#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

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. Reference to work paper documentation should also be included here. Documentation is to be sufficient to allow an audit trail of the examiner’s thought process and all significant findings.

Based on any weaknesses or risks noted in the CORE ANALYSIS PHASE or as directed by the EIC, the applicable SUPPLEMENTAL ASSESSMENT PHASE (SAP) should also be performed. Responses should be entered in the SAP. All of the important findings/deficiencies identified while performing the SAP should be summarized in the corresponding CORE ANALYSIS comment section.

The Summary of Findings page contains Report Worthy comments which should be included in the report and Discretionary Report Worthy comments which may/may not appear in the report. The SEIC/EIC should determine if the Discretionary Report Worthy comments will be included.

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.
#14 Loans and Leases

## 1. Prior Criticisms

1. Determine whether deficiencies noted in the last examination and most recent internal/external audit have been addressed and/or corrected by management. Detail how deficiencies were corrected. To document: (a) include a copy of the prior criticisms in the work papers; or (b) summarize the exceptions/criticisms in the comment box; or (c) indicate the page number in the last examination report where deficiencies are noted.

### Comments:

## 2. Reconciliation


### Comment:

## 3. Participations

3. For participations purchased or sold:
   - Verify confirmations
   - Document any non-compliance reported for FAS 140 (ASC Topic 860 – Transfers and Servicing) the Interagency Statement on Sales of 100% Loan Participations (refer to OCC Bulletin 97-21 and CALL Report Instructions Glossary)

   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
#14 Loans and Leases

5a. 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)

5b. Determine compliance with the regulatory limits.

5c. Are the necessary records 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.

Comment:

### LEGAL LENDING LIMIT AND REGULATION O CALCULATIONS

<table>
<thead>
<tr>
<th></th>
<th>Tier 1 Capital</th>
<th>Legal Lending Limit (25%)</th>
<th>Tier 1 Capital</th>
<th>Tier 2 Capital</th>
<th>Disallowed ALLL</th>
<th>Total</th>
<th>Reg O Limit (15%)</th>
<th>Executive Officer Limit</th>
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<td>Lesser of 2.5% of Reg O capital or $100,000</td>
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</table>
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. If there are numerous and/or critical documentation exceptions associated with the loans reviewed, complete the SAP.

Comment:

6b. If there are significant and/or numerous deficiencies noted with loan underwriting standards and/or credit administration, complete the respective SAP. Determine compliance with Part 365 Real Estate Lending Standards of FDIC Rules and Regulations and Regulation H, Sub Part E, Real Estate Lending Standards (12 CFR 208.51).

Comment:

6c. 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:

6d. If any concentrations of credit are noted:

- Determine if the concentration is prudently managed, measured, and monitored. Describe management’s practices.

- If CRE loans are at or approaching concentration levels (defined 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. 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.

The CRE Work Program and FDIC CRE Work Program Users Guide are available on DOBIE.

CRE Guidance:

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


Concentrations of Credit

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

1) Asset concentrations of 25% or more of Total Capital by individual borrower, small interrelated group of individuals, single repayment source or individual project;
2) Concentrations of 100% or more of Total Capital 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 total risk-based capital limits) or exceeds the following supervisory criteria:

1) Total reported loans for construction, land development, and other land represent 100% or more of Total Risk-Based Capital; or

2) Total commercial real estate loans represent 300% or more of Total Risk-Based Capital, and the outstanding balance of the institution’s commercial real estate loan portfolio has increased by 50% or more during the prior 36 months.

**Comment:**

6e. 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:**

6f. 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. Complete the Summary of Findings.

8b. Print the final Classification Report and Leadsheet Report from ETS-ALERT. Ensure that all electronic line sheets are completed before printing the Classification report. Include in 14-A of the work papers.
<table>
<thead>
<tr>
<th>#14 - Loans and Leases</th>
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<tbody>
<tr>
<td>Describe all strengths evident from the evaluation.</td>
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<tr>
<td>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.</td>
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<tr>
<td>Report Worthy:</td>
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<td>Discretionary Report Worthy:</td>
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<tr>
<td>Determine why weaknesses exist and comment on management’s response and plan of action. Identify bank personnel making the response.</td>
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<tr>
<td>SUMMARY RISK RATING ASSIGNED: enter rating here</td>
</tr>
</tbody>
</table>

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

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.

Return to Core Analysis
SUPPLEMENTAL ASSESSMENT PHASE

SAP

Document findings within the SAP and summarize (include weaknesses and statements on compliance with regulations or policies) in the corresponding CORE ANALYSIS section.

Loan Administration (Q6a.)

DOCUMENTATION EXCEPTIONS

Evaluate the bank’s system to track and follow-up on missing documentation. Describe the bank’s practices in the Core Analysis section.

Consider the following:

a. Are pre-funding procedures sufficient to ensure receipt of loan documents prior to loan disbursement?

b. Does the bank employ adequate and effective tracking systems to obtain missing documents?

c. Has the examination identified a substantial number of technical exceptions that were undetected by the bank?

d. What percentage in terms of dollar amount and number of lines reviewed do loans with documentation exceptions represent?

   Dollar volume of Loans with TEs $_______ and _____% of dollar amount reviewed.
   Number of lines with TEs ______ and _____% of number of line reviewed.

e. Are the percentages noted above higher or lower than the percentages noted previously?

f. What is the most common type of exception noted?

g. Why doesn’t management obtain and/or maintain the proper documentation?

h. What should be done by the Board and management to improve loan documentation?

i. How does management plan to improve loan documentation?

Comments:

Return to Core Analysis
### Loan Administration (Q6b)

#### UNDERWRITING STANDARDS

1. Evaluate the bank’s loan-underwriting standards. Note any deficiencies.

   Consider the following:
   - **a.** Are problems or concerns noted with the credit quality of any new loans?
   - **b.** Do the problems or concerns result from poor underwriting standards?
   - **c.** Do new loans violate internal policies or guidelines?
   - **d.** Do new loans violate any laws or regulations?
   - **e.** Are new loans inadequately documented at inception?
   - **f.** Are prudent lending practices being compromised for loan growth objectives?
   - **g.** What should the Board and management do to improve loan underwriting standards?
   - **h.** How does management plan to alter their loan procedures to improve the poor underwriting practices identified above?

### Comments:

### CREDIT ADMINISTRATION

1. Based upon the sample of loans reviewed, determine the strengths and weaknesses in the bank’s credit administration practices. Describe the bank’s practices.

   Consider how the bank’s practices relate to the following:
   - **a.** Are pre-funding and post-funding analyses adequate?
   - **b.** Is the use of proceeds clearly defined?
     - As needed, trace proceeds and payments to verify use of proceeds and source of repayment.
   - **c.** Are appropriate approvals received?
   - **d.** Are secondary sources of repayment identified and analyzed?
   - **e.** Are credit files complete and orderly?

### Comments:
2. Evaluate the depth and succession of management in the loan area. Describe any weaknesses.

Consider the following:

a. Do senior executive officers demonstrate adequate expertise to achieve the desired lending and credit administration goals?

b. Are officers and staff adequately familiar with the operations and industries in the bank’s target trade area?

c. Does management provide for continuing education of its loan officers and staff?

d. Have provisions been made for a continuing succession of experienced staff?

Comments:

3. Review the effectiveness of the loan committee. Identify any weaknesses.

Consider the following:

a. The composition of the committee (board or bank) charged with approving and ratifying loans.

b. Reasonableness of the officer and loan committee lending authorities (limits).

c. Frequency of committee meetings.
   - Is this sufficient to monitor and control lending activity? A substantial number of ratifications (versus approvals) may indicate that frequency is inadequate to oversee the volume of activity.

d. Adequacy of recent packets going to the loan committee. For instance, are loan presentations adequate to allow the committee to make an informed decision?

e. Adequacy of loan committee minutes (review a sample) since the previous examination. Consider:
   - Is there evidence of informed decision-making?
   - Do the minutes indicate that the loan committee is adequately fulfilling its duty by enforcing the loan policy and limiting excessive extensions?

Comments:

4. Attend a meeting of the loan committee (if requested by EIC).

a. Is discussion effective and pertinent?

b. Do all members participate freely?

c. Is the loan committee effective in determining credit risk as well as prudent work-out procedures for weak credits?

Comments:

5. Assess overall credit administration giving consideration to all questions and answers in this
section. Include the following in your evaluation:

a. What should the Board and management do to improve overall credit administration?

b. What are their plans?

Comments:

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APPENDIX

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 nonaccretion 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:

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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.
**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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