Office of Inspector General

February 2008
Report No. AUD-08-005

FDIC's Consideration of Commercial Real Estate Concentration Risk in FDIC-Supervised Institutions

AUDIT REPORT

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Why We Did The Audit

The audit objective was to assess the FDIC's consideration of institution commercial real estate (CRE) risk management practices during its examination of institutions with identified CRE concentration risk.

Background

The FDIC is the primary federal regulator for over 5,200 state-chartered institutions. The FDIC's Division of Supervision and Consumer Protection (DSC) conducts risk management examinations of FDIC-supervised financial institutions.

Concentrations in CRE lending have been rising in FDIC-supervised institutions and have reached record levels that could create safety and soundness concerns at these institutions in the event of a significant economic downturn. CRE loans are land development and construction loans (including 1- to 4-family residential and commercial construction loans) and other land loans. The risk profile for a CRE loan is sensitive to the condition of the general CRE market (for example, market demand, vacancy rates, or rents).

In December 2006, the FDIC, in conjunction with the other federal banking agencies, issued joint guidance to financial institutions entitled, *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,* to reinforce sound risk-management practices regarding concentrations in CRE lending. DSC issued examiner guidance on CRE concentrations in the *Risk Management Manual of Examination Policies*.

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Audit Results

The DSC examiners considered institution CRE risk management practices during FDIC examinations of institutions with potentially significant CRE concentration risks. In particular, DSC examination work products for these examinations, including Pre-Examination Planning Memoranda and Reports of Examination (ROE), provided evidence that the examiners had considered the identified CRE concentration risks.

We also determined that under FDIC guidance, examiner use of a Concentrations page in the ROE for institutions that have potentially significant CRE and other loan concentrations is optional, including for institutions with identified CRE concentration risks. Examiner use of the Concentrations page for reporting potentially significant CRE and other loan concentrations is an important control for assuring that associated risk, if any, is considered by institution management and in the examination process. Further, the Summary Analysis of Examination Report (SAER), a tool DSC uses to ensure that the level of oversight accorded to an institution is commensurate with the level of risk it poses to the Deposit Insurance Fund, does not capture CRE concentrations as a separate category for tracking purposes. A key purpose of the SAER is to collect data from the examination for entry into the FDIC's examination database. Including CRE concentrations or adding a CRE concentrations line to the SAER would enable the FDIC to effectively capture and highlight CRE concentrations information and would provide a better means of updating the examination database.

The FDIC can increase DSC and institution management awareness of potentially significant CRE concentration risk and the cumulative effect of CRE and other loan concentrations on the risk profile of the institution through enhancements in the use of the Concentrations page and SAER.

Recommendations and Management Response

We recommend that the Director, DSC:

(1) Clarify guidance regarding the use of the Concentrations page in the ROEs for institutions with potentially significant CRE loan concentrations.

(2) Clarify the SAER instructions so that potentially significant CRE loan concentrations detected during the examination process are included, or add a line item to the SAER specifically for CRE concentrations.

DSC agreed with both recommendations and will clarify examiner guidance, by September 30, 2008, as DSC reviews and updates its risk management program.

To view the full report, go to www.fdicig.gov/2008reports.asp

Federal Deposit Insurance Corporation
3501 Fairfax Drive, Arlington, VA 22226

Office of Audits
Office of Inspector General

DATE: February 7, 2008

MEMORANDUM TO: Sandra L. Thompson, Director
Division of Supervision and Consumer Protection

/Signed/

FROM: Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: *FDIC's Consideration of Commercial Real Estate Concentration Risk in FDIC-Supervised Institutions* (Report No. AUD-08-005)

This report presents the results of our audit of the FDIC's consideration of commercial real estate (CRE) concentration risk in FDIC-supervised institutions. CRE loans are land development and construction loans (including 1- to 4-family residential and commercial construction loans) and other land loans.[1] The risk profile for a CRE loan is sensitive to the condition of the general CRE market (for example, market demand, vacancy rates, or rents). The objective of this audit was to assess the FDIC's consideration of institution CRE risk management practices during its examination of institutions with identified CRE concentration risk. We conducted this performance audit in accordance with generally accepted government auditing standards. Appendix 1 of this report discusses our audit objective, scope, and methodology in detail.

BACKGROUND

The FDIC is the primary federal regulator for over 5,200 state-chartered institutions that are not members of the Federal Reserve System. Under section 10(d) of the Federal Deposit Insurance Act (FDI Act), all FDIC-insured institutions are required to undergo on-site risk management examinations every 12-18 months, depending on asset size and bank performance, to assess the safety and soundness of the financial institution and help promote stability and public confidence in the nation's financial system. (Appendix 2 discusses the risk management examination process.) The FDIC's Division of Supervision and Consumer Protection (DSC) conducts risk management examinations of FDIC-supervised financial institutions.

[1] CRE loans also include loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third-party, nonaffiliated rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

Increase in CRE Loan Concentrations

CRE concentrations have been rising in FDIC-supervised institutions and have reached record levels that could create safety and soundness concerns in the event of a significant economic downturn. To some extent, the level of CRE lending reflects changes in the demand for credit within certain geographic areas and the movement by many financial institutions to specialize in this lending sector that is perceived to offer enhanced earnings potential. In particular, small to mid-size institutions have shown the most significant increase in CRE concentrations over the last decade.

DSC tracks FDIC-supervised financial institutions with potentially significant CRE concentration risk through its regional office management information groups or with the assistance of regional Division of Insurance and Research staff. DSC uses the ratio of CRE loans to total capital to identify individual institutions' CRE concentrations, which could represent increased risk to the safety and soundness of an institution. Specifically, if this ratio exceeds 300 percent, the institution is at risk of having potentially significant CRE concentrations, and heightened examination attention may be warranted. Reports of Condition (Call Reports) data showing the growth in CRE concentrations among FDIC-supervised banks are provided in Table 1.

Table 1: Percentage of FDIC-Supervised Institutions with CRE Loans/Total Capital Ratios >300%, by FDIC Region

Region	June-00	June-01	June-02	June-03	June-04	June-05	June-06
San Francisco	42.0	46.8	51.8	54.1	55.2	60.0	59.8
Atlanta	21.9	28.6	35.7	40.4	44.1	47.6	50.9
Chicago	12.6	15.3	20.1	20.8	24.8	28.2	30.4
New York	10.5	12.1	17.7	19.2	21.7	24.8	27.6
Dallas	11.5	13.3	15.9	17.7	20.4	22.8	24.8
Kansas City	7.4	8.1	8.8	10.2	12.2	14.7	17.1

Source: The FDIC's *Supervisory Insights*, Winter 2006, article entitled, *Examiners Report on Commercial Real Estate Underwriting Practices*.
Note: Data from June 2000 through June 2006 Call Reports.

Additionally, as of June 30, 2006, 1,626 institutions (31 percent) of the 5,240 FDIC-supervised institutions had CRE loan concentrations as detailed in Table 2 on the next page.

Table 2: Number of FDIC-Supervised Institutions with CRE Loan Concentrations

Region	Number of FDIC-Supervised Institutions	Institutions with a CRE Concentration*	Percentage
San Francisco	460	275	59.8
Atlanta	741	377	50.9
Chicago	1,088	331	30.4
New York	594	164	27.6
Dallas	989	245	24.8
Kansas City	1,368	234	17.1
Total	**5,240**	**1,626**	**31.0**

Source: The FDIC's *Supervisory Insights*, Winter 2006, article entitled, *Examiners Report on Commercial Real Estate Underwriting Practices*, and information obtained from DSC officials.
*These numbers have been extrapolated based on the percentages shown in the *Supervisory Insights* article.
Note: Data as of June 30, 2006.

Interagency Guidance

In December 2006, the FDIC, in conjunction with the other banking agencies,[2] issued *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (interagency guidance). This guidance was developed to reinforce sound risk-management practices regarding concentrations in CRE lending and acknowledges that the sophistication of an institution's CRE risk management process should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. The interagency guidance provides institutions a set of principles for heightening awareness of the following key elements in the risk assessment area:

- Board and management oversight
- Portfolio management
- Management information systems
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

Moreover, the guidance provides that an institution that (1) has experienced rapid growth in CRE lending, (2) has notable exposure to a specific type of CRE, or (3) is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or

[2] Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System.

- total CRE loans, as defined in the interagency guidance,[3] represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Examiners use these criteria as a preliminary step in identifying institutions that may have CRE concentration risk.

DSC Guidance

DSC's *Risk Management Manual of Examination Policies* (Manual) contains a section on concentrations. The Manual states that if CRE concentrations are an issue, examiners should make note of them in either the *Risk Management Assessment* (RMA) or *Examination Comments and Conclusion* (ECC) sections of the Report of Examination (ROE). The Manual also contains a sample Concentrations page that examiners could use in the ROE to summarize information on CRE and other concentrations in the institution's loan portfolio.

Pre-examination planning generally takes place off-site at the field office, where the Examiner-in-Charge (EIC) completes an analysis and review of the institution, contacts the institution for financial records and other pertinent information, and develops an examination work plan. During this planning stage, the EIC decides on areas that need special attention and work that will be done first. The EIC prepares a Pre-Examination Planning (PEP) Memorandum to document initial conclusions relative to the perceived risk an institution poses and the examination procedures that will be used. According to the PEP Memorandum instructions, the examiner will comment on any targeted risk area that requires additional examination resources, briefly discuss loan penetration strategies, and summarize discussions with management. As such, it is expected that the EIC would comment in the PEP Memorandum on (1) the institution's CRE loan concentrations, specifically if the interagency guidance criteria are met or exceeded; and (2) tests, if any, on risk management practices related to CRE concentrations.

RESULTS OF AUDIT

DSC examiners considered institution CRE risk management practices during FDIC examinations for 29 of the 30 FDIC-supervised institutions we sampled with potentially significant CRE concentration risks. For example, all but 1 of the applicable PEP Memoranda for examinations of the 30 institutions discussed CRE concentrations. Further, either the RMA or ECC sections of the ROEs for 28 of the 30 sampled

[3] The interagency guidance acknowledges that because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on an institution's lending activity but rather serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk.

institutions provided evidence that the examiners had considered the identified CRE concentration risks.

We also determined that under FDIC guidance, examiner use of a Concentrations page in the ROE for institutions that have potentially significant CRE and other loan concentrations is optional, including for institutions with identified CRE concentration risks. Examiner use of the Concentrations page for reporting potentially significant CRE and other loan concentrations is an important control for assuring that associated risk, if any, is considered by institution management and in the examination process. Further, the Summary Analysis of Examination Report (SAER), a tool DSC uses to ensure that the level of oversight accorded to an institution is commensurate with the level of risk it poses to the Deposit Insurance Fund, does not capture CRE concentrations as a separate category for tracking purposes. A key purpose of the SAER is to collect data from the examination for entry into the Virtual Information System on the Net (ViSION), the FDIC's examination database.[4] Including CRE concentrations or adding a CRE concentrations line to the SAER would enable the FDIC to effectively capture and highlight CRE concentrations information and would provide a better means of recording CRE concentrations information into the examination database.

The FDIC can increase DSC and institution management awareness of potentially significant CRE concentration risk and the cumulative effect of CRE and other loan concentrations on the risk profile of the institution through enhancements in the use of the Concentrations page and SAER.

EXAMINATION PROCESS CONSIDERS INSTITUTION CRE RISK MANAGEMENT PRACTICES

DSC examination work products, including the PEP Memoranda and ROEs for 29 of the 30 institutions we sampled[5] showed that DSC is considering institution CRE risk management practices during examinations of institutions with potentially significant CRE loan concentrations. We focused on these two work products because they document the key elements in scoping an examination and reporting examination results, respectively. Examiners addressed CRE concentrations in various sections of the specific work products we reviewed.

[4] ViSION provides automated support for many aspects of bank supervision, including safety and soundness examinations.

[5] One examination did not address CRE concentrations because the examiner miscalculated the ratio of CRE loans to Tier 1 capital during the pre-examination phase. Therefore, it appeared that the institution did not meet the significant risk threshold, and the examiner decided not to conduct examination steps to determine if the institution was potentially exposed to CRE concentration risk.

The PEP Memorandum

The purpose of the PEP Memorandum is to document examiners' initial conclusions relative to the perceived risk an institution poses and the examination procedures that will be used. All but one of the PEP Memoranda we reviewed indicated that examiners generally were aware of CRE concentrations through Real Estate Stress Test[6] scores and other off-site planning tools. Additionally, the PEP Memoranda showed that examiners had planned for testing institution risk management practices related to CRE concentrations. The PEP memoranda we reviewed contained information such as annual changes in CRE loan-to-capital percentages, anticipated loan penetration ratios, plans to review CRE loan underwriting practices, and plans to review diversity within the CRE loan portfolio.

ROE Information on CRE Concentrations

The purpose of the ROE is to factually present the institution's condition, identify problems, provide management with suggestions and recommendations, and present examination ratings. The ROE also documents the basis upon which the institution's composite rating was determined. We found that 28 of the 30 sampled ROEs contained evidence that the examiner had considered CRE concentration risk in the institutions in the course of risk management examinations. In most cases, the examiners considered key elements such as bank board and management oversight, loan portfolio management, or market analysis of CRE concentrations. For several of the examinations, examiners made specific recommendations to the institutions to implement certain risk management practices based on the interagency guidance. For the two remaining institutions sampled, we contacted the EICs to clarify the extent of the work performed on CRE concentrations. One EIC stated that she had reviewed CRE concentrations during the examination but did not identify any concerns. The other EIC did not cover CRE concentration risk during the examination as described earlier.

OPPORTUNITIES FOR IMPROVING CRE CONCENTRATION REPORTING AND TRACKING

Under current FDIC guidance, use of a Concentrations page[7] in the ROE for institutions that have potentially significant CRE loan concentrations is optional. Further, the SAER, which DSC uses to ensure that the level of oversight accorded to an institution is commensurate with the level of risk it poses to the Deposit Insurance Fund, does not capture CRE concentrations as a separate category for tracking purposes. Therefore, the FDIC can increase DSC and institution management awareness of potentially significant

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[6] The Real Estate Stress Test (REST) attempts to simulate what would happen to banks today if they encountered a real estate crisis similar to the early 1990s crisis in New England. REST uses statistical techniques and Call Report data to forecast an institution's condition over a 3- to 5-year horizon and provides a single rating from 1 to 5 in descending order of performance quality.

[7] The Concentrations page may include any type of concentration where a lack of diversification is cause for regulatory concern.

CRE concentration risk and improve tracking of CRE concentrations for FDIC-supervised institutions, in particular, those with CRE concentrations greater than 300 percent of total capital, through enhancements in the use of the Concentrations page and SAER.

DSC Guidance on the Concentrations Page

For the examinations we sampled, the examiners did not always include a Concentrations page in the ROEs for institutions that had potentially significant CRE concentrations. Rather, the examiners most often addressed CRE concentration risks in either the ECC or RMA sections of the ROEs. The optional Concentrations page was not completed in 16 of the 48 examinations we reviewed,[8] even though all of the institutions had been identified as having potentially significant CRE loan concentrations.

The *Risk Management Manual of Examination Policies* contains a sample Concentrations page that an examiner could use to report a possible absence of risk diversification within the institution's asset structure. The Manual states that the Concentrations page:

> . . . is informational and all concentrations listed should not automatically be subject to criticism. However, if the intent is to criticize management's diversification policies, the examiner should carry forward comments to the RMA page or, if warranted, to the ECC page.

The Manual does not require the examiner to include the Concentrations page in the ROE. Nevertheless, the Manual does state, "List any concentration in the <u>25 percent</u> category if elevated risk is evident and/or it supports examination findings." [Emphasis added.]

Additionally, the concentration categories in the Manual's sample Concentrations page are not specific to CRE lending. The Manual defines individual concentrations as those aggregating 25 percent or more of Tier 1 Capital and industry concentrations representing 100 percent or more of Tier 1 Capital. The Manual also states:

> . . . in determining whether a group of related obligations comprises a concentration, remember concentrations by their nature are heavily dependent upon a key factor (for example, financial capability, management, source of revenue, industry, or collateral support). If a weakness develops in that factor, it could not only adversely affect the individual obligation(s) in the concentration, but it could also impact the institution's capital position.

In contrast to the Manual guidance, the interagency guidance heightens the awareness of and risks associated with CRE loan concentration growth and exposure. Specifically, when total CRE loans, as defined in the guidance, approach or exceed 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased 50 percent or more during the prior 36 months, the interagency guidance calls for further supervisory analysis of the level and nature of an

[8] To collect additional data on examiners' use of the Concentrations page, we expanded our sample from 30 to 48 examinations. Our sampling methodology is discussed in Appendix 1.

institution's CRE concentration risk. DSC may want to consider a more robust control process that warrants the consistent use of the Concentrations page in the ROE.

One FDIC regional office has already established such a control process. In January 2005, the San Francisco Regional Office issued a memorandum entitled, *Concentration of Credit in Commercial Real Estate Examination Methodologies and Best Practice,* requiring examiners to use the Concentrations page in the ROE when institutions have a CRE concentration. According to this memorandum, "CRE-related concentrations can be segregated as a sector and reported as such on the Concentrations page in the ROE. One benefit of such an approach is that bank management will more easily be able to identify, measure, monitor, and report the existence and market-related information by these industry sector categories."

The other DSC regions do not have a similar requirement because the Manual states that using the Concentrations page in the ROE is not mandatory. When a Concentrations page was included in the ROE for some examinations that we sampled, some pages listed, for example, the institution's controls for mitigating CRE concentration risk, while other Concentrations pages only recorded the concentration total and the amount as a percentage of Tier 1 Capital. For some of the other sampled examinations, additional information on the institution's risk management practices for the CRE loan concentration was included in either the ECC or RMA sections of the ROE. We agree with the approach taken by the San Francisco Regional Office. Consistent examiner use of the Concentrations page for reporting potentially significant CRE and other loan concentrations is an important control for assuring that associated risk, if any, is considered by institution management and in the examination process.

CRE Concentrations in the Summary Analysis of Examination Report (SAER)

The SAERs, which capture concentration information for supervisory purposes, were inaccurate or incomplete for 16 of the 48 institutions we sampled that had potentially significant CRE loan concentrations. Specifically, examiners did not effectively use two line items in the report--item 57, *Number of Concentrations*, and item 58, *Concentration/ Tier 1 Capital*--to effectively identify CRE concentration risk in ViSION.

The purpose of the SAER is to collect data from the examination for entry into ViSION, thereby providing an historical record of an institution and briefly summarizing examination findings. The case manager, who oversees the bank examination program, uses the SAER as a tool to ensure that the level of regulatory oversight accorded to an institution is commensurate with the level of risk it poses to the Deposit Insurance Fund.

Specifically, the SAER instructions[9] state that for line item 57, *Number of Concentrations*, and line item 58, *Concentration/Tier 1 Capital*, the examiner is to "obtain this number and ratio from the Concentrations page" of the ROE. The instructions also state that:

> There must be an entry for each line item. In cases where no data is generated for a particular line item, a clear distinction between zero and NA (Not Available) is made. In those circumstances where the line item of information does not exist or is irrelevant to the institution, make the entry a zero…. When the line item of information is unavailable because the Report schedule is not included in the Report; make the entry an NA. When the line item of information is readily available but the related examination schedule is not included in the Report, the item of information may still be entered.

We initially sampled ROEs for 30 institutions with potentially significant CRE loan concentrations and found that in 12 cases, the concentrations data for line items 57 and 58 of the SAER were either inaccurate or incomplete. Specifically, the EIC had recorded a zero in those line items for all 12 institutions. According to the SAER instructions, this means that concentration data either did not exist or were irrelevant. We expanded our sample to include 18 additional ROEs and identified 4 more cases where the SAER concentrations information was inaccurate. We also noted that the concentration line items in the SAER relate to all concentrations identified during the examination and that the current form of the SAER does not accommodate capturing CRE concentrations as a separate identifiable category. As such, there is no specific place to highlight or track CRE concentrations.

According to the SAER instructions, the examiner is to obtain the information for line items 57 and 58 from the Concentrations page of the ROE. We found that in 16 of the 48 ROEs we sampled, the Concentrations page was not used. Additionally, in 12 of these cases, concentrations information was not recorded correctly into the SAER. Further, in 4 of the 32 cases where a Concentrations page was in the ROE, the information was not transferred to the SAER (see Table 3 on the next page).

[9] In April 2005, Regional Director's Memorandum, Transmittal No. 2005-011, *DSC Risk Management Manual of Examination Policies*, no longer required that the SAER be a page in the ROE. However, examiners use the General Examination System (GENESYS), which automates the preparation of the ROE. GENESYS generates SAER information and uploads the SAER data directly to ViSION at the conclusion of each examination.

Table 3: Concentrations Page and SAER for 48 Institutions with Potentially Significant CRE Concentrations

Concentrations Page in the ROE		Entries on the SAER			
		Line Item 57		Line Item 58	
Yes	32	Yes	28	Yes	27
		No	4	Yes	5
Subtotal			32		32
No	16	Yes	4	Yes	4
		No	12	No	12
Subtotal			16		16
Total	**48**		**48**		**48**

Source: OIG analysis of Concentrations page and SAER entries for our sample.

A key purpose of the SAER is to collect data from the examination for entry into the examination database. Including CRE concentrations or adding a CRE concentrations line to the SAER would enable the FDIC to effectively capture and highlight CRE concentration information and would provide a better means of recording CRE concentrations information into ViSION, the examination database. Accordingly, the FDIC can increase DSC and institution management awareness of potentially significant CRE concentration risk and the cumulative effect of CRE and other loan concentrations on the risk profile of the institution through enhancements in the use of the Concentrations page and SAER.

Recommendations for Improving CRE Concentration Reporting and Tracking

We recommend that the Director, DSC:

(1) Clarify guidance regarding the use of the Concentrations page in the ROEs for institutions with potentially significant CRE loan concentrations.

(2) Clarify the SAER instructions so that potentially significant CRE loan concentrations detected during the examination process are included, or add a line item to the SAER specifically for CRE concentrations.

CORPORATION COMMENTS AND OIG EVALUATION

On January 30, 2008, the Director, DSC, provided a written response to a draft of this report. DSC agreed with both recommendations and will clarify examiner guidance, by September 30, 2008, as DSC reviews and updates its risk management examination program. DSC's response is presented in its entirety as Appendix 3 of this report.

DSC's actions are responsive to our recommendations. A summary of management's response to the recommendations is in Appendix 4. The recommendations are resolved but will remain open until we have determined that agreed-to corrective actions have been completed and are effective.

OBJECTIVE, SCOPE, AND METHODOLOGY

Objective

The objective of this audit was to assess the FDIC's consideration of institution CRE risk management practices during its examination of institutions with identified CRE concentration risk. We conducted this performance audit from August through November 2007 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Scope, Methodology, and Internal Controls

To obtain an understanding of the information FDIC examiners collect and analyze for risk management examinations, we reviewed relevant FDIC and DSC policies and guidelines, including:

- DSC's *Risk Management Manual of Examination Policies;*
- Regional Directors Memorandum 2003-059, *Commercial Real Estate Review Package;*
- Regional Directors Memorandum 2006-038, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*; and
- Regional Directors Memorandum 2007-013, *Frequently Asked Questions for CRE Concentration Guidance*.

We performed our initial work in DSC's Dallas Field Office, where we reviewed pertinent DSC examination reports and supporting work papers for three financial institutions with potentially significant CRE loan concentrations. Also, we interviewed the Dallas Field Office Supervisor, a senior examiner, and an EIC, all of whom had responsibility for reviewing and approving examiners' work papers and finalizing ROEs.

We discussed the interagency guidance, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, with DSC management officials and OIG legal counsel. We also discussed the results of our Dallas Field Office work concerning institution CRE lending practices with DSC management. We then focused our subsequent audit work on reviewing key DSC internal examination controls that address bank CRE lending practices. Specifically, we reviewed examiner use of the PEP Memorandum, in which the EIC would be expected to comment on the institution's CRE concentration risks before beginning the actual on-site examination, and the subsequent FDIC ROE. In addition, for two examinations in our sample, we contacted EICs to either clarify or expound on the information we deemed necessary to conclude on our objective.

We obtained from DSC a nationwide listing of 413 FDIC-supervised institutions that met the criteria for having a potentially significant exposure to CRE concentration risk as well as a completed risk management examination between January 1, 2007 and August 31, 2007. We used sampling software[10] to obtain a random sample of 60 institutions. Based on discussions with OIG management, we chose an initial sample size of 30 institutions to review. We selected the 30 institutions from the random listing, in order of generation, eliminating only those institutions for which the state supervisor had conducted the examination and those for which DSC could not yet provide the finalized report. After determining that there were inconsistencies in the use of the Concentrations page and inaccuracies with the SAER concentrations data, we expanded our sample within the universe of 60 institutions and selected 18 additional institutions to review. Hence, our expanded review of Concentrations page and SAER data involved a sample size of 48 ROEs.

We performed our audit work at the FDIC's Headquarters offices in Washington, D.C., and the Dallas Regional and Field Offices in Dallas, Texas.

Reliance on Computer-processed Information

For purposes of the audit, we did not rely on computer-processed information to support our findings, conclusions, or recommendations. Our assessment centered on reviews of PEP Memoranda and ROEs. We determined that information system controls were not significant to our audit objectives. Accordingly, we did not consider it necessary to develop procedures to assess those controls.

Prior Audit Coverage

In January 2003, the OIG previously reported on examiners' assessments of CRE loans.[11] The OIG determined that examiners could have better assessed appraised value and cash flow for the examinations we reviewed. Specifically, examiners were not consistently (1) using the lesser of the acquisition cost or appraised value to compute the loan-to-value (LTV) ratios, (2) using new financial information to update old appraisal assumptions, and (3) documenting the results of their review of appraisals. Incorrect computation of the LTV ratio and reliance on outdated financial information can cause potential losses to the institution to go undetected. Because the examiners' documentation of performed procedures varied significantly for each loan, it was often difficult to ascertain the supporting logic for examiner conclusions.

Also, for some of the loans we reviewed, there was no evidence on the examiners' loan line sheets that a cash flow analysis had been performed. We also observed many cases where banks did not obtain current financial statements from borrowers. Omission of the cash flow analysis or the use of outdated financial statements in the assessment of cash flow may leave the examiner with insufficient or misleading information for classifying the loan.

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[10] Audit Command Language (ACL) is a data extraction and analysis product used in the audit profession.
[11] OIG Audit Report No. 03-008 entitled, *Examiner Assessment of Commercial Real Estate Loans*.

Additionally, in December 2002, the OIG reported on examiners' assessments of high-loan growth institutions.[12] For the 15 safety and soundness examinations that we reviewed, DSC examiners' loan review process for institutions that had experienced a significant level of loan growth was not sufficient in identifying risk. Specifically, examiners were not always (1) targeting new loans for sampling purposes and reporting on the level of new loans reviewed, (2) assessing or commenting on the loan quality of newly originated loans, and (3) assessing the internal loan risk rating process at institutions based on a methodology that incorporates a review of non-adversely classified loans. As a result, there was insufficient assurance that examiners were consistently performing a comprehensive review and analysis of newly originated loans in high loan-growth institutions.

Compliance with Laws and Regulations

The FDIC Rules and Regulations, Part 365, *Real Estate Lending Standards,* Appendix A, prescribe standards for real estate lending to be used by insured state nonmember institutions in adopting internal real estate lending policies. The regulations state that each insured state nonmember bank shall adopt and maintain written policies that establish appropriate limits and standards for extensions of credit that are secured by liens on, or interests in, real estate. In addressing our audit objective, we did not specifically test for compliance with Part 365; however, no specific violations came to our attention besides those violations reported in the ROEs.

Government Performance and Results Act and Fraud and Illegal Acts

The Government Performance and Results Act of 1993 directs Executive Branch agencies to develop a strategic plan that sets performance goals and objectives for agency management. In fulfilling its primary supervisory responsibilities, the FDIC pursues two strategic goals: (1) FDIC-supervised institutions are safe and sound, and (2) consumers' rights are protected and FDIC-supervised institutions invest in their communities. Moreover, there is one strategic objective related to our audit: FDIC-supervised institutions appropriately manage risk.

In its *2007 Annual Performance Plan*, the FDIC has a strategic goal to ensure FDIC-supervised institutions are safe and sound and a strategic objective that FDIC-supervised institutions appropriately manage risk. To accomplish that objective, the FDIC has an annual performance goal to conduct on-site risk management examinations to assess the overall financial condition, management practices and policies, and compliance with applicable laws and regulations of FDIC-supervised institutions.

We did not perform specific audit tests for fraud or illegal acts as part of this assignment. However, throughout the audit, we were sensitive to the potential for fraud and illegal acts, and no indications of fraud or illegal acts came to our attention during the audit.

[12] OIG Audit Report No. 03-009 entitled, *Examiner Assessment of High-Loan Growth Institutions*.

RISK MANAGEMENT EXAMINATION PROCESS

The purpose of conducting risk management examinations is to assess an institution's overall financial condition, review management practices and policies, monitor adherence with banking laws and regulations, review internal control systems, identify risks, and uncover fraud or insider abuse. This examination process is articulated in DSC's *Risk Management Manual of Examination Policies.* The overall outcome is the CAMELS/Composite rating for a particular financial institution. The components of the CAMELS rating are **C**apital, **A**sset quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to market risk. There are individual component ratings and a composite score (which is not an arithmetic average) that denotes overall condition and is used, in part, to determine deposit insurance premiums. The CAMELS rating system is used by regulators to assess soundness of individual institutions, to identify institutions requiring special supervisory attention, and to monitor industry trends. The CAMELS rating drives the examination procedures.

The FDIC's risk management safety and soundness examinations consist of three parts: pre-examination planning, on-site examination, and completion of the ROE. Pre-examination planning generally takes place off-site at the field office, where the EIC completes an analysis and review of the institution, contacts the institution for financial records, and develops an examination work plan. During this stage, the EIC decides on areas that need special attention and on the work that will be done first. The EIC prepares a PEP Memorandum to document the initial conclusions relative to the perceived risk an institution poses and the examination procedures that will be used. Examination instructions tell the examiner to summarize significant discussion topics, such as risk areas, management's concerns regarding economic conditions, and any other data meaningful to the examiner's efforts to allocate examination resources. Also, the PEP Memorandum should mention targeted risk areas, specifying areas with more than normal risk to which the examiner intends to devote additional or "above-normal" examination resources; and the proposed loan scope, with emphasis on risk areas within the portfolio where loan file review will be concentrated.

Once on-site at the institution, the examiners concentrate on the institution's asset quality, financial condition, and operations. The examination team also evaluates the institution's adherence to banking laws and regulations, the adequacy of the institution's internal controls and procedures, and the capability of management reporting systems to provide reliable and accurate data.

Finally, the ROE factually presents the institution's condition, identifies problems, provides management with suggestions and recommendations, and discloses the examination ratings. The ROE, in other words, documents the results of the examination and the basis on which the composite rating was determined. This report is a confidential document shared only with the institution's senior management and board of directors, and its contents can be disclosed only with the FDIC's authorization.

CORPORATION COMMENTS

FDIC

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990
Division of Supervision and Consumer Protection

January 30, 2008

TO: Russell A. Rau
Assistant Inspector General for Audits

FROM: Sandra L. Thompson
Director

SUBJECT: Response to Draft Report Entitled:
FDIC's Consideration of Commercial Real Estate Concentration Risk in FDIC-Supervised Institutions **(2007-029)**

The Division of Supervision and Consumer Protection (DSC) has received and considered the draft report entitled *Consideration of Commercial Real Estate Concentration Risk in FDIC-Supervised Institutions* (Draft Report) prepared by the FDIC's Office of Inspector General (OIG). The Draft Report indicates that FDIC examiners are effectively assessing institution commercial real estate (CRE) risk management practices in institutions with identified CRE concentration risk. DSC has well-developed procedures for evaluating CRE concentration risk from both an off-site surveillance and on-site supervision perspective. The OIG review found DSC work products evidence that examiners identified CRE concentration risk in pre-planning memorandums and in Reports of Examination (ROE).

The Draft Report contains two recommendations, which are discussed below. DSC agrees with both recommendations and will provide clarification to examiners on these points by September 30, 2008, as we review and update the risk management examination program.

OIG Recommendations

1. **Clarify guidance regarding the use of the Concentrations page in the ROE for institutions with potentially significant CRE loan concentrations.**

During bank examinations, DSC uses the ROE's Concentrations Page to highlight significant bank exposures to CRE in relation to Tier 1 Capital. This report schedule is informational, and is intended to be flexible so that examiners can exercise judgment whether to include it in ROEs. In practice, examiners have discretion to determine how concentrations should be illustrated. Simply noting the existence of a bank's concentration in CRE loans may be helpful in supporting examination findings; however, more granular concentration data on exposures to certain industries, geographic areas, single repayment sources, or CRE category types (construction, residential, office, retail, industrial, owner-occupied, etc.) can provide significant insight for the ROE audience. By September 30, 2008, DSC will clarify its guidance to examiners regarding the use of the Concentrations page in the ROE for institutions with potentially significant CRE loan concentrations.

2. **Clarify the Summary Analysis of Examination Report (SAER) instructions so that potentially significant CRE loan concentrations detected during the examination process are included, or add a line item to the SAER specifically for CRE concentrations.**

Currently, the SAER instructions provide examiner discretion in specifying the concentrations that should be listed. It is worth noting that from an off-site monitoring and pre-examination perspective, FDIC relies more heavily on quarterly Call Report data to track CRE concentrations and contacts with the bank than on the prior examination's SAER. The value of the information contained in SAER may, however, increase during a more difficult and transitional environment for commercial real estate markets. By September 30, 2008, DSC will clarify the SAER instructions so that potentially significant CRE loan concentrations detected during the examination process are included, or add a line item to the SAER specifically for CRE concentrations.

MANAGEMENT RESPONSE TO RECOMMENDATIONS

This table presents the management response on the recommendations in our report and the status of the recommendations as of the date of report issuance.

Rec. No.	Corrective Action: Taken or Planned	Expected Completion Date	Monetary Benefits	Resolved:[a] Yes or No	Open or Closed[b]
1	DSC will clarify its examiner guidance regarding the use of the Concentrations page in the ROE for institutions with potentially significant CRE loan concentrations.	September 30, 2008	$0	Yes	Open
2	DSC will clarify the SAER instructions so that potentially significant CRE loan concentrations detected during the examination process are included or will add a line item to the SAER specifically for CRE concentrations.	September 30, 2008	$0	Yes	Open

[a] Resolved – (1) Management concurs with the recommendation, and the planned corrective action is consistent with the recommendation.
(2) Management does not concur with the recommendation, but planned alternative action is acceptable to the OIG.
(3) Management agrees to the OIG monetary benefits, or a different amount, or no ($0) amount. Monetary benefits are considered resolved as long as management provides an amount.

[b] Once the OIG determines that the agreed-upon corrective actions have been completed and are effective, the recommendation can be closed.