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Income Property Lending Program

This document and any attachments are replaced by Comptroller's Handbook - Commercial Real Estate Lending

EXAMINATION OBJECTIVES

To determine the adequacy of the association's policies, procedures, and internal controls regarding income property real estate mortgage activities.

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

To evaluate the quality and performance of the association's income property loans.

To ensure compliance with applicable laws and regulations.

To initiate corrective action where supervisory concerns exist.

EXAMINATION PROCEDURES

You should use the following examination procedures in conjunction with Handbook Section 201, Lending Overview. Where an association has multiple loan departments (e.g., segregated by lending type(s)), you will typically review each area separately and bring the evaluations and conclusions reached from these separate reviews to the examiner-in-charge (EIC) or assisting examiner responsible for Asset Quality. Avoid duplication of efforts by exchanging information and results with examiners reviewing the other asset quality sections.

LEVEL I

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1. Review the preceding report of examination (ROE) and all of the lending related exceptions that were noted. Determine if the association has taken the appropriate corrective action. Discuss any significant uncorrected items with management and consider commenting on these unresolved issues in the ROE.

2. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

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3. Review Examination Handbook Section 201, Level I findings.

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4. Discuss income property lending activities with management. Inquire whether the association has begun any new activities, had an increase in lending volume, changed policies or underwriting standards, experienced higher delinquencies or had any other problems in this area. Review management's due diligence prior to initiating new loan products during the review period.

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5. Determine if the institution:

- Is approaching its HOLA investment limit for nonresidential real estate loans.
- Has experienced rapid growth in its CRE lending.
- Has notable exposure to a specific type of CRE lending.
- Was subject to supervisory concern during recent examinations.
- Complies with the 400 percent of capital HOLA investment limit for nonresidential real estate lending.

Note: these steps will normally be performed during the examination scoping process.

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6. For institutions actively engaged in CRE lending, review the association's assessment of its CRE concentration risks, and determine if the association has adequately:

- Performed an internal self-assessment of exposure to concentration risk.
- Continually monitors potential exposure to such risk.
- Reports any such identified concentration risk to senior management and the board of directors.

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- Has implemented risk management policies and procedures appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risks, to monitor and manage those risks effectively.

7. Review the adequacy of the association's real estate lending policies, procedures, and practices pertaining to income property lending. The review should focus on whether the policies and procedures address LTV ratio limits, appraisals and evaluations (12 CFR Part 564), and documentation, and whether underwriting guidelines are in accordance with OTS regulation 12 CFR §§ 560.100-101.

8. Review internal classification reports or other MIS reports that relate to income property loans to evaluate their accuracy, adequacy of board and management reporting, and the quality (i.e., risk characteristics, concentrations, and performance) of the income property loan portfolio.

9. Review loan portfolio performance and trends and determine whether further review is needed to assess performance concerns. The use of the electronic loan data (ELD) to perform portfolio analysis is often useful.

10. Discuss the association's appraisal and evaluation policies and procedures relating to income property lending with management. Determine that the association adheres to the appraisal and evaluation requirements of 12 CFR Part 564 and Examination Handbook Section 208. In conjunction with the Level I review of Handbook Section 208, verify that the association has an adequate appraisal review function.

11. Evaluate the adequacy of the association's inernal asset review function related to income property lending.

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12. Determine that the association's loan administration function is adequate and that it:

- Clearly designates the specific activities to perform for each loan type/size depending on the risk. This could include:
  - — Sending letters to the borrower requesting property P&L data.
  - — Reviewing periodic borrower supplied data such as rent rolls, vacancy, and operating statements for large commercial and multifamily real estate loans.
  - — (For small, well-seasoned loans with low LTV ratios, the review need only focus on performance.)
  - — Performing inspections of the collateral.
- Clearly indicates the measures to take if the borrower fails to provide the requested information.

13. Verify that the association obtains a valid security interest, hazard insurance, property tax information, current operating and financial statements, and annual property inspections for all its income property real estate loans, consistent with its policies and procedures.

14. Determine that the institution calculates loan to value ratios for all covered real estate loans and tracks loans in excess of the supervisory LTV limits. (See the Real Estate Lending Standards Guidelines of 12 CFR §§ 560.100-101.)

15. Determine that management reports to the board of directors at least quarterly, and at a minimum, the aggregate amount of high LTV, non-one- to four-family real estate loans and limits these loans to 30 percent of capital.

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16. Review the association's Environmental Risk Policy. Coordinate review with the examiner responsible for the review of Handbook Section 208, Real Estate Appraisals. If the association does not have a formal Environmental Risk Policy, review formal and informal controls in place to address such risk.

17. Obtain a listing of real estate income property loans and select loans for review in accordance with OTS policy. Use minimum cut-off or dollar proportional and judgmental sample selection to select a sample of loans for review. The judgmental sample should primarily focus on loans made during the review period but should also include loans from other review periods that you may want to select for review because of risk factors such as their large size, payment irregularities, classification, refinance or modification during the review period.

18. Obtain the association's credit files on the loans selected for review. Test for compliance with the association's written policies, procedures, and controls. Also, consider the following during your review:

- The credit quality of the loan, including the adequacy of the primary and secondary sources of repayment.
- Debt service capacity of the subject property.
- The quality and liquidity of the security property and the adequacy of the appraisal.
- The adequacy and timely receipt and review by institution staff of borrower financial statements and financial information on the security property.
- Property inspections.
- Loan covenants.
- Internal credit memoranda and loan correspondence.
- The financial information on and the adequacy of guarantors, if any.

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- Compliance with OTS polices and procedures and applicable laws and regulations.

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19. Look for the following areas of supervisory concern:

- Inadequate cash flow.
- Property maintenance problems and/or inadequate reserves.
- Income or expenses trends that compare unfavorably with historical trends and budget projections.
- Lending limit violations.
- The lack of current, complete, and signed financial information or the lack of review by association staff.
- Deficient collateral documentation.
- Absence of on-going monitoring of the property and the borrower.
- Borrower noncompliance with provisions in the loan agreement or loan covenants.
- Lack of adherence to loan officer and "team" lending authorities.
- Conflicts of interest to affiliated parties.
- Excess debt ratios.
- Conflicts of interest in the approval or appraisal process.
- Modification of troubled loans done primarily to bring the loans current.
- Inappropriate loan structures.

20. Update (or develop) Loan Review Line Sheets or create electronic line sheets from the electronic loan data (ELD) for appropriate loans. The information should include the current balance, past due, nonaccrual, or problem status.

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

LEVEL II

22. Review the underwriting, structure, and safety and soundness of significant loan purchases and participations, as appropriate.

23. Investigate any significant problem loans sold immediately prior to the examination, as appropriate.

24. Investigate any collateral release relating to delinquent loans that weakens the association's security position.

25. Ensure that your review has met the objectives of this handbook section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages. Obtain management responses, and update programs and the electronic continuing examination file (ECEF) with any information that will facilitate future examinations. File exception sheets in the electronic work papers.

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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