References to reputation risk have been removed from this booklet as of March 20, 2025. Removal of reputation risk references is identified by a strikethrough. Refer to OCC Bulletin 2025-4.

The grayed out text has been superseded by *Comptroller's Handbook* - Concentrations of Credit, dated December 2011

Overview: Lending Operations and Portfolio Risk Management

Lending is the principal business activity for most savings associations. The loan portfolio is typically the largest asset and the most predominant source of income. As such, it is one of the greatest sources of risk to an association. Lax credit standards, poor portfolio risk management, or poor internal controls can expose an association to excessive loss. Effective management of the loan portfolio and the credit function is fundamental to an association's safety and soundness.

The risks associated with any specific lending program or activity will depend in large part on:

LINKS

- Program
- Questionnaire: Lending Overview
- Questionnaire: Portfolio Diversification

- The extent to which the activity is in keeping with the strategic direction and risk capacity of the association
- How it fits in with the other activities of the association
- The adequacy of lending policies and procedures, underwriting and documentation practices, and pricing decisions
- Monitoring and reporting systems, and internal controls
- The experience and knowledge of staff
- Current and prospective market conditions
- Interest rates
- Financial condition of the association

Credit risk should be assessed across the entire loan portfolio and within the context of other noncredit related risks. A risk management system that provides the board of directors and management the ability to identify, measure, monitor, and control risks associated with an association's lending activities as a whole is essential and must be appropriate to the size, complexity, and risk profile of the association.

While this and other sections of this handbook focus largely on **credit risks** and risk mitigation factors for various types of lending programs, there are obviously a number of other risks associated with lending activities, such as interest rate risk, market risk, operational risk and compliance risk.

Management and the board of directors must ensure that lending activities are managed and evaluated in the context of the broad array of risks and their potential impact on the association's earnings and capital. For example, a loan portfolio that, although performing well financially, is riddled with operational or compliance problems (e.g. inaccurate truth in lending disclosures, deceptive marketing practices, RESPA problems) exposes the association to substantial legal, restitution, ~~and ultimately reputation~~ consequences.

This overview section presents guidance fundamental to all lending programs and overall loan portfolio and credit risk management. The subsequent sections and appendices provide comprehensive detail on prudent lending and risk management practices for specific lending programs. The sections completed during an examination will depend on the types of lending activity conducted at the association and the adequacy of portfolio risk management practices. This overview section might be the only one you use for the asset quality phase of the examination for some small or low-risk associations, or for completing the lending review during a risk-focused or targeted examination. However, you should consult with the examiner-in-charge (EIC) when making this determination.

In this overview section, we will focus primarily on the responsibilities of the board of directors and management in overseeing and managing the lending function of an association including:

- Strategic planning
- Portfolio diversification
- Lending policies:
  - Underwriting standards
  - Documentation standards
  - Credit administration
- Portfolio Risk Management:
  - Internal loan review
  - Management Information Systems
  - Internal controls

RESPONSIBILITIES OF THE BOARD OF DIRECTORS AND MANAGEMENT

Strategic Planning

The board of directors has the fiduciary responsibility for all of the activities of the association. The board is responsible for establishing the strategic direction and investment objectives of the association. An association's lending activities should be in keeping with the strategic direction of the association. When developing the lending strategies, the board and management should consider:

- The association's strategic plan and risk tolerances.
- The desired composition of the portfolio: loan product mix, portfolio diversification, loan quality goals, loan growth rates, etc.
- The association's defined and targeted market areas and market conditions within those areas.
- The size, financial condition and financial goals of the association.
- The expertise of its lending and credit administration as well as compliance personnel.
- Legitimate credit needs and nature of its community.

The board of directors is also responsible for establishing a lending framework and portfolio risk-management program consistent with the size, complexity, and risk profile of the association. Elements of a sound risk-management system include:

- Adequate board and management oversight.
- Adequate policies, procedures, and strategic lending goals including lending limits.
- Adequate portfolio monitoring, risk assessment, and management information systems.
- Comprehensive internal controls.

The board of directors relies on management to operate the association on a day-to-day basis. Thus, it must select a management team that is experienced and competent, and that will follow its guidance and directives.

Management is responsible for the day-to-day operation of the association and for implementing the policies established by the board in a manner consistent with safe and sound banking practices and in accordance with laws, regulations, and supervisory policies. Management is also responsible for providing timely and accurate reports to the board of directors, to OTS, and to any other applicable regulatory agencies, such as the SEC.

Portfolio Diversification

The board of directors should address diversification strategies as part of the strategic planning process, and its decision should be reflected in the board of directors' minutes, the association's lending and risk management policies, the annual budget, and the strategic business plan. A diversification policy should contain quantified goals and objectives that establish the composition of the loan portfolio mix and limits in dollar amount or percentage of assets for each loan type, category, or geographic area.

Loan portfolio diversification is a means of controlling and limiting overall credit risk. By prudently diversifying loans among different loan types, industries, borrower groups, and locations, the association can spread credit risk and limit losses that may arise from a regional economic recession, failure of a critical industry, or any factor affecting a group of loans having similar risk characteristics.

Limits and Guidelines for Concentrations of Credit

The board of directors should establish limits on and monitor the association's concentrations of credit. A credit concentration will typically relate to a key factor (such as a common industry or employer), and when weakness develops in that key factor, every individual loan in the concentration may be affected. Certain types of concentrations may be unavoidable (or even desirable, such as single-family mortgage loans in the association's primary lending area).

It is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.

To evaluate both the need for diversification and collectibility of an association's loan portfolio, management should be alert to indicators of weakness in the markets served. Management should also be alert for indicators of actual or potential problems in the individual projects or transactions financed.

Indicators of potential or actual difficulties in local markets and projects may include:

- Increase in unemployment.
- High or increasing vacancy rates in the area.
- Numerous similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).

- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buy-outs.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a local market, business, or project become more pronounced, problems with related credits may also surface.

In general, you should include in the Report of Examination concentrations that present a supervisory concern, for example, those that exceed 25 percent of core capital plus the allowance for loan and lease losses (ALLL) or two percent of total assets for undercapitalized associations. When loans have an especially high risk of loss, you should report lower levels of concentrations, such as ten percent of capital plus ALLL or one percent of assets. Moreover, it is generally a matter of supervisory concern if management does not properly identify and control concentration risks or does not report them to the board of directors.

Loans-to-One Borrower

Multiple loans, or a very large loan, to one borrower, related entities, or a common enterprise, are a form of credit concentration. OTS regulation 12 CFR § 560.93 establishes a general 15 percent of an association's unimpaired capital and unimpaired surplus limit on loans-to-one borrower or a related group of borrows. The loans-to-one borrower (LTOB) regulatory limitations are an important safety and soundness standard intended to prevent financial institutions from concentrating too great a portion of their assets in any one borrower. (For further information on the LTOB limits, exceptions, and additional requirements, consult 12 CFR § 560.93 of the OTS regulations.)

Aggregate Limits on Loans Outstanding

In addition to establishing controls for credit concentration risks, savings associations should establish procedures and guidelines to monitor and limit the total volume of loans outstanding (usually expressed relative to deposits, capital, or total assets), primarily to ensure adequate liquidity. In setting such guidelines, the association should consider various factors such as credit demand, the volatility of the deposit structure, and availability of alternative funding sources.

Limits and Guidelines for Purchasing Loans

Associations that purchase whole and/or participation loans must thoroughly review such loans prior to purchase or commitment. The association's loan policies should address the acquisition of purchased or participation loans, establish standards for review, and require that such loans meet the underwriting, documentation, and compliance standards applied to loans originated by the association. When purchasing loans, the association may rely on the stated written underwriting standards of the originating lender, provided it performs a due diligence review of the purchased portfolio that includes a review of the loan portfolio's performance as well as a review of a statistically valid and representative sample of individual loans within the portfolio.

Major loan purchases should have board of directors or designated loan committee authorization. In addition, the association should determine the financial health and capability of the selling institution, and if the selling party retains the servicing of the loan, the association should ensure that all contracts require the selling party to administer the loan in accordance with prudent industry standards, and enable the association to change servicers if performance is inadequate. Finally, the policy should consider establishing aggregate limits on the amount of loans purchased from any single outside source.

Loan Policies

An association's loan policies, and underwriting guidelines and procedures should communicate and support the strategic objectives for the portfolio. The loan policy is the primary means by which senior management and the board guide lending activities. Although the policy primarily imposes standards, it is also is a statement of the bank's basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the lending activities in a manner consistent with the bank's strategic direction. Loan policy sets forth standards for portfolio composition, individual credit decisions, fair lending and compliance management.

The board of directors and management should formulate lending policies that are appropriate for the size and complexity of the association's existing and planned lending operations, and ensure that the association has sufficient staff with the expertise to originate, service, and monitor the lending programs and loan portfolio. Lending policies must be specific and detailed enough to foster prudent and compliant credit practices.

If properly formulated, communicated to all lending personnel, and monitored, a well-structured and prudent lending policy will serve to guide, direct, and control the decisions of lending officers consistent with safe and sound and compliant lending practices. Because each association is unique, no single policy can best serve all associations; rather, each association should tailor its policy and procedures to its own needs and characteristics.

It is an unsafe and unsound banking practice for a savings association not to have written well-defined policies and procedures in place for the type and complexity of its lending activity. The lending policy should include a statement of the general credit philosophy of the association (referencing the importance of compliance with consumer credit protection laws and regulations), portfolio diversification objectives, underwriting standards, loan structure and documentation standards, loan administration policies, risk mitigation strategies, and requirements for an internal monitoring and reporting system. OTS requires general lending standards for all loans under 12 CFR § 560.1(b). In addition, 12 CFR § 560.100-101 requires associations to have written real estate lending standards. (Examination Handbook Section 212 covers the latter standards in detail.)

The association's lending standards should:

- Clearly state the board of directors' objectives for the composition and risk of the loan portfolio, including the types of investments to avoid or exclude.

- Apply to loan purchases and loan participations as well as to loans originated by the association for portfolio and/or sale. ***The association may not transfer the responsibility for risk analysis to another lender. The association assumes the risk of noncompliance with consumer protection laws and regulations by another lender when acquiring loans.***

- Establish a system of internal controls, monitoring, and reporting.

- State the types of management and board reports for monitoring the association's lending activities, including delinquency and asset classification reports.

- Undergo review by the board of directors at least annually to ensure that policy remains appropriate as loan performance, market conditions, and regulatory obligations change.

- Set forth the composition of the loan committee(s), the frequency of meetings, and loan approval responsibilities.

- Require the board to ratify all significant loans either prospectively or through a series of subsequent reporting events.

- Require that loan review or other monitoring personnel systematically review all credit portfolios for consistency with established lending policies, and regularly review problem credits, identify problem relationships in a timely manner, and initiate remedial action.

- Establish loan authorities and prudent officer lending limits. Moderate limits are generally established for individuals, based on the officer's position, experience, and tenure with the association. Higher lending limits are typically allowed for groups of officers or loan committees.

- Set forth underwriting requirements including the extent of financial information necessary for the type and risk of the loan, acceptable collateral limits and the means for securing a lien against the collateral, and credit file content requirements, such as loan offering sheets, records of officer, committee, and board approvals, business and guarantor credit reports, financial statements and analysis, and memoranda supporting and/or criticizing the credit.

- Establish loan administration procedures for the servicing, collection, charge-off, and foreclosure of loans and establish guidelines to ensure that charge-offs are taken in accordance with interagency standards. Establish effective collection policies and procedures to reduce lending risk and prevent loan losses.

- Establish policies and procedures for the use of automated underwriting and credit scoring systems.

- Address standards for loans made as exceptions to standard underwriting requirements, paying particular attention to fairness in underwriting exception practices.

- Establish effective loan product pricing strategies consistent with sound financial planning.

Underwriting Standards

An association's first defense against excessive credit risk is the initial credit-granting process. Sound underwriting standards are key. The association's lending policies and procedures should include prudent underwriting standards to mitigate and manage credit risk. The application of sound underwriting principles to the lending process is essential to a high-quality loan portfolio.

Underwriting standards should be in keeping with the types of loans being originated. The extent of the credit evaluation needed to support the lending decision should be commensurate with the size and complexity of the loans. In today's environment, the underwriting process for certain types of credit (e.g., single-family mortgage loans, automobile financing and credit cards) is often highly standardized, automated and largely driven by secondary market requirements. For single-family mortgages, credit evaluation is often based on the borrower's credit score, debt to income ratios and the loan to value ratio. More complex lending (e.g., commercial and income property, agricultural and large consumer loans) is often not standardized and requires careful evaluation and consideration of the borrower's ability and willingness to repay the loan. Prudently underwritten loans should reflect consideration of all credit evaluation factors relevant to the type of loan, including:

- The borrower's *capacity*, or income from the underlying property or business, to adequately service the debt. (Note that in certain lending programs, including small balance consumer loans, or well-secured, low-documentation residential loans, the lender may assess the ability and willingness to repay from the borrower's credit history, collateral, and other factors.) The capacity to successfully repay debt is a critical consideration. It is important that the lender have a clear understanding of the purpose of the loan and the source of repayment so that it can be structured in a way that is consistent with realistic prospects of repayment. For business loans, the lender may determine capacity from income statements, debt coverage ratios, or cash flow analyses. For consumer loans, the lender may assess capacity from debt-to-income ratios, where the borrower's total monthly obligations are compared with gross income. The lender may use other methods. For example, if a borrower has difficulty documenting income, but has performed well on other loans of similar size with the association or with other lenders, the lender may determine that the borrower has demonstrated capacity.

- *Capital* or the money a borrower has personally invested in the property or business. How much does the borrower have at risk? Savings associations should consider the amount of equity in the property, capital invested in the business, and/or subordinated financing invested in the property or business by the borrower, guarantors or other interested parties, such as government agencies and partnerships in many CRA related investments. The association should ensure that borrowers have sufficient capital and cash flow to repay the loan even during economic downturns. Small businesses are often thinly capitalized and illiquid and may not have access to external sources of capital. Very often, the small business must rely on borrowings, secured by equity in business assets or the personal assets of the business owner to finance growth or to assist the business through a difficult period. Associations are encouraged to find ways to accommodate the small business credit needs in their communities without exposing themselves to excessive credit risk.

- *Collateral* or guarantees as an additional form of security against the loan. Collateral is a secondary source of repayment for a loan should the borrower become unable to repay. Generally, lenders require collateral when the purpose of the loan is to purchase or refinance real estate, automobiles, recreational vehicles, or long-lived business assets. In general, the longer the term or the greater the size of the loan, the more likely and appropriate it is for the lender to require collateral. Often lenders will also require collateral for smaller, short-term loans when the borrower has not established or has only marginal credit. The association should appropriately consider any secondary sources of repayment, including any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or take-out commitments.

  The association's lending policy should include an explanation of when collateral is required as well as loan-to-value or margin requirements, what constitutes acceptable collateral, and the means for perfecting liens against various collateral types. The association should generally not rely on collateral liquidation as the primary source of repayment. The association should base loan term and amortization on the economic life of the asset being financed, and take into account market price variances, depreciation, condition, usefulness, and any technological and functional obsolescence.

  When collateral is necessary or prudent to support the loan decision, sound banking practices require that the association obtain an accurate valuation of the security property. An appraisal or evaluation of the primary collateral for real estate loans should be in accordance with 12 CFR § 564. The association should also document its perfected security interest and the insurance policies protecting the collateral (such as hazard insurance, hurricane, flood, business interruption, etc.).

- *Character* or the overall creditworthiness of the borrower. A positive assessment of the borrower's character or willingness to repay is essential in the underwriting process. The borrower's payment record on existing and previous loans with the association, his or her credit history in general and reputation in his or her business or industry or community all provide evidence of the borrower's character and willingness to repay the loan and should be documented in the loan file. For most consumer loans, character is generally documented by the borrower's credit report and credit score.

- The *conditions* surrounding the loan. What is the purpose of the loan? How will the proceeds be used? What are the key economic factors that could contribute to the success or failure of a loan's repayment? The credit analysis should reflect consideration of such external factors as: area income-level; employment trends; vacancy rates; the market for the products or services of a business; the customer base; competition; any competitive advantage or disadvantage the business may have; the likely effect of national and local economic conditions on continued employment or the success of the business; and other factors that affect the borrower's ability to repay the loan.

- Conformance with consumer protection and fair lending laws.

You should closely scrutinize from both a safety and soundness and compliance perspective any underwriting standard that gives consideration to credit factors that are not directly relevant to the borrower's ability or willingness to repay the debt. The lending policies should provide clear and measurable standards that enable the lending staff to determine whether the loans comply with the association's underwriting standards.

Underwriting standards should address the following items:

Loan Types

Specific departmental lending policies should outline borrower qualifications and documentation standards for each type of loan offered and should take into consideration the economic composition of its entire market area.

Maximum Maturities

The association should establish realistic repayment plans for loans, including maturities that relate to the anticipated source of repayment, the purpose of the loan, and the useful life of any collateral. For each type of loan, the lending policy should state the maximum number of months for amortization or the maximum length of time to maturity. The association may also develop specific procedures for unique situations. For example, when making a home improvement loan to a borrower on fixed income, the association could offer extended terms or a loan with a balloon payment and option to renew.

Loan Pricing

The association's loan pricing should reflect the association's cost of funds, overhead, credit risk premium, and a reasonable profit, yet must be at a level that is competitive in the market. It is not uncommon to see some lenders adequately estimate their cost of funds and losses, yet fail to estimate the true servicing costs of the loans. Pricing models should also take into account the high degree of variance in loan losses and servicing costs associated with higher-risk lending programs, including subprime. In making such an assessment, management must ensure that risk-based pricing is applied equitably and does not result in pricing based on a prohibitive basis under the fair lending laws and regulations.

Guarantees

The lending policy should include guidance for guarantees and endorsements. Support from financially responsible endorser/guarantors can be an important factor in assessing the credit risk of a loan.

Loan-to-Value Ratios

An association should establish internal loan-to-value (LTV) ratio limits for all types of secured loans, and apply those standards consistently. Loan performance data has shown that borrowers are more likely to repay their loans when they have equity in the property securing them. OTS has not established LTV ratio limit guidelines for non-real estate lending activities. The absence of such guidance, however, does not reduce the need for an association to follow safe and sound business practices by establishing prudent internal LTV ratio limits.

For real estate lending activities, LTV limits should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (Appendix to 12 CFR § 560.101). Section 212 of the Examination Handbook provides additional guidance on real estate related LTV ratio limits.

Exceptions to Lending Standards

Some approved loans do not comply with an association's written loan standards. Policy exceptions may be appropriate in certain instances; however, the reasons for the exceptions should be well documented in the loan file and approved by the board of directors, its delegates, or a committee thereof. Also, the board of directors is responsible for establishing standards for handling requests that do not meet articulated policy statements but are deemed worthy of consideration. Frequent exceptions to a policy may mean that the policy needs revision or may indicate the more serious problem of management's unwillingness or inability to follow established policy. You should scrutinize policy exceptions to ensure management is not exercising them in a manner inconsistent with sound lending practices, including fair lending laws and regulations. Policy exceptions that thwart or diminish legislative or regulatory mandated consumer protections are never appropriate.

Loan Documentation Standards

An effective loan approval process establishes minimum requirements for the information and analysis upon which a credit decision is based. It provides standards for the documents needed to approve new credit, renew credit, increase credit to existing borrowers, and change terms in previously approved credits. It is important that an association's loan policies include loan documentation standards to help ensure that underwriters and approving officials have the necessary information to make prudent credit decisions. Furthermore, a properly documented loan file is needed to enable internal loan review staff, external auditors, and examiners to readily ascertain the quality of the loan and whether it was underwritten in compliance with board-approved policies. The inability of an independent third party to ascertain the loan officer's reasoning for approving a loan often indicates poor credit management and may be an unsafe and unsound banking practice.

Section 560.170 requires that the association establish and maintain loan documentation practices that:

- Ensure that the association can make an informed lending decision and can assess risk on an ongoing basis.
- Identify the purpose and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the indebtedness in a timely manner.
- Ensure that any claims against a borrower, guarantor, security holders, and collateral are legally enforceable.
- Demonstrate appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

Lenders should establish procedures to ensure that adequate documentation, consistent with the size and complexity of each loan transaction, is obtained and maintained.

Lenders should establish procedures to ensure that it obtains and maintains adequate documentation, consistent with the size and complexity of each loan transaction. The association should tailor the documentation for the various types of loans they originate. Below is a partial list of documents that associations should include in the credit files for various loans. Although the documents listed are generally appropriate for prudent lending, a rigid requirement that all these documents be present for each loan is too restrictive and does not take into account other mitigating factors.

- **Loan application** – should include the purpose of the loan and the identity of any security property. The borrower should sign the loan application. If not, there should be some form of acceptable verification that the borrower requested the loan (e-signature, phone verification etc.). Certain mortgage-related loan applications require the collection of government monitoring information.
- **Promissory note** – evidence of the borrower's obligation to repay the loan, executed by the borrower or agent.
- **Deed of trust or mortgage for real estate loans** – evidence of the creation of a security interest in the real property for the benefit of the lender, signed by the borrower (or agent).
- **Valuation Report** – a report prepared by a qualified individual or firm independent of the borrower (which may include a bank employee or agent) that discloses an estimate of the market value of the security offered by the borrower as collateral for the loan as of a specific

date. For valuations on real estate loans, refer to Examination Handbook Section 208, Appraisals.

- **Financial Statement and Credit Report** – should include a written credit report prepared by one of the credit reporting agencies and the borrower should sign the financial statement. The documents should be current at the time of application. Up-to-date and accurate financial information on each borrower is essential:

  — For individual borrowers seeking personal credit, a credit report and a statement of gross income may be all that is necessary. Financial statements are often requested for larger consumer loans and mortgages. In such cases, the financial information should reflect the borrower's financial condition as of the day of application.

  — For individuals or businesses seeking financing for a commercial or business venture:

    - Audited annual financial statements should be the most current available.

    - Unaudited financial statements should be signed and dated by the principals as close to the date of commitment as possible, but in all cases, within six months of the application or commitment date.

    - Tax return statements must be for the most recent tax year.

    The board of directors should establish the amount or type of loan that requires audited financial statements. For large loans, the association should require audited financial statements or ensure that staff verifies pertinent information in unaudited financial statements. For example, if a business reports real estate as one of its primary assets, the lender should verify ownership, determine that the value stated on the financial report is reasonable and that there are no undisclosed liens on the property. Likewise, if inventory is a significant business asset reported on the borrower's unaudited financial statement, the lender should perform an inspection of the business premises and ask to see the most recent inventory and monthly inventory reports. The lender should also perform a Uniform Commercial Code (UCC) search to determine whether those assets have already been pledged. Of course, such steps are only necessary where the presence of such assets is an important consideration in the loan decision.

  — Associations should review several years of financial statements and compare income and assets between periods. Loan personnel should carefully scrutinize borrowers whose income fluctuates considerably and insist on up-to-date financial information.

- **Approval** – approval sheet or committee minutes showing the officer(s) or committee responsible for reviewing and approving the loan request, and establishing the terms and conditions of the approval.

- **Disbursement** – use of a "proceeds schedule" disclosing date, amount, purpose, and recipient of the loan proceeds.

- **Title Policy/Opinion of Title/Uniform Commercial Code filings/or other filings that are appropriate in the local jurisdictions in order to perfect the security interest** – affirming the description, validity, and priority of the lender's lien on the collateral taken as security for the loan, and any continuing filings required to maintain the association's lien position.

- **Settlement Statement/Disclosure Statement** – evidence proving that the lender provided the borrower, upon closing, an application, a loan settlement statement and disclosure statement(s) (as appropriate) setting forth in detail the charges or fees payable by the borrower to the lender and any legal rights the borrower may have with respect to those charges or fees and the transaction in general.

- **Record of Payment** – showing the status and current payment of taxes, assessments, insurance premiums, other charges on the security of the loan, and documentation for any loss (and subsequent recoveries) on the loan security by an insurance settlement.

- **Evidence of hazard, flood, and other insurance policies** – maintenance of appropriate insurance policies that will protect the association from loss in the event of damage to or destruction of the collateral securing the loan. All applicable policies should list the savings association as a loss payee.

- **Modifications** – evidence of any changes to the loan or original security interest with the appropriate approval of each party.

- **Collateral Release** – evidence of any portion of the collateral pledged to secure the loan, showing the portion released, consideration (if any), documentation that the required pay down has been collected and cleared, and appropriate officer approvals.

With any type of lending, experienced and competent legal assistance is particularly important in developing a lending operation. Likewise, engaging the services of a professional compliance officer at the outset of development of a lending operation will significantly reduce any risk of noncompliance and will enhance the association's ability to adjust loan programs in the future without running afoul of consumer protection laws and regulations.

Loan administration is perhaps one of the more complex areas of the association that requires strong management, experienced staff, and diligent oversight.

Properly executed legal documentation is critical in establishing and maintaining collateral liens, endorser/guarantor liability, and in working out problem credits through restructuring, liquidation, or rehabilitation of the credit.

Credit Administration

It is important that an association have a strong loan administration function, particularly when it is engaged in construction, nonresidential, or commercial lending. Loan administration includes loan closing and disbursement, payment processing, collateral administration and control, servicing and participation reports, and the timely receipt, review (both initially and ongoing, as needed), and follow-up of all borrower financial information.

Loan administration duties are much more involved for business, construction, and multifamily lending, so associations may have a separate loan administration department for these loans. Loan administration includes monitoring the borrower's periodic financial statements, determining ongoing collateral adequacy, and maintaining contact with the borrower to evaluate his condition and determine additional funding needs.

Loan administration is perhaps one of the more complex areas of the association that requires strong management, experienced staff, and diligent oversight. It is important that the association establish operating procedures and internal controls for the loan administration function in the following areas:

- Loan closing and disbursement; payment processing; escrow administration; and loan payoffs.
- Collateral administration and control, including type and frequency of collateral evaluations.
- Claims processing.
- Servicing and participation agreements.
- Type and frequency of financials statements reviews, including verification of information where appropriate.
- Segregation of duties (where appropriate).
- Collateral release; site inspections.
- Loan refinancing and modification procedures; collections and foreclosure procedures; and charge off and recovery policies.

Portfolio Risk Management: Internal Loan Review, Management Information Systems, and Internal Controls

Effective portfolio risk management requires managing credit risk across the loan portfolios, not just on a loan-by-loan basis. Effective risk identification starts with the evaluation of individual credits. Rating the risk of individual loans in timely credit evaluations is fundamental to loan portfolio management. The association should implement an internal loan review system to monitor the credit quality of the portfolio and compliance with or conformity to loan policies. The internal asset review (IAR) process should be separate and independent of the lending function. We discuss in detail the objectives and elements of effective internal loan review systems in Examination Handbook Section 260, Asset Classification, and Appendix A in Handbook Section 261, Allowance for Loan and Lease Losses.

To manage their portfolios, associations must understand not only the risks posed by individual credits but how the risks of individual loans, loan portfolio segments and the entire portfolio interrelate—and manage those risks accordingly. Effective loan portfolio risk management depends in large part on the quality of management information systems (MIS). Credit related MIS helps management and the board to fulfill their respective oversight roles. Considerations in effective management information systems are whether the right people are receiving the right information at the right time, and whether that information is up-to-date and accurate. Such information might include:

- Total loans and commitments by type, including new extensions, credit renewals and restructured credits.
- Loans in excess of existing credit limits.
- Aggregate exception tracking and reporting.
- Concentration or credit exposure monitoring reports (by type, geographic area, collateral, large employers, etc.).
- Delinquent and nonaccrual loans, and credits adversely graded.
- Stress testing results reports.
- Risk pricing models.
- Internal audit and loan review reports.

You should consider:

- Whether the association's risk monitoring practices and reports address all of its material risks.
- The appropriateness of key assumptions, data sources and procedures used.
- Accuracy and timeliness of reports to management and the board.

Another element of an effective portfolio risk management system is internal controls appropriate to the size and complexity of the association and the level of risk it accepts. The association should ensure that its lending operations are subject to strong internal controls (see discussion of Internal Controls in Examination Handbook Section 340).

Finally, an effective self-assessment compliance review program should verify that the association is complying with all applicable consumer protection laws and regulations.

SUPERVISORY REVIEW

You should assess to the extent to which the board of directors and management have in place the policies, processes and systems necessary to identify, measure, monitor, and control risk exposures within the loan portfolio. You should assess the extent to which management and the board of directors are able to evaluate and manage risk of individual credits, individual portfolios by loan type, and across the portfolio as a whole. The analysis of an association's lending operations and portfolio risk management should include a review of portfolio objectives and risk tolerance levels, portfolio diversification and concentrations, loan policies, loan administration practices, underwriting and documentation requirements, and internal credit portfolio risk systems, including internal asset review function, MIS and internal controls to evaluate the association's asset quality. Under a risk focused examination approach the degree of transactions testing should be reduced when internal risk-management processes are determined to be adequate or when risks are minimal. The maintenance of prudent written lending policies and effective internal systems and controls are essential to quality loan production. If an association has concentrations of credit, management should show a heightened degree of diligence in the review of controls and policies.

In evaluating the quality of an association's assets, follow the sampling guidelines in Examination Handbook Section 209. If the sampling review indicates significant asset quality concerns, it may be necessary to expand the review for one or more of the loan portfolios. Section 209 provides several sampling methods to limit the number of assets reviewed while mitigating sampling risks.

If further review is deemed necessary for any of the areas of lending, the sections in the Asset Quality chapter of this Handbook will guide you to perform an assessment of each of the association's lending activities, overall loan portfolio performance, and the adequacy of the ALLL.

You should also consider whether management has implemented an internal compliance review program that focuses on systems, monitoring, assessment, accountability, response, and training or a "SMAART" compliance review program. The SMAART framework is the cornerstone to assessing and managing compliance risk associated with an association's lending operations. (Refer to the Self-Assessment Guide and Examination Handbook Section 1100, Compliance Oversight Examination Program.)

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§1464(5)(c)(1)	Loans or Investments Without Percentage of Assets Limitations
§1464(5)(c)(2)	Loans or Investments Limited to a Percentage of Assets or Capital
§1464(5)(c)(3)	Loans or Investments Limited to 5 Percent of Assets

Code of Federal Regulations (12 CFR)

Part 560	Lending and Investment
§ 560.93	Lending Limits
§ 560.100-101	Real Estate Lending Standards
§ 560.160	Asset Classification
§ 560.170	Records for Lending Transactions
§ 561	Definitions
§ 563.41	Transactions with Affiliates
§ 563.43	Loans by Savings Institutions to their Executive Officers, Directors and Principal Shareholders
§ 563.170	Examinations and Audits; Appraisals; Establishment and Maintenance of Records
Part 564	Appraisals
§ 567.6	Risk-Based Capital

OTS CEO Memoranda

No. 137, Expanded Guidance for Subprime Lending Programs

No. 142, Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions

No. 222, Credit Risk Management Guidance for Home Equity Lending

Office of Thrift (OTS) Supervision Bulletins

RB 3b	Policy Statement on Growth for Federal Savings Institutions
TB 55a	Interagency Appraisal and Evaluation Guidelines
TB 70	Interagency Statement on Sales of 100% Loan Participations
TB 78	Classifying Commercial and Other Loans Under the HOLA
TB 79	Lending Limits Pilot Program

OTS Handbook Sections

Examination Handbook Section 1100, Compliance Oversight Examination Program

FFIEC Interagency Policy Statements

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (11/7/91)

Interagency Policy Statement on Credit Availability and Fair Lending Initiatives (06/10/93)

Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms (03/30/93)

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Specifies GAAP Accounting for Losses and Contingencies
No. 34	Capitalization of Interest Cost
No. 58	Capitalization of Interest Cost in Financial Statements that Included Investments Accounted for by the Equity Method
No. 66	Accounting for Sales of Real Estate
No. 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects
No. 91	Specifies GAAP Accounting for Loan Fees
No. 114	Accounting by Creditors for Impairment of a Loan
No. 118	Accounting by Creditors for Impairment of Loans-Income Recognition and Disclosure – an Amendment to SFAS No. 114
No. 144	Accounting for the Impairment and Disposal of Long-lived Assets

American Institute of Certified Public Accountants Pronouncements

Practice Bulletin 1, Exhibit I, "ADC Arrangement"

AICPA SOP No. 92-3, Accounting for Foreclosed Assets

Other References

Federal National Mortgage Institution Underwriting Guidelines

Compliance Regulatory References

Fair Credit Reporting Act: 15 USC 1681-1681(u)

Truth in Lending Act: 12 CFR Part 226; FRB Reg Z

Real Estate Settlement Procedures Act: 12 CFR Part 3500; HUD Reg X

Homeowners' Protection Act: 12 USC 4901-4910

Consumer Leasing Act: 12 CFR 213; 15 USC 1667

Flood Disaster Protection Act: 12 CFR Part 572

Fair Debt Collection Practices Act: 15 USC 1692

Unfair and Deceptive Acts: 12 CFR Part 535; 15 USC 45

Homeownership Counseling Procedures: 12 USC 1701x(c)(5)

Electronic Banking: FFIEC Interagency Guidance on Electronic Financial Services and Consumer Compliance

Advertising: 12 CFR 563.27; Part 328 FDIC

Fair Lending and Nondiscrimination: 12 CFR Part 528

Equal Credit Opportunity Act: 12 CFR Part 202; FRB Reg B

Fair Housing Act: 42 USC 3601 et. Seq.

Home Mortgage Disclosure Act: 12 CFR Part 203; FRB Reg C