments are delinquent and trace to inclusion in delinquency report.
- f. Determine that appropriate action has been taken to bring delinquent accounts to a current status.
4. Review collateral records and:
  - a. Determine the reason for differences between the branch's collateral records and the actual items held by the branch.
  - b. Investigate other differences to the extent considered necessary.

This section addresses securities activities in the broadest meaning of the term. It is divided into three sections: Investment Securities, Trading Securities, and Other, which includes resale and repurchase transactions.

### INVESTMENT SECURITIES

Since January 1, 1994, investment securities activities of branches are subject to FASB Statement No. 115 (Accounting for Certain Investments in Debt and Equity Securities). Under this standard, all branches are required to segregate their investment securities portfolios into three categories: (1) held-to-maturity, (2) available-for-sale, and (3) trading securities. The held-to-maturity category replaces the former held-for-investment category. The available-for-sale category is new, and the trading category is the same as before.

*Held-to-maturity (HTM) securities* are debt securities that the branch has both the intent and ability to hold until maturity. The branch will continue to report HTM securities at amortized cost.

*Available-for-sale (AFS) securities* are defined as debt or equity securities for which the branch does not have the positive intent and ability to hold to maturity, yet does not intend to trade actively as a part of its trading account. AFS securities transactions must be reported at fair value with any unrealized gains and losses reported directly as a separate component of equity capital. Thus, unrealized changes in these securities' value will have no effect on the reported earnings of the branch.

*Trading securities* are those debt and equity securities that a branch buys and holds principally for the purpose of selling in the near term. Trading securities will continue to be reported at fair market value with unrealized gains or losses reported directly in the income statement as a part of the branch's earnings.

This section will deal only with investment securities, or those categorized as HTM and AFS. A complete discussion of trading securities is contained in the Federal Reserve's *Trad-*

*ing Activities Manual*. Additional reference material includes:

- FFIEC's Supervisory Policy Statement on Securities Activities as of January 10, 1992.
- SR 93-69—"Risk Management and Internal Controls for Trading Activities of Banking Organizations."
- SR 95-17—"Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities."

The rationale behind FASB creating the AFS category and allowing institutions to report AFS securities at fair value is that it presents a more accurate and realistic picture of an institution's financial condition. The inclusion of net unrealized gains and losses with Tier 1 capital provides incentives to institutions to hold securities that have depreciated or appreciated in value, thereby reducing market volatility. However, although market volatility is reduced, bank's capital ratios are subject to increased volatility since their assets will be marked-to market while liabilities remain at book value.

In addition to any restrictions imposed by state law or regulation, under Section 7(c)(2) of the International Banking Act of 1978, all branches may only hold the types of investment securities that may be held by national banks and state member banks. See 12 USC 24(7); 12 CFR Part 1. State-licensed branches, additionally, may only hold those types of investment securities permitted under state law. It should be noted that branches must obtain Federal Reserve approval, before commencing commodity or equity-linked transactions. See 12 CFR 208.128 (made applicable to branches by 12 USC 3105(c)(2)).

For branches, investment securities include U.S. government obligations and certain domestic corporate debt securities; as well as various federal agency bonds; state, county, and municipal issues; special revenue bonds; and industrial revenue bonds. Securities included in the investment account should provide a reasonable rate of return as well as provide the necessary liquidity the branch requires. Accordingly, an investment account should contain some securities that may be quickly converted into cash by sale or by maturity. Hence, liquidity and marketability are of the utmost importance. A bond

is a liquid asset if its maturity is short and if there is reasonable assurance that it will be paid at maturity. It is marketable if it may be sold quickly at a price commensurate with its yield and quality. The highest quality bonds have either or both of those two desirable qualities.

Occasionally, it may be difficult to distinguish between a loan and a security. Loans generally result from direct negotiations between a borrower and a lender. A branch may refuse to grant a loan unless it and the borrower can agree to terms. A security, on the other hand, is usually acquired through a third party, a broker or dealer in securities. Most securities have standardized terms, which can be compared to the terms of other market offerings. Because the terms of most loans do not lend themselves to such comparison, the average investor may not accept the terms of the lending arrangement. Thus, an individual loan cannot be regarded as a readily marketable security.

An interesting hybrid between a security and a loan is a private placement. A private placement is a security transaction whereby the issuer did not involve any "public offering" but rather offered the securities privately. The securities are not reviewed by the SEC, and are offered and sold only to those parties who the issuer believes are (1) sufficiently experienced to evaluate merits and risks of the investment, or (2) able to bear the risk of the investment. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and the investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction privately without being subject to regulatory and public scrutiny. The major disadvantage of private placements is the lack of a secondary market, and therefore it may be highly illiquid. Although private placements have many characteristics of loans, for regulatory reporting purposes they are considered securities.

## INVESTMENT POLICY

The branch should have an investment policy, which was developed in conjunction with and approved by its head office, to control and monitor the branch's investment activities. This policy should include guidelines for personnel involved in securities activities.

The basic objectives of a sound investment policy are the same for all financial institutions but the emphasis placed on each objective will vary, according to the individual branch's needs. The basic objectives include:

- Minimizing risks.
- Generating a favorable return on investments, without undue compromise of the other objectives.
- Providing for and managing liquidity.
- Meeting any applicable pledge requirements.
- Temporary use of excess funds.

The investment policy must encompass more than a philosophical description of objectives. If policy development is delegated to local branch management, the examiner should verify that head office management has reviewed or is aware of the policy and the branch's level of compliance.

## TYPES OF INVESTMENT SECURITIES

The investment policy should include guidelines on the quality and quantity of each type of security to be held. Credit quality is of major importance.

*U. S. government obligations* are the highest quality investments and are the most readily marketable. They are riskless from a credit standpoint but are subject to price fluctuations because of changes in money market interest rates. Longer-term issues tend to fluctuate more widely than shorter-term issues. All things being equal, maturity, credit, etc., smaller coupon securities are more volatile than larger coupon securities.

*Federal agency securities* are also of very high quality. Similar investments that enjoy wide acceptance in the banking community are U.S. government guaranteed public housing authority issues. New housing authority and public housing authority notes or bonds generally provide the investor with tax exempt income and a full faith and credit guaranty of the U.S. government.

Other *tax exempt bonds* have varying levels of indirect U.S. government support. Pre-refunded

or escrowed bonds are often fully and directly secured by obligations issued by or otherwise supported by the full faith and credit of the United States. Certain municipal housing bonds are partially payable from rental subsidies and/or mortgage credit insurance provided by federal agencies. Pools of partially guaranteed student loans are sometimes pledged for payment of municipal higher education bonds. There are numerous programs that provide federal backing for municipal bonds. Care must be taken to distinguish between those issues that are federally guaranteed and those that are not.

*High quality municipal bonds* frequently are desirable because of their tax exempt status. Many municipal bonds, however, possess an

unfavorable market aspect. Except for high quality issues of larger municipalities, municipal bonds often are not readily marketable and, as a result, may produce sizeable spreads between bid and ask prices. The spread may be so wide, it may cost the selling bank a sizeable portion of a year's interest.

## BOND RATINGS

Monthly rating service publications are useful in determining the investment quality of municipal and corporate obligations. The standard bond rating symbols, as shown on the following page, are listed in the order of their credit quality.

<i>Standard &amp; Poor's</i>	<i>Moody's</i>	<i>Description</i>
<i>Bank Quality Investments</i>		
AAA	Aaa	Highest grade obligations.
AA	Aa	High grade obligations
A	A-1, A	Upper medium grade
BBB	Baa-1, Baa	Medium grade, on the borderline between definitely sound obligations and those containing predominantly speculative elements. Generally, the lowest quality bond that may qualify for bank investment.
<i>Speculative and Defaulted Issues (High Yield or Noninvestment Grade)</i>		
BB	Ba	Lower medium grade with only minor investment characteristics.
B	B	Low grade, default probable.
Ccc, cc, c, D	Caa, Ca, C	Lowest rated class, may be in default, extremely poor material prospects.
<i>Provisional or Conditional Rating</i>		
Rating-P	Con. (Rating)	Debt service requirements are largely dependent on reliable estimates as to future events.

Although the analyses of major rating agencies are basically sound and updated frequently, it should be kept in mind that ratings are only evaluations of probabilities. In order to determine appropriate credit limits to a particular counterparty, bond ratings should be supplemented by the branch's own credit analysis of the issuer.

Sub-investment-quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes securities in grades below the four

highest grades and unrated securities of equivalent quality, defaulted securities and sub-investment-quality stocks. As noted in the following chart, securities in grades below the four highest grades and unrated securities of equivalent quality will be valued at market price. The market value will be classified substandard, and the depreciation will be classified doubtful. Depreciation in defaulted securities and sub-investment-quality stocks will generally be classified loss; market value will be classified substandard.

## SECURITY CLASSIFICATIONS

<i>Type of Security</i>	<i>Classification</i>		
	<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>
Investment-quality	XXX	XXX	XXX
Sub-investment-quality, except—	Market Value	Market Depreciation	XXX
Sub-investment-quality, municipal general obligations	Book Value	XXX	XXX
Defaulted securities and sub-investment-quality stocks, except—	Market Value	XXX	Market Depreciation
Defaulted municipal general obligations:			
Interim	XXX	Book Value	XXX
Final, i.e., when market is reestablished	Market Value	XXX	Market Depreciation

As a matter of policy, an institution should not acquire securities until it has assessed the creditworthiness of the issuer and determined that the risk exposure conforms with its policies. At a minimum, the examiner should expect such a policy to require credit reviews on all transactions before purchase, annual internal credit reviews, and more frequent credit updates on all nonrated issues, municipal obligations with a credit rating that has declined, special revenue and other debt obligations with limited or no marketability, speculative and defaulted issues,

and stocks acquired through DPC transactions. Credit analysis is always necessary to determine if an investment is appropriate for the branch to own. According to Federal regulation (12 CFR, Section 1.8) it is incumbent upon management to demonstrate that it has exercised prudence in acquiring all investment securities.

The examiner should be mindful, however, that as part of a larger organization, the branch may operate soundly outside of the parameters normally considered acceptable due to its unique role within the FBO's network. When traditional

liquidity analysis results in unsatisfactory findings, the examiner should discuss with management the influence of the branch's relationships with related offices.

Policy guidelines for risk diversification should be formulated in conformity with legal and prudent investment restrictions. Concentrations resulting from the obligations of a single or related issuer, credit ratings, geographic and type distribution may all be compatible with sound investment policy. In many cases, concentrations would not be considered unwarranted but, in all cases, it is essential that investment concentrations be monitored at the head office level.

The investment policy should also take into consideration the applicable federal and state income tax laws. Finally, the investment portfolio should be reviewed at least annually by head office management and quarterly by senior officers of the branch. Sufficient analytical data must be provided to allow head office management to make an informed judgment of the investment policy's effectiveness. Such reviews should consider the information discussed in this section and the current market value of the portfolio.

Management should maintain clear lines of authority and responsibility for acquiring securities and managing risk. This includes setting appropriate limits on risk taking, creating adequate systems for measuring risk, providing effective internal controls, and implementing a comprehensive risk reporting and risk management review process.

## TRADING SECURITIES

The following section deals with securities portfolio trading but does not include derivative-related activity. For an in-depth discussion of derivative-related activity, refer to the Federal Reserve's *Trading Activities Manual*.

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which, when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the branch's income and a filing of false regulatory reports. It is an unsafe

and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards that are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts must be periodically marked-to-market with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the branch.

## Covered Calls

The writing of covered calls is an option strategy that, for a fee, grants the buyer of the call option the right, but not the obligation to purchase a security owned by the option writer at a pre-determined price before a specified future date. The option fee<sup>1</sup> received by the writing (selling) depository institution provides income and has the effect of increasing the effective yield on the portfolio asset "covering" the call.

Covered call programs have been promoted as hedging strategies because the fee received by the writer can be used to offset a limited amount of potential loss in the price of the underlying security. If interest rates rise, the call option fee can be used to partially offset the decline in the market value of a fixed rate security or the increased cost of market rate liabilities used to carry the security. However, there is no assurance that an option fee will completely offset the price decline on the security or the increased cost of liabilities and the resulting reduced spread between the institution's return on assets and funding costs.

As a practical matter, the gain on a security covered by a written call is limited to the amount of the difference between the carrying value of the security and the strike price at which the security will be called away. The potential for losses on the covered security is not similarly limited. In an effort to obtain higher yields, some portfolio managers have mistakenly relied on the theoretical hedging benefits of

1. Recognition of option fee income should be deferred until the option is exercised or expires. The covered call writer shall value the option at the lower of cost or market value at each report date.

covered call writing, and have purchased extended maturity U.S. government or Federal agency securities. This practice can significantly increase risks taken by the branch by contributing to a maturity mismatch between its assets and its funding.

Institutions should only initiate a covered call program for securities when head office and branch management have specifically approved a policy permitting this activity. This policy must set forth specific procedures for controlling covered call strategies, including recordkeeping, reporting, and review of activity, as well as providing for appropriate management information systems to report the results. Since the purchaser of the call acquires the ability to call the security away from the institution that writes the option, the ability of that institution to continue to hold the security rests with an outside party. Securities held to maturity against which call options have been written should therefore be redesignated as available for sale and reported at fair value. However, when the option contract requires the writer to deliver held-to-maturity securities, or when management has a pattern of practice of delivering held-to-maturity securities when called, management's intent to hold other securities to maturity may be called into question.

However, if an option contract requires the writer to settle in cash, rather than delivering an investment portfolio security, the institution writing the option maintains the ability to hold the security and, thus, the security may be reported as held-to-maturity. In this case, the option must still be reported at fair value.

## Adjusted Trading

Adjusted trading is a practice involving the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower grade issue or one with a longer maturity, at a price greater than its market value. Thus, the broker or dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 USC

sections 1001-False Statements or Entries and 1005-False Entries.

## Coupon Stripping

Coupon stripping involves detaching unmatured coupons from securities and selling either the coupons or the remaining stripped security. Such transactions are often motivated by anxiety for immediate income recognition or by tax considerations. This practice significantly diminishes the worth, marketability, and liquidity of the securities.

U.S. government obligations are the most common type of security used for coupon stripping. Corporate or municipal issues may be used but are not viewed as attractive alternatives because of credit risk and early redemption features.

The Internal Revenue Service has ruled that the proceeds from the sale of unmatured coupons constitute ordinary income and are included in the taxable income for the year in which the sale occurred. A branch can increase current period taxable income to utilize a prior year's tax loss carry-forward by selling all or a portion of the unmatured coupons of their securities. Similarly, an ex-coupon security may be sold at its discounted value. The difference between the sale proceeds and the cost basis of the security is recognized as a current period tax loss.

There are a limited number of dealers that participate in wholesale and retail trading and reoffering of detached coupons and ex-coupon securities. That activity is generally viewed as inappropriate for branch dealers; the marketability and liquidity shortcomings attendant with either the coupons or the securities result in uncertain suitability for customer purchase without complete customer disclosure and consent. Ex-coupon securities or stripped coupons are distinctly different from securities that have all the unmatured coupons attached. The ex-coupon security and resulting coupons generally:

- Have a diminished and uncertain market value and impaired practical liquidity.
- Are not, absent adequate customer disclosure, suitable for sale to customers or as repurchase agreement collateral with customers.
- Are not considered good delivery items by securities dealers.

If a branch has engaged or elects to engage in such transactions, they must be reported as follows:

- The book value must be allocated between the principal portion and the coupons at the time the security is divided. This allocation will be based upon the present value of each component (principal and coupons) at the time of sale using the yield to maturity at the time the security was purchased as the discount rate.
- The profit or loss on the portion sold must be recognized during the period in which the sale occurred as other income or other expense. It will be the difference between that portion of the book value, allocated as above to the portion sold, and the actual selling price of that portion. The portion retained will be carried on the books of the branch at its allocated portion of the book value. Detached coupons or principal portions held by a branch, either as a result of purchase or of stripping securities held for its own account, will be reported as other notes, bonds and debentures, and not as U.S. Treasury securities, obligations of other U.S. government agencies and corporations, or obligations of states and political subdivisions in the United States.

### Special Guidance on Mortgage-Backed Products

Some mortgage-backed products exhibit considerably more price volatility than mortgages. Some mortgage pass-through securities can expose investors to significant risk of loss if not managed in a safe and sound manner. This price volatility is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages.

In addition, because these products are complex, a high degree of technical expertise is required to understand how their prices and cash flows may behave in various interest rate and prepayment environments. Moreover, because the secondary market for some of these products can be relatively thin, they may be difficult to liquidate should the need arise. Finally, there is additional uncertainty because new variants of these instruments continue to be introduced and their price performance under varying market and economic conditions has not been tested.

### General Guidance

Under the FFIEC policy statement, the banking agencies call for special management of mortgage-backed products. A general principle underlying this policy is that mortgage-backed products possessing average life or price volatility in excess of a benchmark fixed rate 30-year mortgage-backed pass-through security are “high-risk mortgage securities” and are not suitable investments. All high-risk mortgage securities, defined later in this section, acquired by depository institutions after February 10, 1992, must be carried in the institution’s trading account or as assets available for sale. Mortgage-backed products that do not meet the definition of a high-risk mortgage security at the time of purchase may be reported as held to maturity, available for sale, or held for trading, as appropriate. Branches must ascertain no less frequently than annually whether such products have become high-risk mortgage securities.

Branches generally should hold mortgage-backed products that meet the definition of a high-risk mortgage security only to reduce interest rate risk in accordance with safe and sound practices.<sup>2</sup> Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. Levels of activity involving high-risk mortgage securities should be reasonably related to a branch’s capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place and the branch must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Prior to taking a position in any high-risk mortgage security, branch management should conduct an analysis to ensure that the position will reduce the overall interest rate risk. Liquidity

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2. Notwithstanding the provisions of the Board’s supervisory policy generally requiring that high-risk mortgage securities be used only for the purpose of reducing interest rate risk, this supervisory policy is not meant to preclude an institution with strong capital and earnings and adequate liquidity that has a closely supervised trading department from acquiring high-risk mortgage securities for trading purposes. The trading department must operate in conformance with well-developed policies, procedures, and internal controls, including detailed plans prescribing specific position limits and control arrangements for enforcing these limits.

and price volatility of these products also should be considered prior to purchasing them. Circumstances in which the purchase or retention of high-risk mortgage securities is deemed by the appropriate regulatory authority to be contrary to safe and sound practices for depository institutions will result in criticism by examiners, who may require the orderly divestiture of high-risk mortgage securities. Purchases of high-risk mortgage securities prior to February 10, 1992, generally will be reviewed in accordance with previously-existing supervisory policies.

Securities and other products, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), having risk characteristics similar to high-risk mortgage securities will be subject to the same supervisory treatment as high-risk mortgage securities.

Long-term zero coupon bonds also exhibit significant price volatility and may expose an institution to considerable risk. Disproportionately large holdings of these instruments may be considered an imprudent investment practice, which will be subject to criticism by examiners. In such instances, examiners may seek the orderly disposal of some or all of these securities. Assets slated for disposal are to be reported as assets available for sale at their market value.

### *Definition of "High-Risk Mortgage Security"*

In general, any mortgage-backed product that exhibits greater price volatility than a benchmark fixed rate thirty-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of the FFIEC policy statement, a "high-risk mortgage security" is defined as any mortgage-backed product that at the time of purchase, or at a subsequent testing date, meets any of the following tests.<sup>3</sup> In general, a mortgage derivative product that does not meet any of the three tests below will be considered to be a "nonhigh-risk mortgage security."

- **Average Life Test.** The mortgage-backed product has an expected weighted average life greater than 10.0 years.

3. When the characteristics of a mortgage derivative product are such that the first two tests cannot be applied (such as with IOs), the mortgage derivative product remains subject to the third test.

- **Average Life Sensitivity Test.** The expected weighted average life of the mortgage-backed product:
  - Extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or
  - Shortens by more than 6.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.
- **Price Sensitivity Test.** The estimated change in the price of the mortgage-backed product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.<sup>4</sup>

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use these median prepayment assumptions in determining if a particular mortgage backed product is high risk.

The above tests may be adjusted to consider significant movements in market interest rates, to fairly measure the risk characteristics of new mortgage-backed products, and to take such action that is deemed appropriate to prevent circumvention of the definition of a high-risk mortgage security and other such standards.

Generally, a CMO floating-rate debt class will not be subject to the average life and average life sensitivity tests described above if it bears a rate that, at the time of purchase or at a

4. When performing the price sensitivity test, the same prepayment assumptions and same cash flows that were used to estimate average life sensitivity must be used. The only additional assumption is the discount rate assumption.

First, assume that the discount rate for the security equals the yield on a comparable average life U.S. Treasury security plus a constant spread. Then, calculate the spread over Treasury rates from the bid side of the market for the mortgage derivative product. Finally, assume the spread remains constant when the Treasury curve shifts up or down 300 basis points. Discounting the aforementioned cash flows by their respective discount rates estimates a price in the plus and minus 300 basis point environments.

The initial price will be determined by the offer side of the market and used as the base price from which the 17 percent price sensitivity test will be measured.

subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest rate contracts that effectively uncapped the instrument.) For purposes of this policy statement, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely-used market interest rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating rate debt classes are not included in the definition of a floating rate debt class.

### *Supervisory Policy for Mortgage-Backed Products*

Prior to purchase, a branch must determine whether a mortgage-backed product is high-risk. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed prior to purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available.

### *Nonhigh-Risk Mortgage Securities*

Mortgage-backed products that do not meet the definition of high-risk mortgage securities, at the time of purchase, should be reported as held to maturity, available for sale, or held for trading, as appropriate. Branches must ascertain and document prior to purchase and no less frequently than annually thereafter that nonhigh-risk mortgage securities that are held to maturity remain outside the high-risk category. If a branch is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities market place are acceptable and are considered independent sources. In order to rely on such independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Such documentation will be subject to examiner review.

A mortgage-backed product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the

high-risk category. When this occurs, the branch may continue to designate the mortgage-backed product as held to maturity, providing that management still maintains the positive intent and ability to hold the security to maturity. Furthermore, examiners should consider any unrecognized net depreciation in held-to-maturity high-risk securities when reviewing earnings and evaluating liquidity risk.

Once a mortgage-backed product has been designated as high-risk, it may be redesignated as nonhigh-risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a nonhigh-risk security, it does not need to be tested for another year.

### *High-Risk Mortgage Securities*

A branch may, generally, only acquire a high-risk mortgage backed product to reduce its overall interest rate risk. (Branches meeting the previously mentioned guidance regarding the use of these securities in a trading account may also purchase these securities for trading purposes.) A branch that has acquired high-risk mortgage securities to reduce interest rate risk needs to frequently assess its interest rate risk position and the performance of these securities. Since interest rate positions constantly change, a branch may determine that these high-risk mortgage securities no longer reduce interest rate risk. Therefore, mortgage backed products that are high-risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest rate risk. Appropriate circumstances are those in which the examiner determines that continued ownership of high-risk mortgage securities represents an undue safety and soundness risk to the branch. This risk can arise from the size of the branch's holdings of high-risk mortgage securities in relation to its earnings and head office capital, management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash flow risks of these securities, management's inability to prudently manage its overall interest rate risk, or similar factors.

A branch that owns or plans to acquire

high-risk mortgage securities must have a monitoring and reporting system in place to evaluate the expected and actual performance of such securities. The institution must conduct an analysis that shows that the proposed acquisition of a high-risk mortgage security will reduce the institution's overall interest rate risk. Subsequent to purchase, the branch must evaluate at least quarterly whether this high-risk mortgage security has actually reduced interest rate risk.

The branch's analyses performed prior to the purchase of high-risk mortgage securities and subsequently thereafter must be fully documented and will be subject to examiner review. This review will include an analysis of all assumptions used by management regarding the interest rate risk associated with the branch's assets, liabilities and off-balance sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without internal analyses by the institution are unacceptable and reliance on such third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating that it took reasonable steps to assure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers prior to executing a trade. If, because of the unique or proprietary nature of the transaction or product, or for other legitimate reasons, price quotes cannot be obtained from more than one broker, management should document the reasons for not obtaining such quotes.

In addition, a branch that owns high-risk mortgage securities must demonstrate that it has established the following:

- A head office approved portfolio policy which addresses the goals and objectives the branch expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to high-risk mortgage securities;
- Limits on the amounts of funds that may be committed to high-risk mortgage securities;
- Specific financial officer responsibility for and authority over securities activities involving high-risk mortgage securities;
- Adequate information systems;

- Procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest rate risk; and
- Appropriate internal controls.

The branch's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether these instruments are adequately satisfying the interest rate risk reduction objectives set forth in the portfolio policy. The branch's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities. Failure to comply with this policy will be viewed as an unsafe and unsound practice.

## OTHER MORTGAGE-BACKED PRODUCTS

There are advantages and disadvantages in owning these products. A branch must consider the liquidity, marketability, pledgeability, and price volatility of each of these products before investing in them. It may be unsuitable for a branch to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals, and zero coupon bonds, which fluctuate greatly in price.

### *Stripped Mortgage-Backed Securities*

Stripped mortgage backed securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100 percent of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100 percent of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline, while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and

similar instruments held by a branch. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO, the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for all branches. SMBS, however, may be appropriate holdings for branches that have highly sophisticated and well-managed securities portfolios, mortgage portfolios, or mortgage banking functions. In such branches, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by head office management and their terms should be vigorously enforced.

Some branches may account for their SMBS holdings in accordance with Financial Accounting Standards Board Statement Number 91 (FASB No. 91), which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other branches may account for their SMBS holdings at market value or the lower of cost or market value.

## Asset-Backed Securities Residuals

Residuals are the excess of cashflows from asset-backed securities (ABS) transactions after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically, a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the yield on these instruments is inversely related to their effectiveness as a risk manage-

ment vehicle. In other words, the highest yielding ABS residuals have limited risk management value due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows difficult. Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher yielding interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Holdings of ABS residuals should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as Other Assets on regulatory reports.

## Other Zero Coupon or Stripped Products

The interest and/or principal portions of U.S. government obligations are sometimes sold in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATS or TIGRs. Original issue discount bonds (OIDs) have also been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility. Accordingly, disproportionately large, long-maturity holdings (in relation to the total portfolio) of zero coupon securities may be unsuitable for investment holdings for financial institutions.

## STRUCTURED NOTES

This sub-section highlights the growing use of structured notes by banking organizations and the need for examiners to ensure that banks that hold these instruments do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions. Some of these

instruments can expose investors to significant losses as interest rates, foreign exchange rates, and other market indices change. Accordingly, examiners should be mindful of these securities, whether they are used in a branch's trading, investment, or trust activities.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cashflows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium term maturities and reflect a wide variety of cashflow characteristics that can be tailored to the needs of individual investors.

As previously noted, the federal bank regulatory agencies have established price and effective maturity standards for mortgage-backed products based on specified scenarios. Institutions should ensure that they meet these regulatory requirements and should employ similar techniques in controlling the exposures of structured notes. The scenarios specified for assessing the market risk of these products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest rate risk, scenarios such as 100, 200 and 300 basis point parallel shifts in yield curves should be considered as well as appropriate non-parallel shifts in structure to evaluate potential basis, volatility and yield curve risks.

Structured notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and address more specifically an institution's risk exposures. Risk to principal is typically small. Accordingly, when they are analyzed and managed properly, structured notes can be acceptable investments and trading products for banks.

Structured notes, however, can also have characteristics that cause them to be inappropriate holdings for many institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, branches considering the purchase of structured notes should determine whether these

factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cashflows, which can involve both principal and interest payments. Some notes employ "trigger levels," at which cashflows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to manage the market risks of their institution in a satisfactory manner. Therefore, examiners should evaluate the appropriateness of these securities branch-by-branch, with a knowledge of management's expertise in evaluating such instruments, the quality of the institution's relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the institution's ability to conduct stress tests. Failure of management to understand adequately the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banks.

When making investment decisions, some institutions may focus only on the low credit risk and favorable yields of these notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the institution's risk management process and assess management's recognition of their potential volatility.

## OTHER

### Resale and Repurchase Agreement Activities (REPOS)

Repos typically involve short-term U.S. government securities purchased for the branch's own account or acquired under an agreement to resell and then sold under the counterparties agreement to repurchase. The rate of interest received and paid is generally dictated by prevailing market rates. Profits are based on a small spread

between interest earned and interest paid. Since both the profit margin and inherent risk are minimal, repos are generally used to satisfy a branch's short-term funding needs. A branch may attempt to improve profits by increasing the volume of such transactions by using the proceeds of completed transactions to finance an inventory of assets to be used in further repurchase arrangements. An alternative method of increasing profits is to increase the earnings yield of the instruments employed in these transactions by lowering the quality or by mismatching the maturity of the resale and repurchase agreements.

Risks inherent in repos should be controlled by policy guidelines that:

- Establish account limits.
- Require approximately matched asset and liability maturities with guidelines for acceptable levels of asset and liability mismatches.
- Provide for reasonable collateral margin and valuation techniques.
- Subject the underlying securities of a resale agreement to periodic market valuation in order to determine market exposure.
- Mandate credit approvals for parties providing securities acquired under agreements to resell.
- Insist that characteristics of the money market instruments be compatible with the branch's own investment standards.

## Other Issues for Examiner Consideration

This section contains several important issues examiners should consider when examining investment portfolios. It covers (1) transfers of low quality securities, (2) the selection of securities dealers, and (3) unsuitable investment practices.

### *Transfers of Low Quality Securities*

Low quality securities, broadly defined, include depreciated or sub-investment grade securities of questionable quality. As with other poor quality assets, the transfer of such securities from the branch to another branch or financial institution may be made to avoid detection and classification during regulatory examinations. These transfers may be accomplished through

participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated entities. Examiners should be alert to situations where a branch's intention seems to be the concealment of low quality securities for the purpose of avoiding examination scrutiny and possible classification. Refer to the section on Credit Risk Management for further information. If situations are uncovered where it is determined that a transfer of securities was undertaken for legitimate reasons, the examiner should make certain that the securities have been properly recorded on the books of the acquiring branch at a reasonable or fair market value during the examination of that branch.

### *Selection of Securities Dealers*

Speculative activity often occurs when an investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

It is common for investment portfolio managers to rely on the expertise and advice of a securities sales representative for recommendations of proposed investments, investment strategies, and the timing and pricing of securities transactions. Accordingly, it is important for branch management to know the securities firms and the personnel with whom it deals. An investment manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Branch management must review the dealer's financial statements and make a judgment about the ability and willingness of the dealer to honor its commitments.

Head office management should review and approve, or at least closely monitor, the list of securities firms with whom local branch management is authorized to do business. The following securities dealer selection standards are recommended but are not all inclusive. The dealer selection process should include:

- A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.

- An inquiry into the dealer's general track record with respect to financial stability and fair and honest dealings with customers, including an inquiry of past or current customers of the securities dealer.
- An inquiry of appropriate state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel.
- An inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise.
- A determination of whether the branch has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) local and head office management is completely satisfied as to the creditworthiness of the securities dealer, (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by local and head office management for unsecured transactions and (3) at least two signatures are required for the sale/release of the security.

The process of managing relationships with securities dealers may affect the branch's code of ethics or conduct as it relates to employee activities. Specifically, the branch should consider prohibiting employees who are directly

involved in purchasing and selling securities for the branch from conducting their own personal securities transactions with the same securities firm employed by the branch unless approved and under periodic review by local and head office management. Local and head office management may also wish to adopt a policy applicable to officers or employees, concerning the receipt of gratuities or travel expenses from approved dealer firms and their personnel.

### *Objectionable Investment Practices*

Local and head office management is responsible for the prudent administration of branch investments in securities. An investment portfolio traditionally has been maintained to provide earnings, liquidity, and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of prudent investment activities and should be conducted in a securities trading account. Securities trading is viewed as an unsuitable activity when conducted in a branch's investment account. Securities trading should take place only in a closely supervised trading account. Acquisitions of the various forms of zero coupon, stripped obligations, and asset backed securities residuals will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a branch.

# Securities Activities

## Examination Objectives

Effective date July 1997

## Section 3130.2

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1. To determine if policies, practices, procedures, and internal controls regarding securities activities are adequate.
2. To determine if branch employees are operating in conformance with the established internal and supervisory guidelines.
3. To determine the scope and adequacy of the internal and external audit functions as it relates to this area.
4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the branch.
5. To determine if the branch is properly accounting for its securities.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Securities Activities

## Examination Procedures

Effective date July 1997

## Section 3130.3

1. If selected for implementation, complete or update the Internal Control Questionnaire for this section.
2. Obtain a list of deficiencies noted in the previous examination report or by internal and external auditors, and determine if management has adequately addressed the deficiencies.
3. Review the branch's investment policy and determine its adequacy. Ascertain whether the policy has been revised since the previous examination.
4. Review the reconciliation of the investment security trial balances to the general ledger.
5. Review management reports for accuracy and completeness.
6. Review policies for classifying transactions as held to maturity, available for sale, or trading.
7. Review policies for classifying investment securities for credit or transfer risk.
8. Obtain a list of securities categorized as held to maturity, available for sale, and trading including:
  - a. Descriptions of securities held (par, book, and market values).
  - b. Names of issuers.
  - c. Issuers' countries of domicile.
  - d. Interest rates.
  - e. Pledged securities.
  - f. Internal credit rating.
9. Reflecting the scope of the examination, select investments for review. If transaction volume permits, include all securities purchased since the prior examination in the population of items to be reviewed. Perform the following procedures for each investment:
  - a. For rated issues:
    - Compare the branch's internal ratings to the most recent published ratings.
    - Verify CUSIP.
    - Check prospectus.
  - b. For unrated issues:
    - Perform a credit analysis to determine if the issues can be considered speculative.
  - c. If market prices are provided to the branch by an independent party (excludes affiliates and securities dealers selling investments to the branch) or if they are independently tested as a documented part of the branch's audit program, those prices should be accepted. If the independence of the prices cannot be established, test market values by reference to one of the following sources:
    - Published quotations, if available.
    - Appraisals by outside pricing services, if performed.
    - If market prices are provided by the branch and cannot be verified by reference to published quotations or other sources, test those prices by using the comparative yield method to calculate approximate yield to maturity as follows:
      - Annual Interest
      - Par Value and Book Value
      - Number of Years to Maturity
      - Branch Provided Market Price + Par Value
  - d. Compare the branch provided market price and the examiner calculated approximate yield to maturity to an independent, publicly offered yield or market price for a similar type of investment with similar rating, trading volume, and maturity or call characteristics.
  - e. Investigate significant market value variances.
10. To the extent practical under the circumstances, perform a credit analysis of:
  - a. Selected obligors on securities purchased under agreements to resell.
  - b. All defaulted issues.
11. Classify speculative and defaulted issues according to the following standards (except those securities with transfer risk where a more severe classification may be warranted):
  - a. The entire book value of speculative grade municipal general obligation securities, which are not in default, will be classified substandard. Market depreciation on other speculative issues should be classified doubtful. The remaining book value usually is classified substandard.
  - b. The entire book value of all defaulted municipal general obligation securities will be classified doubtful. Market depreciation on other defaulted bonds should

- be classified loss. The remaining book value usually is classified substandard.
- c. Market depreciation on nonexempt stock should be classified loss.
  - d. Report comments should include:
    - Description of issue.
    - How and when each issue was acquired.
    - Default date.
    - Date interest paid to.
    - Rating at time of acquisition.
    - Comments supporting the classification.
12. With regard to potential unsafe and unsound investment practices, review the list of securities purchased and/or sold since the prior examination and:
- a. Determine if the branch engages one securities dealer or salesperson for virtually all transactions. If so:
    - Evaluate the reasonableness of the relationship on the basis of the dealer's location and creditworthiness.
    - Compare purchase and sale prices to independently established market prices as of trade dates, if appropriate.
  - b. Determine if investment account securities have been purchased from the branch's own trading department. If so:
    - Independently establish the market price, as of trade date.
    - Review trading account purchase and sale confirmations and determine if the security was transferred to the investment portfolio at market price.
    - Review controls designed to prevent gains trading.
  - c. Determine if the volume of trading activity in the investment portfolio seems unwarranted. If so:
    - Review investment account daily ledgers and transaction invoices to determine if sales were matched by a like amount of purchases.
    - Determine whether the branch is financing a dealer's inventory.
    - Compare purchase and sale prices with independently established market prices as of trade dates, if appropriate. The carrying value should be determined by the market value of the securities as of the trade date.
13. Discuss with appropriate officer(s) and prepare report comments on:
- a. Defaulted issues.
  - b. Speculative issues.
  - c. Incomplete credit information.
  - d. Absence of necessary legal opinions.
  - e. Significant changes in maturity scheduling.
  - f. Shifts in the rated quality of holdings.
  - g. Concentrations.
  - h. Unbalanced earnings and risk considerations.
  - i. Unsafe and unsound investment practices.
  - j. Apparent violations of laws, rulings, and regulations (including compliance with FAS 115).
  - k. Market value depreciation, if significant.
  - l. Weaknesses in supervision.
  - m. Policy deficiencies.
14. Update workpapers with any information that will facilitate future examinations.

# Securities Activities

## Internal Control Questionnaire

Effective date July 1997

## Section 3130.4

Review the branch's internal controls, policies, practices, and procedures regarding purchases, sales, and servicing of the investment portfolio. The branch's system should be documented in a complete, concise manner and should include, *where appropriate*, narrative descriptions, flowcharts, copies of forms used, and other pertinent information. For information on trading securities, refer to the *Trading Activities Manual*.

### POLICIES

1. Has local and head office management adopted written investment securities policies that outline:
  - a. Objectives?
  - b. Permissible types of investments?
  - c. Diversification guidelines to prevent undue concentration?
  - d. Maturity schedules?
  - e. Limitations on quality ratings?
  - f. Policies regarding exceptions to standard policy?
  - g. Valuation procedures and frequency?
2. Are investment policies reviewed at least annually by local and head office management to determine if they are compatible with changing market conditions?
3. Are securities designated at time of purchase as to whether they are held-to-maturity, available-for-sale, or trading? Who is responsible for the designation?
4. Have policies been established governing the transfer of securities between the held-to-maturity, available-for-sale, and trading accounts? Who is authorized to change a security's designation?
5. Do individual officers have set investment limits?
6. Do security transactions require dual authorization?
7. Are investment securities subject to credit reviews prior to purchase, and are annual reviews performed on nonrated issues and issues with significant deterioration?
8. Are securities purchases within prescribed approval limits?
9. Are below investment grade securities included on internal watch lists and subject to the same scrutiny as problem credits?
10. Are stress tests appropriately performed for high risk securities?

### CUSTODY OF SECURITIES

11. Do procedures preclude the custodian of the branch securities from:
  - a. Having sole physical access to securities?
  - b. Preparing release documents without the approval of authorized persons?
  - c. Preparing release documents not subsequently examined or tested by a second custodian?
  - d. Performing more than one of the following transactions:
    - execution of trades,
    - receipt or delivery of securities,
    - receipt and disbursement of proceeds?
12. Are securities physically safeguarded to prevent loss or unauthorized removal or use?
13. Are securities, other than bearer securities, held only in the name or nominee of the branch?
14. Are bearer securities safeguarded appropriately?

### RECORDS

15. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected, and accrued?
16. Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?
17. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items investigated by persons who do not also have sole custody of securities?

**PURCHASES, SALES AND REDEMPTIONS**

18. Is the preparation and posting of purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?
19. Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales, checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?
20. Are purchase confirmations compared to delivered securities or safekeeping receipts

to determine if the securities delivered are the securities purchased?

**CONCLUSION**

21. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
22. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

# Securities Activities

## Audit Guidelines

Effective date July 1997

## Section 3130.5

1. Verify the accuracy of the investment account trial balances.
2. Test the reconciliations of the trial balances to the general ledger.
3. If investments are held in safekeeping at locations outside the branch, request the safekeeping agent to provide lists of securities held including name, description, par value, interest rate, due date, pledge status, and payment date of next coupon.
4. Using appropriate sampling techniques, select certain investments and:
  - a. For investments held at the branch:
    - Examine and count the securities.
    - Compare details of certificates to trial balances.
    - If securities are pledged to secure the branch's liabilities, determine that they are properly segregated from other securities.
    - Determine if coupons are intact.
    - Investigate any discrepancies.
  - b. For investments *not* held at the branch:
    - Compare trial balance details to safekeeping receipts and the safekeeping agent's confirmation list.
    - Determine that pledge status, if any, is properly noted on the safekeeping agent's confirmation list.
    - Investigate any discrepancies.
  - c. For investments purchased since the prior audit:
    - Verify cost by examining invoices, broker's advices, or other independent sources.
    - Determine that the securities were properly recorded in the general ledger.
    - Determine that purchases were approved by local and head office management.
  - d. For investments purchased at a premium or discount, test book value by:
    - Determining the branch's method of calculating and recording amortization of premiums and accretion of discounts.
    - Determining the gross amount of premium or discount at purchase date.
    - Determining the period to maturity or call date.
    - Calculating the amount of premium remaining to be amortized or discount remaining to be accreted.
    - Determining that book value is reflected properly in the general ledger.
    - Investigating any discrepancies.
    - Scanning previously tested amortization or accretion schedules for investments acquired before the prior audit and investigating any significant departure from these schedules.
5. Test gains and losses on disposal of investment securities since the prior audit by sampling investment sales records and:
  - a. Determining sales price by examining invoices or brokers' advices.
  - b. Checking computation of book value on settlement date.
  - c. Calculating gain or loss and tracing the amount to its proper recording in the general ledger.
  - d. Determining that the general ledger properly reflects the disposal of the investment and other related accounts.
  - e. Determining that sales were approved by local and head office management or a designated committee.
6. Test accrued interest by:
  - a. Determining the branch's method of calculating and recording interest accruals.
  - b. Determining that interest accruals are not being made on defaulted issues.
  - c. Randomly selecting certain transactions and:
    - Determining the interest rate and last interest payment date of coupons and money market instruments.
    - Calculating accrued interest and comparing it to the trial balance(s).
7. If the branch is engaged in mortgage-backed or high risk securities, evaluate the interest risk exposure associated with the various instruments by performing independent stress tests.