Bank:

Date of Exam:

Charter #:

Prepared By:

#14-LOANS and LEASES (Risk Focused)

ASSIGNMENT OVERVIEW

Loans comprise a major portion of most bank's assets and it is the asset category which ordinarily presents the greatest credit risk and potential loss exposure to banks. Examiners will evaluate the depth and scope of the bank's lending policies and credit administration procedures used to manage and control the loan portfolio. The evaluation also involves assessing the quality of the loan portfolio, which is among the most important aspects of the examination process.

For more detailed information, refer to the “Loans” section in the FDIC Examination Manual. The related DOB Reference document for this procedure identifies useful regulations, guidance, and other issuances by various regulatory authorities.

INSTRUCTIONS

Examiners must follow the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations.

All examiners performing these procedures must be listed above in the “Prepared By” section. All of the CORE ANALYSIS PHASE should be completed. Comments and findings for each step should be made in the comment box below each question. If there is non-compliance with a regulation or policy, a comment must be made. Reference work paper documentation in the Comment section. Documentation is to be sufficient to allow an audit trail of the examiner’s thought process and all significant findings.

Information on the Summary of Findings page must tie back to the findings noted within the procedure. The SEIC/EIC will determine which information in the Summary of Findings will be included in the Report of Examination.

The EIC/AEIC should review this procedure when complete. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be noted on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION’S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANAYLSIS PHASE

#14 Loans and Leases

1. Prior Criticisms

1. Determine if deficiencies were noted in the last examination and most recent internal/external audit. If yes, determine if deficiencies have been addressed and/or corrected by management. Detail how deficiencies were corrected.

Review and discuss audit deficiencies with the examiner performing the audit procedure.

Include a copy of the prior criticisms in the work papers; or summarize the exceptions /criticisms in the comment box; or indicate the page number in the last examination report where deficiencies are noted.

Comment:

2. Reconcilement

2a. Review internally prepared reconcilements and verify Call Report Schedules RC-C, RC-L, RC-M, and RC-N. Document/explain any adjustments. *Include copy of reconcilements in 14-B of work papers.*

Comment:

2b. Determine if the bank has High Volatility Commercial Real Estate (HVCRE). If yes, determine the following:

1) How much HVCRE does the bank have?
2) How is management retroactively accounting for HVCRE?
3) How has the bank changed underwriting procedures to address HVCRE?
    a. Do loan worksheets include consideration?
    b. Do they put in an automated system?
4) How are reports generated to account for HVCRE?
5) How has the bank trained employees on HVCRE?
6) Is the board aware of the new regulatory capital rules, including the HVCRE category? What discussions has the board had regarding any restrictions on growth due to regulatory changes?

Comment:

3. Participations

3. For participations purchased or sold:

- Verify confirmations
- Document any non-compliance reported for ASC Topic 860 –Transfers and Servicing (formerly FAS 140) the Interagency Statement on Sales of 100% Loan Participations (refer to OCC Bulletin 97-21 and Call Report Instructions Glossary)

#14 Loans and Leases

For participations purchased:

Consider the risk factors outlined in:

- CSBS Considerations for Reviewing Participation Credits; and
- Regulatory Guidance 3009 Loan Participation Risks.

Include listing of participations purchased and sold in 14-D of the work papers. Include confirmations in 14-E of the work papers.

Comment:

4. Loan Policy

4. Review the Loan Policy and note any deficiencies in the policy or exceptions that have not been approved by the Board or their designee. Refer to **Appendix** for Loan Policy guidance. Consult with examiners performing loan review procedures regarding loans made outside of loan policy guidelines.

Comment:

5. Regulatory Limits

5. Calculate the various regulatory limits (use chart below):

- Legal Loan Limit
  - §34.201 of the Texas Finance Code;
  - 7 TAC §§12.1 - 12.10
- Regulation O Limits for Directors and Executive Officers (12 CFR 215)

Determine compliance with the regulatory limits.

Determine if the necessary records are maintained on insiders to comply with the requirements of 12 CFR 215.8 (Regulation O). Record keeping and disclosure requirements in 12 CFR 215 (Regulation O) are made applicable to state nonmember banks by 12 CFR 337.3**.** Confer with the EIC regarding whether proper approval of loans was obtained.

Compliance with Regulatory Limits

TFC §34.201: Choose an item.

TAC §§12.10 – 12.10: Choose an item.

Reg O Limits 12 CFR 215: Choose an item.

Reg O Recordkeeping (answer applicable one)

Non- Member: 12 CFR 337.3: Choose an item.
FRB-Member: 12 CFR 215.8: Choose an item.

A response indicating non-compliance requires a comment.

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Comment:

LEGAL LENDING LIMIT AND REGULATION O CALCULATIONS

Tier 1 Capital	
Legal Lending Limit (25%)	
Tier 1 Capital	
Tier 2 Capital	
Disallowed ALLL	
Total	
Reg O Limit (15%)	
Executive Officer Limit Lesser of 2.5% of Reg O capital or $100,000	

#14 – Loans and Leases

6. Loan Administration

NOTE: Loan Worksheets for various types of loans are available as additional guidance to this procedure. The worksheets are separate documents from this procedure.

6a. Evaluate and assess the level and severity of documentation exceptions associated with the loans reviewed, and the effectiveness of the bank's documentation tracking system and follow-up process. If weaknesses/deficiencies, discuss how management will improve loan documentation.

Consider the following:

1) Pre-funding procedures
2) Most common documentation exceptions
3) Trends in documentation exceptions (since last examination)
4) Level of documentation exceptions noted during examination, not previously identified by bank
5) Board and management follow-up to exceptions

Dollar Volume of Loans with TEs: $ ____________

Percent of Dollar Amount Reviewed: ____%

Number of lines with TEs: ________

Percent of Number of Lines Reviewed: ____%

Comment:

6b. Assess the adequacy of loan underwriting standards and practices. Discuss any weaknesses/deficiencies identified and management's plans to improve weak practices and/or underwriting standards.

Consider the following:

1) Credit quality of new loans
2) Adherence to internal policies and guidelines
3) Compliance with laws or regulations
4) Documentation exceptions at inception of new loan
5) Impact of loan growth objectives on lending practices

Comment:

6c. Assess overall credit administration practices considering the points below. Discuss weaknesses, if any, and Board and management's plans to improve overall credit administration.

1) Bank's practices related to:
   - Pre-funding and post-funding analyses

- Use of proceeds (consider tracing proceeds and payments to verify use of proceeds and source of repayment.)
- Loan Approvals
- Secondary sources of repayment
- Condition of credit files

2) Depth and succession of management in the loan area:
   - Expertise of senior executive officers to achieve the desired lending and credit administration goals
   - Familiarity and knowledge of the operations and industries in the bank's target trade area
   - Continuing education of loan officers and staff
   - Provisions for a continuing succession of experienced staff

3) Effectiveness of the loan committee:
   - Composition of the committee
   - Officer and loan committee lending authorities
   - Frequency of committee meetings
   - Committee Packets/loan presentations
   - Loan committee minutes (review a sample) since the previous examination
   - Informed decision-making
   - Enforcement of the loan policy
   - Limiting excessive extensions

4) Attend a meeting of the loan committee (if requested by EIC). Consider the following:
   - Effective and pertinent discussions
   - Members participate freely
   - Effectiveness in determining credit risk and prudent work-out procedures for weak credits

5) Assess management's servicing practices
   - Obtaining current and ongoing financial statements
   - Reviewing and understanding borrower's business model considering current economic conditions, including COVID-19

Comment:

6d. Determine whether the bank's credit underwriting and loan documentation practices meet the standards established in the Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR 364 for state nonmembers; 12 CFR 208, Appendix D-1 for member banks).

Determine compliance with Part 365 Real Estate Lending Standards of FDIC Rules and Regulations (non-member banks) or 12 CFR 208.51,Regulation H, Subpart E, Real Estate Lending Standards (member banks).

Meets Standards in Interagency Guidelines for Safety and Soundness (answer applicable one):

Non-Member-12 CFR 364: Choose an item.

FRB Member-12 CFR 208, Appendix D-1: Choose an item.

Compliance with RE Lending Standards (answer applicable one):

Part 365 (FDIC Rules and Regulations): Choose an item.

Reg H (12 CFR 208.51): Choose an item.

A response other than "YES" requires a comment.

Comment:

6e. Determine if the bank performs stress testing on the loan portfolio. If not, explain why stress testing is not done. If applicable, review the bank's internal program and determine if the methodology and practices appear appropriate for the size of the portfolio and the types of credit. If stress testing is not performed but appears to be needed, make appropriate recommendations.

Comment:

6f. If any concentrations of credit (defined below) are noted, determine if the concentration is prudently managed, measured, and monitored. Describe management's practices.

Determine if CRE loans (loans for which the cash flow from the real estate is the primary source of repayment) are at or approaching supervisory concentration levels (as defined in the Interagency Guidance and shown below), perform the Supplemental CRE Work Program. Confer with EIC regarding the completion of the CRE Work Program if the bank is **approaching** the concentration levels or if the bank has a growing concentration that isn't to 90% of the capital limits yet but based on projections **will reach the limit soon**. The CRE Work Program and FDIC CRE Work Program Users Guide are available on DOBIE.

Weaknesses noted in the CRE Work Program should be summarized in the comment section below. *If performed, include copy of completed CRE Work Program in the work papers.*

CRE Guidance:

2006 Interagency Guidance, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* ; and

2015 Agency *Statement on Prudent Risk Management for Commercial Real Estate Lending*.

Concentrations of Credit

Defined as obligations, direct and indirect, according to the following guidelines:

1. Asset concentrations of 25% or more of either (1) Tier 1 Capital plus the entire ALLL for banks that have not adopted CECL; or (2) Tier 1 Capital plus the ACL related to loans and leases for banks that have adopted CECL, by:
   - individual borrower,
   - small interrelated group of individuals,
   - single repayment source or
   - individual project.

2. Concentrations of 100% or more of either (1) Tier 1 Capital plus the entire ALLL for banks that

have not adopted CECL; or (2) Tier 1 Capital plus the ACL related to loans and leases for banks that have adopted CECL, by:

- industry,
- product line,
- type of collateral or
- short-term obligations of one financial institution or affiliated group.

CRE Concentrations

May occur when an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching (90% of the Tier 1 Capital plus the ALLL or ACL related to loans and leases limits) or exceeds the following supervisory criteria:

1. Total reported loans for construction, land development, and other land represent 100 % or more of Tier 1 Capital plus the ALLL or the ACL related to loans and leases; or
2. Total commercial real estate loans (as defined in the 2006 Interagency Guidance) represent 300% or more of Tier 1 Capital plus the ALLL or the ACL related to loans and leases, and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50% or more during the prior 36 months.

Per 2006 Interagency Guidance:

- CRE loans are land development and construction loans (including 1- to 4-family residential and commercial construction loans) and other land loans.
- CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.
- Loans to real estate investment trusts (REITs) and unsecured loans to developers also should be considered CRE loans for purposes of this Guidance if their performance is closely linked to performance of the CRE markets.
- **Excluded** from the scope of this Guidance are loans secured by nonfarm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property.

Comment:

6g. If the bank has originated or purchased any non-traditional, alternative, or exotic residential mortgage products, utilize Loan Worksheet #11 (not included in this procedure) and evaluate for sound underwriting, risk management, and portfolio performance. [These procedures also apply to mortgage operations of a mortgage subsidiary of the bank.] Refer to the *Interagency Guidance on Nontraditional Mortgage Product Risks* and *Statement on Subprime Mortgage Lending* for guidance. Refer to **Appendix** for additional information on non-traditional mortgage products.

Comment:

6h. Evaluate loan quality, the level of past dues, nonaccrual and renegotiated troubled debt; and the distribution, trends and severity of adverse classifications since the last exam.
Comment:
7. Reports Provided to Board
7. Review reports provided to the board for quality and accuracy. Test a sample using a non-financial date as well as a month-end date. Include in your review Watch List, Past Dues, and Nonaccruals. Consider who can change the settings for these reports, who sets the parameters, and if there is any unusual activity during the month that doesn't appear at month end.
Comment:
8. Final Analysis
8a. Prepare an Asset Quality comment and assign a rating for the bank. Refer to Supervisory Memorandum 1001 for definitions of ratings. Complete the **Summary of Findings**.
8b. Print the final Classification Report and Leadsheet Report from ETS. Ensure that all electronic line sheets are completed before printing the Classification report. *Include in 14-A of the work papers.*

SUMMARY OF FINDINGS

#14 - LOANS AND LEASES
Describe all strengths evident from the evaluation.
Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/ noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.
Determine why weaknesses exist and comment on management's response and plan of action. Identify bank personnel making the response.
SUMMARY RISK RATING ASSIGNED: **Select Rating**

Risk Rating Definitions:
1-Strong; 2-Satisfactory; 3-Less than satisfactory; 4-Deficient; 5-Critically deficient; NR-Not Rated

Ratings Matrix.xlsm

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM.

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APPENDIX

High Volatility of Commercial Real Estate (HVCRE)

Effective January 1, 2015, the new regulatory capital rules require High Volatility Commercial Real Estate (HVCRE) loans to be reported on a separate item in the Call Report and are assigned a risk weighting of 150%.

HVCRE does not include:

1. 1-4 Family Residential Projects
2. Loans for Agricultural Purposes
3. Community Development Loans; and
4. Certain Acquisition, Development, and Construction (ADC) Loans
    - ADC Loans that meet the following are not HVCRE:
        - LTV is below supervisory limits; AND
        - Borrower has contributed 15% or more of "as completed" AV in cash or unencumbered readily marketable assets; AND
        - Borrower contributed capital is contractually committed until completion.

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Loan Policy Guidance

Lending policies should be clearly defined and effectively supervised by the directors and senior officers. A lending policy should not be a static document but must be reviewed periodically and revised in light of the complexity of the bank's portfolio and operating environment. There are several broad areas of consideration and concern that should be addressed in the lending policies of all banks regardless of size or location.

A. Has the board of directors formally reviewed/revised/ approved the loan policy within the last year to ensure its continued relevance?

B. Does the policy include the following important points:

- Trade area and circumstances under which the bank may extend credit outside of such area;
- Acceptable/Unacceptable loans;
- Goals for diversification and limits on concentrations of credit;
- Requirements for pre- and post-funding analysis;
- Insider lending restrictions, approvals and requirements;
- Unsecured lending criteria;

- Guidelines for rates of interest and the terms of repayment for secured and unsecured loans;
- Maintenance and review of complete and current credit files on each borrower;
- Officer lending authority (limits);
- Loan committee composition and responsibilities;
- Loan committee lending authority (limits);
- Loan review and grading system
- Identification and treatment of nonaccrual loans;
- Review and treatment of past due loans;
- Criteria for when a loan is to be charged off and how it is handled thereafter;
- Criteria for approval and monitoring of loan policy exceptions; and
- Guidelines addressing the bank's review of the Allowance for Loan and Lease Losses (ALLL).

If the policy does not include any of the items listed above, determine if the item should be addressed in the policy.

C. Does the policy properly address or provide adequate guidelines for any relevant type of lending activity that the bank is pursuing?

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Nontraditional Residential Mortgage Product Definitions

Interest-Only Mortgage Loan—A nontraditional mortgage on which, for a specified number of years (e.g., three or five years), the borrower is required to pay only the interest due on the loan during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or fluctuate based on the prescribed index and payments include both principal and interest.

Payment Option ARM—A nontraditional, adjustable rate mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15-year or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Subprime ARM products: ARM products typically marketed to subprime borrowers with the following characteristics:

- Offering low initial payments based on a fixed introductory or "teaser" rate that expires after a short initial period then adjusts to a variable index rate plus a margin for the remaining term of the loan.[1]
- Loans for which borrowers are approved without considering appropriate documentation of their income.
- Loans with very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") at reset periods, potentially causing a substantial increase in the monthly payment amount "payment shock."
- Loans containing product features likely to result in frequent refinancing to maintain an affordable monthly payment.
- Loans that include substantial prepayment penalties and/or prepayment penalties that extend beyond the initial interest rate adjustment period.
- Soliciting and transacting loans where borrowers are provided inadequate information relative to product features, material loan terms and product risks, prepayment penalties, and the borrower's obligations for property taxes and insurance.

***Subprime "extended amortization" products*:** Adjustable rate and fixed rate products marketed to subprime borrowers with amortization period longer than the term of the loan, such as to require the payment of a balloon amount at the end of the loan term.[2]

Other Definitions:

***Reduced Documentation*—** A loan feature commonly referred to as "low doc/no doc," "no income/no asset," "stated income" or "stated assets." For mortgage loans with this feature, a provider sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

***Simultaneous Second-Lien Loan*—**A lending arrangement where either a closed-end second-lien mortgage loan or a home equity line of credit (HELOC) is originated simultaneously with the first-lien mortgage loan, typically in lieu of a higher down payment.

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[1] For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed rate of interest and the fully indexed interest rate in effect at loan origination may range from 300 (3%) to 600 (6%) basis points.
[2] For example, products known as "50/30" loans feature an amortization period of 50 years with a loan term of 30 years. As a result, at the end of the 30 year term, the borrower is required to make a final balloon payment to repay the remaining principal of the loan.