Loan Portfolio Management and Review: General

Examiners should evaluate the above-captioned function against the following control and performance standards. The Standards represent control and performance objectives that should be implemented to help ensure the bank operates in a safe and sound manner, and that the entity's objectives are carried out. Associated Risks represent potential threats to the bank if the standards are not achieved and maintained. The Standards are intended to assist examiners in analyzing important functions that may warrant additional review. All of the following Standards may NOT need to be considered at every bank. Conversely, these do NOT represent all of the control and performance standards needed for every bank. Examiners should continue to use their judgement when assessing risk.

Standards	Associated Risks
MANAGEMENT AND CONTROL	
The board establishes adequate lending policies, procedures, and operating strategies.	Inadequate lending policies and procedures expose the bank to greater credit, interest rate, liquidity, and other risks. Lending objectives are not consistent with the bank's overall goals.
A knowledgeable and independent board of directors, and committees of the board supervise the affairs of the bank.	Unqualified management ineffectively monitors and controls lending activities. Concentrated authority in the lending area could create ineffective checks and balances. The potential for self-serving practices and conflicts of interest increases. The board may not develop and enforce accountability and performance standards.
Management has established adequate internal controls for its lending operation.	Weak controls may increase the bank's exposure to errors and omissions. Inadequate controls increase the potential for fraud and abuse.
Internal reviews and audits discuss deficiencies in the lending function, and reports are provided directly to senior management and the board.	Identification, communication, and correction of deficiencies may be inadequate.
Loan information systems provide management with relevant information.	Ineffective information systems could lead to uninformed business decisions, inappropriate reaction to external influences or internal results, and lost opportunities. Poor communication could result in inadequate accountability and oversight of lending personnel.
Controls exist to ensure adherence to accounting standards.	Failure to use proper accounting could result in material misstatement of income and capital levels.
Management performs effective and timely evaluations of loan portfolio quality and conformance with established lending policies.	Unauthorized high-risk loans could go undetected. Losses might not be easily traced to the responsible department or individual. Underwriting controls could break down and

Standards	Associated Risks
	lending practices depart from established corporate policies and procedures.
Management follows an appropriate method for determining the level of the Allowance for Loan and Lease Losses (ALLL).	The ALLL is inadequate to absorb estimated losses in lending activities, including off-balance sheet lending activities.
Procedures exist to identify and react to changing economic, industry, and regulatory environments.	Management may violate new or revised regulations. Economic changes may produce unfavorable financial performance. Concentrations of credits could deteriorate. Rapid and uncontrolled growth may occur.
Management assigns prudent lending authorities to officers and committees.	The potential for over-lending to individuals and industries heightens. Certain loan officers may not be experienced enough to originate large or high-risk loans. The lack of lending authorities impedes loan officer accountability and oversight.
Loan committee meets regularly to review and approve loans.	Lack of direction and oversight may cause imprudent lending decisions and increase credit risk.
The lending area is adequately staffed for planned objectives, and personnel are knowledgeable and competent for the size and nature of the bank's lending functions.	Poorly administered loans may cause greater portfolio risk. Insufficient knowledge impedes management's ability to adapt to changes in economic conditions, technology, products, etc. Unqualified lenders may inadequately underwrite and analyze credits. The potential for loan losses and poor financial performance increases. Management may be unable to monitor lending activities effectively. Inadequate staffing could result in insufficient collection activity and monitoring.
Management adheres to and supports policies regarding conflicts of interest and insider dealing.	Public confidence and funding sources may be lost if guidelines are not followed. Violation of policies, procedures, rules and regulations, and criminal statutes result.
Management identifies and analyzes relevant risks.	Inadequate analysis could result in excessive credit risk. Loan pricing may not reflect risks. Lending objectives may not be achieved.

Standards	Associated Risks
PERFORMANCE	
Internal loan review functions accurately identify loan problems.	Failure to detect existing and emerging loan problems could result in escalating problem assets.
The ALLL adequately protects against the risks inherent in the bank's loan portfolio and off-balance sheet lending activities.	An insufficient ALLL results in an overstated capital position and earnings. An under-funded ALLL results in inaccurate financial reports to shareholders and regulators. Loan losses might exhaust the ALLL and erode capital.
Management recognizes losses in a timely manner.	Deferred loan losses overstate current period earnings. Understated losses could result in inaccurate financial reports.
The overall quality of the loan portfolio is satisfactory.	Sub-quality loans increases loan losses, and operating expenses and can erode capital. Officers spend an inordinate amount of time collecting and monitoring loans.
Bank officers comply with established guidelines and policies.	Officers may originate unauthorized loans.
Credit files contain timely and accurate documentation.	Incomplete documentation impedes management's ability to properly analyze borrowers' creditworthiness. Undetected loan problems and financial weaknesses delay successful workout agreements. Improperly perfected liens and missing documentation hinder efforts to foreclose or repossess collateral.
The bank complies with all laws and regulations related to the lending function.	Intentional and continuing violations could result in costly penalties and increased supervisory oversight. Regulators, shareholders, and customers may lose confidence in the bank and its executive management.
Loan operations meet profit targets.	The net interest margin may be reduced.
MANAGEMENT AND CONTROL	
The board or designee approves loans to facilitate the sale of ORE and repssessed other assets.	Loans with excessive credit risk go undetected.
Management monitors the level, trend, and holding periods of ORE parcels and other repossessed assets.	Management may not identify or respond to poor credit underwriting standards, lax collection policies, or unsatisfactory loan review procedures. Poor marketing may extend holding periods and increase the probability of loss. The holding may not comply with applicable regulations.
PERFORMANCE	

Standards	Associated Risks
Appropriate persons underwrite loans to facilitate the sale of ORE.	Inexperienced underwriters may improperly originate loans with below market rates and low equity positions when not warranted. Loans to facilitate the sale of ORE may not be accounted for properly and result in overstated earnings.

Loan Portfolio Management and Review: General

Core Analysis Decision Factors

Examiners should evaluate Core Analysis in this section for significance and to determine if an Expanded Analysis is necessary. Negative responses to Core Analysis Decision Factors may not require proceeding to the Expanded Analysis. Conversely, positive responses to Core Analysis Decision factors do not preclude examiners from proceeding to the Expanded Analysis if deemed appropriate.

Do Core Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled ?

Core Answer: General Comment:(If any)

<u>Core Analysis Decision Factors</u>

C.1. Has the Board of Directors established adequate policies and risk limits for the bank's current and anticipated areas of lending?

C.2. Are internal controls adequate?

C.3. Are the audit or independent review functions adequate?

C.4. Are information and communication systems adequate and accurate?

C.5. Does management accurately identify, monitor, and reserve for credit risk?

C.6. Is portfolio quality satisfactory?

C.7. Is the volume of ORE and repossessed assets manageable and the process adequately controlled?

C.8. Has operating management established sufficient procedures to effectively implement policy guidelines, to remain compliant with applicable laws and regulations, and to effectively carry out strategic initiatives?

Loan Portfolio Management and Review: General

Expanded Analysis Decision Factors

This section evaluates the significance and materiality of deficiencies or other specific concerns identified in the Core and Expanded Analyses.

Do Expanded Analysis and Decision Factors indicate that risks are appropriately identified, measured, monitored, and controlled?

Expanded Answer: General Comment:(If any)

Expanded Analysis Decision Factors

E.1. Are deficiencies immaterial to the supervision of the lending function?

E.2. Are deficiencies immaterial to the bank's condition?

Loan Portfolio Management and Review: General

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

References to lending policies and loan functions in this section include off-balance sheet lending activities. Analysis of lending functions must consider off-balance sheet lending activities. In addition, this section also includes procedures relating to ORE, repossessed assets, and non-ledger loan related assets.

PRELIMINARY REVIEW

1 Review prior examination reports, prior examination work papers, pre-examination memorandum, and file correspondence for an overview of any previously identified lending deficiencies. In addition, determine if there were any prior concerns related to repossessed assets and ORE.

2 Review interim internal and external audit reports, and assess the adequacy of the audit scope.

3 Review remedial actions taken by management to correct audit and examination deficiencies.

4 Review internal and external loan review reports as well as other reports provided by third party sources.

5 Discuss with management any planned changes in lending philosophy, portfolio composition, new products, pricing strategies, etc. Determine if current and planned lending strategies are consistent with the bank's overall strategic plan.

6 Review loan committee minutes.

7 Obtain and analyze data used by management to supervise the loan portfolio. This data may include the following:

7 A Organizational Charts.

7 B Written policy and procedures manual.

7 C Problem loans and watch list reports.

7 D Delinquency and nonperforming asset reports.

7 E Concentration Reports.

7 F ALLL analysis.

7 G Significant and/or concentrations of charge-offs (by industry or types of borrowers) since the prior examination.

8 Review the composition of the loan portfolio by type and dollar volume. Determine specialty lending areas and assign responsibility for completing appropriate reviews. Refer to individual specialty Loan References for additional guidance.

9 Determine the volume of other real estate.

10 Determine the volume of repossessed assets.

POLICY CONSIDERATIONS

11 Determine if lending policies are adequate for the lending activities of the bank.

11 A Evaluate the frequency and timeliness of reviews and updates by the board of directors.

11 B Determine if policies include the following broad areas of concern:
1. General fields of lending in which the bank engages and the kinds or types of loans within each general field.
2. Lending authority of each loan officer.
3. Lending authority of a loan committee or executive committee.
4. Responsibility of the board of directors in reviewing, ratifying, or approving loans.
5. Guidelines under which unsecured loans will be granted.
6. Guidelines for collateral requirements, pricing, and the terms of repayment for various types of loans offered.
7. Limitations on the amount advanced in relation to the value of the collateral and documentation required by the bank for each type of secured loan.
8. Guidelines for obtaining and reviewing appraisals of real estate or other collateral as well as for ordering reappraisals.
9. Maintenance and review of complete and current credit files on each borrower.
10. Appropriate and adequate collection procedures including, but not limited to, actions to be taken against borrowers who fail to make timely payments.
11. Limitations on the maximum volume of loans in relation to total assets.
12. Guidelines for purchased loans.
13. Limitations on the extension of credit through overdrafts.
14. Description of the bank's normal trade area and circumstances under which the bank may extend credit outside the area.
15. Guidelines which address the goals for portfolio mix and risk diversification and cover the bank's plans for monitoring and taking appropriate corrective action on any existing concentrations.
16. Guidelines addressing the bank's loan review and grading system ("Watch list").
17. Guidelines addressing the bank's review of the Allowance for Loan Losses.
18. Guidelines addressing collection and workout procedures.
19. Guidelines addressing charge-off practices and appropriate follow up for potential recovery.
20. Guidelines for adequate safeguards to minimize potential environmental liability.
21. Guidelines regarding loans to insiders.

12 Determine if incentive compensation programs promote behaviors that are inconsistent with strategic portfolio objectives and risk tolerances.

13 Determine if repossessed asset and ORE policies are sufficient for the needs of the bank.

14 Review the bank's charge-off policy. Consider the consistency with regulatory and accounting definitions, adherence to policy, timeliness, and senior management and board review.

INTERNAL CONTROLS

15 Review management's procedures to prevent, detect, and respond to lending policy exceptions.

16 Determine the adequacy of subsidiary loan record reconciliations to the general ledger. Consider the following items:

16 A Frequency of reconciliations.

16 B Disposition of reconciling amounts.

16 C Separation of duties.

17 Determine if controls exist over loan closings and disbursements. Consider the following issues:

17 A Documentation is complete and appropriate waivers are obtained before loans are funded.

17 B Use of documentation waivers is not excessive.

17 C Funds are disbursed in accordance with loan terms.

17 D Transactions where broker's fees are paid from the proceeds of related loans instead of being paid directly by the bank as a cost of obtaining the funds.

18 Ascertain if items held in suspense accounts clear in a timely manner.

19 Determine if controls exist over off-balance sheet lending activities.

20 Verify if commitments are limited in amount, cover a specific period of time, and indicate the conditions that must be satisfied before draws will be honored.

21 Determine if controls exist over loan participation activities. Consider the following issues:

21 A An independent credit analysis is performed prior to purchase.

21 B Agreements require parties to furnish timely information, consult with participants prior to taking action on defaulted loans and specify the rights and remedies of the lead bank and participant.

22 Determine if controls exist over loan renewals and extensions.

23 Evaluate controls regarding capitalization of interest.

23 A Determine if there are loans on which interest is not being collected in accordance with the terms of the note, including loans which have been renewed without full collection of interest, with interest being rolled into principal, or interest paid from the proceeds of a separate note.

23 B Determine if there are any loans in which the terms have been modified by reducing the interest rate or principal payment, by deferring interest or principal, or by restructuring of repayment terms. Include any formally restructured loans which have been returned to accrual status after a partial charge-off or before collection of interest arrears.

24 Evaluate management's procedures for limiting risk in concentrations of credit by industry, type, person, etc.

25 Determine if the proper level of approval is documented and verify that terms are consistent with officer, committee, or board approvals.

26 Determine if credit scoring models are continuously tested and evaluated to ensure that actual performance approximates initial projections.

AUDIT OR INDEPENDENT REVIEW

27 Determine that the audit program is sufficient to obtain reasonable assurance that:

27 A Loans exist and are owned by the institution as of the balance-sheet date.

27 B The allowance for loan and lease losses is adequate for estimated losses inherent in the loan portfolio.

27 C Loans are properly classified, described, and disclosed in the financial statements, including fair values of loans and concentrations of risk.

27 D Recorded loans include all such assets of the institution and the financial statements include all related transactions during the period.

27 E Loan transactions are recorded in the proper period.

27 F Loans held for sale are properly classified and are stated at the lower of cost or market value.

27 G Interest income, fees, and costs and the related balance-sheet accounts (accrued interest receivable, unearned discount, unamortized purchase premiums and discounts, and unamortized net deferred loan fees and costs) have been properly measured and recorded.

27 H Gains and losses on the sale of loans have been properly measured and properly recorded.

27 I Credit commitments, letters of credit, guarantees, recourse provisions, and loans that collateralize borrowings are properly disclosed in the financial statements.

28 Determine if the audit or independent review program provides sufficient coverage relative to the institution's size, scope of lending activities, and risk profile. These programs should:

28 A Recommend corrective action when warranted.

28 B Verify that corrective action commitments have been implemented.

28 C Assess separation of duties, internal controls, and supervision of lending activities.

28 D Determine compliance with policies, procedures, and regulatory requirements.

28 E Assess the adequacy, accuracy, and timeliness of reports to senior management and the board.

INFORMATION AND COMMUNICATION SYSTEMS

29 Determine if managerial reports provide sufficient information relative to the size and risk profile of the organization and evaluate the accuracy and timeliness of reports produced for the board and executive management. Reports may include the following types of information:

29 A Directors

Analysis of ALLL adequacy
Charge-offs and recoveries
New loan approvals/denials (Above certain dollar amount)

Loan renewals (Above certain dollar amount)
Unfunded commitments
Insider borrowings
Participations
Out-of-territory lending
Concentrations
Nonconforming loans

29 B Management

All of the above
Legal lending limits
Overdrafts
Non-sufficient funds
Kite suspect
Technical exceptions
Suspense accounts (contents, reconcilments)

30 Review management's system for aggregating related credit exposures.

31 Analyze growth trends by total and loan type, and determine if actual data satisfactorily mirrors budgeted growth plans.

32 Review the accuracy of accounting for loans sold and participations. Consider partial sales and recourse arrangements.

33 Determine that the procedures for placing loans into nonaccrual status comply with regulatory guidelines.

34 Determine that the practices regarding Troubled Debt Restructuring (TDR) comply with regulatory guidelines.

35 Validate the accuracy of Reports of Condition and Reports of Income where necessary.

IDENTIFYING, MONITORING, AND RESERVING FOR CREDIT RISK

Loan Review

36 Ascertain if the loan review practices are adequate for the size and complexity of the bank.

36 A Verify that the loan review function meets the following objectives:

1. To promptly identify loans having potential credit weaknesses, and appropriately classify loans with well-defined credit weaknesses that jeopardize repayment so that timely actions can be taken and credit losses minimized.
2. To project relevant trends which affect the collectibility of the portfolio and isolate potential problem areas.
3. To provide essential information to determine the adequacy of the ALLL.
4. To assess the adequacy of and adherence to internal credit policies and loan administration procedures, and to monitor compliance with relevant laws and regulations.
5. To evaluate the activities of lending personnel.
6. To provide senior management and the board with an objective and timely assessment of the overall quality of the loan portfolio.

37 Verify that updates to the "watch list" are timely.

38 Validate the internal loan review system and assigned classification ratings. Also evaluate any documentation exception reports and written classification summaries. Evaluate frequency and timeliness of reviews and updates to the board of directors. (NOTE: Preliminary sampling at this level should be sufficient to judge the accuracy of the internal loan review system without becoming so large that examiners duplicate efforts established by banks with satisfactory internal reviews. An inaccurate internal loan review system will result in expanded loan sampling.)

38 A Evaluate a cross section of loans by type, size, and severity of classification.

38 A1 Sample "watch list" loans and assess rating accuracy. When developing the sample consider the following:

1. Credits representing the greatest inherent risk to the bank.
2. Severity of the internal classification
3. Multiple credit types and categories.
4. Loans to industries or groups affected by adverse economic trends.
5. Loans to facilitate the sale of bank assets or loan collateral. (Note: Refer to SFAS 66 and APB 21.)

38 A2 Sample loans NOT on the watch list to validate the internal loan review process, considering the following:

1. Previously classified and Special Mention loans.
2. Significant overdue and nonaccrual loans.
3. Loans to insiders, their related interests, and affiliates.
4. Significant credits originated since the previous examination.
5. New types of loans.
6. Loans originated by each loan officer and loan officers with unusually high loss ratios.
7. Other significant credits as determined by the EIC, including loans to industries or groups affected by adverse economic trends.
8. Loan types and individual borrowers exhibiting high rates of growth.
9. Loans to facilitate the sale of bank assets, insider assets, or loan collateral.
10. Loans at a seasonal low point that could represent large credits when fully drawn.

ALLOWANCE FOR LOAN AND LEASE LOSSES (ALLL)

Methodology

39 Evaluate the bank's method for determining the adequacy of the ALLL, including all binding commitments to lend. (Note: Refer to FASB114.)

39 A Determine if the complexity and scope of the bank's ALLL evaluation process and loan review system are appropriate given the size of the bank and its lending activities.

1. Verify that the bank has an effective loan review system and controls.
2. Verify that management promptly charges off loans, or portions of loans, that are uncollectible.
3. Verify that the bank's method is based on a comprehensive, adequately documented, and consistently applied analysis of the bank's loan and lease portfolio. The methods should consider all significant factors that affect the collectibility of the portfolio and supports the range of credit losses estimated by the process.

40 Determine if the bank's methodology includes an analysis of potential credit losses on those loans classified Substandard or Doubtful.

41 Determine if the bank's methodology includes an analysis of various loan categories as well as significant credits on an individual basis.

42 Determine if the bank's methodology includes an estimate of losses from transfer risk on international loans.

43 Determine if management considers any factors that are likely to cause estimated credit losses to differ from historical loss experience:

1. Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.
2. Changes in national and local economic business conditions and developments, including the condition of various market segments. (Note: Credit loss and recovery experience may vary significantly depending upon the business cycle.)
3. Changes in the nature and volume of the portfolio.
4. Changes in the experience, ability, and depth of lending management and staff.
5. Changes in the trend of the volume and severity of past due and classified loans, and trends in the volume of nonaccrual loans, troubled debt restructurings, and other loan modifications.
6. Changes in the quality of the bank's loan review system and the degree of oversight by the bank's board of directors.
7. The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
8. The effect of external factors such as competition and legal and regulatory requirements.

44 Determine that the ALLL evaluation process is done on at least a quarterly basis.

45 Determine if documentation is maintained to support the adequacy of the ALLL Adequacy

Adequacy

46 Evaluate the overall level of the ALLL for reasonableness.

46 A If the bank's internal loan review system and method for determining ALLL adequacy is accurate, compare the bank's result to the current ALLL balance.

46 B Consider reviewing applicable UBPR ratios as a check for reasonableness.

PORTFOLIO QUALITY

General

47 Determine the individual credit size and other criteria to achieve the desired percentage of the portfolio for which credit files will be reviewed.

48 Evaluate loan commitments, letters of credit, and other contingent liabilities for creditworthiness.

49 Review any loans to out-of-territory borrowers who also have large deposits. Determine if the loans were offered at favorable loan terms as a result of the large deposit relationship.

50 Review overdraft, large items, and uncollected funds reports for possible check kiting or other irregular activity. Pay particular attention to overdrafts of bank insiders and insiders of other banks.

51 Evaluate the current level and trend of past due ratios for each type of credit.

52 Review and analyze loan participations for creditworthiness.

53 If the bank has acquired other institutions or loan portfolios, analyze the effect these purchases have had on the bank's portfolio composition and risk profile.

54 Determine whether any loans were sold prior to the examination to avoid criticism by examiners.

55 Determine if the bank has any borrowing relationships that qualify as Shared National Credits and assign classifications accordingly.

56 Assign classifications to credits reviewed from the above samples, and evaluate the internal loan classifications for accuracy. (Note: If the internal grading system is reliable, use the bank's data for preparing appropriate report pages, for determining the overall level of classifications, and for providing supporting comments regarding the quality of the loan portfolio. If internal classifications are overly conservative, examiners should make adjustments as deemed appropriate.)

57 Evaluate the level and trend of classified loans.

MANAGERIAL EFFECTIVENESS

Procedures and Practices

58 Determine if executive management and loan officers are aware of established lending policies and practices.

59 Review the bank's loan approval process and determine if loan presentations include an adequate analysis of the following items:

1. Loan purpose.
2. Repayment source.
3. Collateral.
4. Background of borrower.
5. Principals and management.
6. Financial information including balance sheet and income statement.
7. Financial projections.
8. Industry and economic outlooks, including real estate trends.
9. Cash flows.
10. Borrowing and deposit histories.
11. Loan structure and terms.
12. Loan covenants.
13. Justification for policy exceptions.

60 Determine if the bank's financial analysis of borrowers is adequate in relation to the size and complexity of the debt.

60 A Review financial analysis for appropriate financial ratios, trends, cash flow history, and projections sufficient to determine the financing needs and repayment capacity of the borrower.

60 B Assess whether the bank's review evaluates important items such as salaries, fees, dividends, notes and accounts receivable, and notes and accounts payable, including those to insiders.

60 C Determine whether significant balance sheet and income statement changes are properly explained and whether the bank identifies and reviews contingent liabilities.

60 D Evaluate the bank's comparison of actual results to projected performance.

60 E Consider the prospects for support from any financially responsible guarantors, with emphasis on excess liquidity, cash flow, and demonstrated willingness to honor guaranty agreements.

61 Determine if the bank is tracking borrowers' compliance with financial and reporting covenants.

62 Determine if underwriting practices are acceptable. Consider the following items:

1. Borrowing purpose is identified.
2. Appropriate analysis of credit history and borrower capacity as well as evaluation of collateral.
3. Pricing, recourse provisions, and loan-to-value requirements reflect underlying credit risk.
4. Debt amortization and maturity consider the timing and duration of borrower cash flows.
5. Additional advances to an existing loan are supported by evidence that the loan will be repaid.
6. Renewals, extensions, and refinancings have reliable repayment sources and repayment schedules are reasonable.

63 Determine if the bank maintains adequate documentation. Consider the following items:

1. Loan purpose.
2. Financial statements. (Balance sheet, income statement, cash flow)
3. Sources of repayment.
4. Collateral evaluation.
5. Lien integrity.
6. Insurance protection.
7. Credit history.
8. Extension/renewal activity.
9. Loan approval.
10. Corporate resolutions and guarantees.

Applicable Laws and Regulations

The following procedures cover assessing compliance with State and Federal banking laws as well as common regulations relating to loan and lease reviews. The descriptions are brief overviews, and if an examiner suspects an apparent violation, he/she should reference the applicable regulations and state laws. Although not all inclusive, review should include the following:

64 Review the bank's compliance with legal lending limits.

65 Review the bank's compliance on transactions with affiliates. (Note: Section 23A, Federal Reserve Act (12 U.S.C. 371 (c)) defines covered transactions; sets quality, terms, and collateral requirements; and places aggregate limits on such activities.)

66 Review the bank's compliance on extensions of credit to insiders.

67 Review the bank's compliance with anti-tying provisions. (Note: Section 106 of the Bank Holding Company Act amendments of 1970 (12 U.S.C.1972) prohibits extensions of credit that are conditioned upon the borrower obtaining or providing any additional credit, property or service to or from the bank or its holding company.)

68 Review the bank's compliance on loans secured by stock.

68 A Secured by bank's own stock.   (12 U.S.C.83, Section 5201 of the Federal Reserve Act.)

68 B Loans for the purpose of purchasing or carrying margin stock. (If secured directly or indirectly by margin stock, Federal Reserve Boards Regulation U is applicable.)

68 C Loans secured by the same stock or bond(s) may not exceed the aggregate limit restrictions specified in Section 11(m); Federal Reserve Act (12 U.S.C. 248(m)).

68 D Determine that the institution is familiar with the Lost and Stolen Securities program (SEC Rule 240.17f1) and has taken the appropriate measures to minimize exposure on loans secured by stock. Refer to www.secic.com for further guidance.

69 Review the bank's compliance with real Estate Lending Standards.   (FDIC: Part 323 and 365, FRB: Section 208.52 of Regulation H regarding Real Estate Lending Standards (See SR 93-1, SR93-11 and SR 93-33) establish policy requirements, appraisal standards, and supervisory Loan-to-Value (LTV) limitations.)

69 A Loans made in excess of LTV limitations are to be monitored and reported to the directorate.

69 B The aggregate volume of loans in excess of LTV limitations may not exceed regulatory guidelines.

69 C The bank must maintain an approved list of appraisers.

69 D Appraisers must be currently licensed or certified to operate in the states in the bank's lending area. (States set licensing or certification requirements)

69 E Appraisals, when required, are to conform to specific regulatory requirements.

69 F For transactions not requiring appraisals, conforming evaluations are normally required.

Credit Administration

70 Assess the adequacy of management's actions to correct criticisms noted in the previous examination reports, most recent loan review reports, as well as in recent internal/external audits conducted since the last examination.

71 Evaluate management's effectiveness at reacting to changing economic, industry, and regulatory environments.

72 Evaluate the business experience of loan committee members. Determine if members are independent and qualified to function effectively.

73 Determine that appropriate lending authorities exist at the loan committee as well as individual account officer level.

74 Determine if the lending staff is adequate given the size and nature of current and/or planned lending activities.

75 Determine if lending officers' skills are commensurate with their lending responsibilities. Possible ways of measuring skill levels include the following items:

75 A Review lending area job descriptions.

75 B Review individual resumes.

75 C Evaluate the expertise of lending officers during loan discussions.

76 Evaluate the effectiveness of the organization's appraisal review process.

77 Evaluate the effectiveness of the organization's collection and workout procedures.

78 Determine the extent and adequacy of training and continuing education provided to lending personnel.

79 Determine if lending officers, line managers, credit administrators, and credit analysts, as well as different lending divisions, work together in an atmosphere of teamwork and cooperation to reach decisions which are in the best interest of the organization.

80 Determine if lending personnel avoid "conflicts of interest" as well as any appearance of a conflict of interest.

81 Evaluate management's effectiveness at establishing a well defined credit culture throughout the organization.

82 Determine that the lending staff understands and supports the credit culture of the organization.

OTHER LOAN RELATED ITEMS

Other Real Estate

83 Determine how ORE was acquired.

84 Determine that ORE files are adequately documented. Consider the following:

84 A Evidence of ownership.

84 B Book value currently and at the time of acquisition.

84 C Appropriateness of capitalized costs, if any.

84 D Current outside appraisal or internal valuation.

84 E Formal purchase offers (if applicable).

84 F Sales efforts or listing agreements.

84 G Current hazard and liability insurance.

84 H Disposal of the parcel (who, when,how), if applicable.

85 Determine the appropriateness of ORE accounting procedures, carrying values, and dispositions. Consider the following:

85 A Prior liens.

85 B Appropriateness of rental income and expense entries.

85 C Appropriate review of expenses.

85 D Adequacy of appraisal.

85 E Environmental concerns.

85 F Holding period in compliance with state laws.

85 G Use of a specific or general valuation reserve.

86 Evaluate the quality of the portfolio and classify parcels accordingly.

Repossessed Assets

87 Determine the appropriateness of repossessed asset accounting policies, carrying values, holding periods, and dispositions. Classify as necessary.

Non-ledger Assets

88 Determine that appropriate approval authorities and levels of review are in place given the volume and magnitude of charge-offs.

89 Ascertain if the audit practices are sufficient given the volume and magnitude of charge-offs. Consider the following:

89 A The audit program should determine the validity/existence of charged-off assets by physical inspection of items held at the bank or by direct confirmation with persons who have possession of them outside of the bank. (attorneys, collection agents, etc.)

89 B The validity of charged-off items should also be tested, with particular attention given to possibly fictitious loans that were charged-off. Methods of authenticating the validity of charged-off items include:

1. Direct confirmation with borrowers.

2. Evidence of personal contact with the borrower by persons other than the loan officer regarding borrowing relationship.

3. Verification through bank records that the borrower received the loan proceeds.

4. Verification through nonbank records such as telephone and city directories that the borrower may exist.

89 C The auditor may choose to confirm all charge-offs of more than a certain size or may prefer to confirm a statistical sample of all charges over a certain amount.

90 Evaluate the controls over charged-off assets.

90 A Determine that the bank segregates and maintains satisfactory and detailed records of charged-off assets.

90 B Determine that there is an appropriate segregation of duties between the recordkeeping function and the collection and handling of payments.

90 C Determine that charged-off notes are periodically verified to subsidiary records.

90 D Determine that these assets are reviewed by the board of directors at least annually.

91 Determine that appropriate efforts are being made to dispose of these assets.

Loan Portfolio Management and Review: General

Generally, procedures used in the Expanded Analysis should target concerns identified in the Core Analysis and Decision Factors. Expanded procedures associated with Core Analysis and Decision Factors of no concern need not be used. The flexible guidelines specified for the Core Analysis also apply here.

POLICIES AND PROCEDURES

1 Investigate why the lending and loan review policy or procedure deficiencies identified in the Core Analysis exist. Discuss with management its response to examiner recommendations.

1 A Management overlooked these issues.

1 B Management is unfamiliar with prudent loan and loan review guidelines and procedures.

1 C Management is unwilling to create or enhance policies and procedures.

2 If poor compliance with policies and procedures exist, determine the reasons. Possible reasons are detailed below:

2 A Poor internal communication of policy and procedures or subsequent revisions.

2 B Lack of awareness of policy existence.

2 C Disregard for established policies.

2 D Misunderstanding of policy or procedures.

3 Determine if management commits to and supports proper controls and monitoring to ensure policy and procedures are followed in the future. Determine if proposed controls, if any, are reasonable.

INTERNAL CONTROLS

If material weaknesses exist in the Core Analysis section, consideration should be given to completing the following procedures as needed:

4 Determine the underlying cause of internal control deficiencies identified in the Core Analysis section.

5 If internal loan reconcilements are inadequate, perform loan account reconcilements.

6 Determine if management gives proper attention to out-of-balance conditions and does not charge-off or close out small balances without investigation.

7 Evaluate the ability of loan records to provide satisfactory audit trails that allow for the tracing of transactions from initiation to disposition.

8 Consider tracing loan proceeds for a sample of loans including large and unusual credits and ascertain the adequacy of the disbursement controls.

9 Determine if loan terms and other information on new loans are checked for accuracy and verified against loan trial reports.

10 Determine that two employees are required to effect a status change in a customer account record.

11 Determine if source documents supporting loan modifications are supported by proper authorizations.

12 Determine if supervisory overrides or approvals are required to perform the following functions:

12 A Processing payments on loans and leases in the process of foreclosure or other legal action.

12 B Waiving late charges or other penalties.

13 Determine if loan officers are prohibited from processing loan payments.

14 Determine if receiving and releasing collateral to borrowers and posting entries in the collateral register are performed by different employees and if appropriate records are maintained.

15 Determine if collateral receipts exist and identify each item retained by the bank.

16 Determine if negotiable collateral is held under dual control.

17 Determine if discount, interest, commission, and fee computations are compared or tested to initial records by employees who cannot originate entries.

18 Determine the extent of collateral attachment problems.

19 Determine that the bank is identified as loss payee on collateral insurance coverages.

20 Determine if tickler systems for insurance, taxes, and collateral filings are adequate.

21 Determine if officers and employees are prohibited from holding blank signed notes in anticipation of future borrowings.

22 Determine if paid and renewed notes are canceled and promptly returned to customers.

23 Determine if charged-off notes are adequately segregated and controlled.

24 Determine if loan charge-offs are approved in writing and reported to the board or appropriate committee.

25 Determine if the record of charged-off loans is maintained by a person other than the one who has custody of the notes or receives payment.

25 A Determine if the record is reconciled to the actual notes at least annually.

26 Determine if subsidiary payment records and files for serviced loans are adequately segregated and identifiable.

27 Review reciprocal situations where loans to bank insiders are sold to other institutions and loans to insiders of the institutions are purchased.

AUDIT OR INDEPENDENT REVIEW

28 Research the inaccuracies or inadequacies cited in audit or independent review findings to determine the underlying cause.

29 Evaluate the materiality of the deficiencies disclosed in the core section.

30 If deficiencies are deemed material, expand the scope of the examination.

INFORMATION AND COMMUNICATION SYSTEMS

31 Research the inaccuracies or inadequacies in the loan reporting systems to determine the underlying cause.

32 Determine the appropriate distribution of reports to operating management.

33 Determine if any of the inaccuracies cited above compromise executive management's planning efforts and negatively impact the overall effectiveness of implementing strategic initiatives.

IDENTIFYING, MONITORING, AND RESERVING FOR CREDIT RISK

Loan Review

34 Evaluate the inadequacies in the loan review process to determine the underlying cause.

35 Expand loan sampling in order to gain a better understanding of credit risk in the portfolio.

Allowance for Loan and Lease Losses (ALLL)

NOTE: Many of the factors necessary to determine an appropriate level of the ALLL may have already been reviewed within the CORE ANALYSIS section. Coordinate procedures with other team members to avoid unnecessary duplication.

36 Determine an appropriate ALLL level.

36 A Consider comparing the reported ALLL (after the deduction of all loans, or portions thereof, classified Loss) against the sum of the following amounts: (Note: Refer to interagency policy statement on the ALLL dated December 21, 1993.)

1. 50 percent of the portfolio that is classified Doubtful.
2. 15 percent of the portfolio that is classified Substandard.
3. For the portions of the portfolio that have not been adversely classified (including those loans designated Special Mention), estimated credit losses over the upcoming twelve months (based on the institution's average annual rate of net charge-offs experienced over the previous two or three years on similar loans, adjusted for current conditions and trends).

36 B Determine if the ALLL is sufficient to cover all of the following risks:

1. Any losses on loans accorded Loss classifications (in whole or in part) that have not yet been charged-off.
2. Estimated probable losses for all loans accorded Doubtful classifications (without partial Loss classification).
3. Estimated probable losses for all remaining adversely classified loans (without partial Loss or Doubtful classification).
4. Other problem loans (either individually or in pools).
5. Estimated probable losses for the remaining categories of loans in the portfolio.
6. Supplemental amount for unidentified loan portfolio losses.

36 C Consider the bank's loan loss history in aggregate and by loan type.

1. Calculate the average loan loss history for the past five years using gross loan losses to average total loans. (Data available from latest year-end UBPR).

2. Evaluate any aberrations in a specific year, and make adjustments needed for current conditions to arrive at a realistic average.
3. Consider migration analysis.

36 D Consider the average reserve coverage of non-performing loans by state, rating, and charter. (Note: Provided by the FDIC Regional Offices or FRB District Banks on a quarterly basis.)

36 E Consider the historical average of loan loss reserves to nonperforming loans for all banks in the region and nation. (Reserve coverage of nonperforming loans is typically higher for sound loan portfolios than those where problems exist. FDIC: Refer to FDIC Quarterly Banking Profile.)

36 F Estimate the potential loss exposure in classified and Special Mention loans.

36 G Consider the following factors to determine an appropriate percentage for nonclassified loans: (Note: If the bank uses a formula approach to determine reserve adequacy, it may be feasible to use the internal formula in arriving at the reserve requirements for non classified loans even though the overall system may be considered inadequate).

1. Degree of board or committee involvement, oversight, and control.
2. Expertise, training, and adequacy of loan staff.
3. Adequacy of loan policy and adherence to policy requirements.
4. Effectiveness of collection procedures.
5. Adequacy of renewal and extension policies.
6. Adequacy of charge-off policies.
7. Effectiveness of internal loan review function.
8. Adequacy of appraisal procedures.
9. Maintenance and analysis of financial information.
10. Adequacy of documentation (other than financial information).
11. Capitalization of interest.
12. Over reliance on collateral values.
13. Composition of the loan portfolio. (It may be appropriate to use different percentages for consumer, residential and commercial real estate, and commercial loans.)
14. Existence of self-dealing and insider transactions.
15. Level of classified loans and trend over past few examinations.
16. Level and trend of internally identified loan problems.
17. Level and trend of overdue and nonaccrual loans.
18. General economic considerations (local, state, regional, national).
19. Growth trends.
20. Entry into new areas of lending.
21. Extent of out-of-territory lending.
22. Adequacy of follow-up systems, etc.
23. Existence of off-balance sheet items (loan commitments, letters of credit).

PORTFOLIO QUALITY

General

37 Determine the reasons for the current level of asset quality problems.

37 A Evaluate the impact of local economic conditions on the loan portfolio.

37 B Determine if there are sectors of risk within the portfolio by either type of or concentrations of risk.

37 C Evaluate the impact of ineffective underwriting in new product areas on the level and severity of classifications or delinquencies.

37 D Determine that individual account officers as well as lending committees have appropriate lending authorities.

37 E Evaluate delinquency levels by individual account officer.

37 F Evaluate individual loan officers experience levels and expertise.

38 Based on the results of the above analysis, consider expanding the sample of loans (including off-balance sheet activities).

MANAGERIAL EFFECTIVENESS

Applicable Laws and Regulaions

39 Determine the cause of the violations or contravention to Statements of Policy and responsible party or parties. Consider the following items:

39 A Lack of familiarity with laws, regulations, or policy statements.

39 B Negligence.

39 C Misinterpretation.

39 D Willful disregard and noncompliance.

Credit Administration

40 Determine why collateral appraisals are not sufficient to support current loan advances.

41 Determine why management has not corrected identified deficiencies.

41 A Management overlooked these issues.

41 B Management is unfamiliar with prudent loan portfolio guidelines and procedures.

41 C Management is unwilling or unable to react to changing conditions.

42 Determine why loan losses are not recognized in a timely manner. Reasons for not recognizing losses in a timely manner include the following items:

42 A Lack of identification.

42 B Loss deferral motivated by earnings performance and bonus compensation.

42 C Loss deferral motivated by poor financial condition.

OTHER LOAN RELATED TOPICS

Other Real Estate

43 Determine if management's non-compliance with regulations or accounting pronouncements are due to oversight or a general disregard.

44 Compare expenses and income information contained in the appraisal with actual income and expenses of the income producing properties. Recalculate appraisal results using realistic assumptions, if necessary.

45 Investigate the deficiencies ientified in managing foreclosed real estate.

46 Expand file sampling as necessary to accurately determine the quality of ORE. Where appropriate, consider conducting on-site inspections to assist in valuation and classification.

Repossessions

47 Investigate the deficiencies identified in managing repossessed assets.

48 Expand file sampling as necessary to accurately determine the quality of repossessed assets. Where appropriate, consider physical inspections of these assets to assist in valuation and classification.

Non-Ledger Assets

49 Determine the underlying reasons for asset write-offs.

Loan Portfolio Management and Review: General

Impact Analysis reviews the impact that deficiencies identified in the Core and Expanded Analysis and Decision Factors have on the bank's overall condition. Impact Analysis also directs the examiner to consider possible supervisory options.

1 Determine the impact of noted deficiencies on the institution's capital, earnings, and liquidity, and assess the future impact on the institution if these deficiencies continue.

2 Assess the overall effectiveness of the organizations risk management practices in light of the identified deficiencies.

3 Determine the impact of an underfunded ALLL on the bank's capital accounts.

4 Determine the need for direct confirmation of loan accounts.

5 Determine the need for administrative and enforcement actions, formulate specific recommendations, and advise appropriate supervisors on the nature of the concerns. (FDIC: Field Office Supervisor, Regional Office.)

6 Discuss the possibility of administrative and enforcement actions with executive management and the board of directors.

7 Investigate the circumstances and facts surrounding apparent violations, prepare recommendations for Civil Monetary Penalties, Reports of Apparent Crime. (FDIC: Section 8 removal action, FRB: Administrative hearing.)