Office of Thrift Supervision - West Region

March 21, 2008

Regional Bulletin: 08-04

Credit Risk Management

Dear Chief Executive Officer:

SUMMARY

The current economic environment presents significant challenges, particularly in the area of credit quality and asset management. In many parts of the West Region, we are seeing declining home prices and real estate values, growing inventories of unsold homes, and increasing delinquencies, non-performing assets, and real estate owned. We have received many questions about OTS's expectations for thrift institution Boards of Directors and management in these areas.

We expect thrift institutions to have the appropriate processes and systems in place to identify emerging risks and to manage and service any increase in the level of problem assets. Effective risk management of the loan portfolio and the credit function is fundamental to an institution's safety and soundness. To assist thrift institutions with their management of credit risk, OTS has issued a significant amount of national guidance in this area. This guidance can be located in sections of the OTS Examination Handbook including:

- 201, Overview: Lending Operations and Portfolio Risk Management
- 212, One- to Four-Family Residential Real Estate Lending
- 213, Construction Lending
- 251, Real Estate Owned and Repossessed Assets
- 260, Classification of Assets

Additionally, the OTS has issued a number of CEO Letters referencing both interagency and stand alone OTS guidance relating to credit risk including:

- 261, Loss Mitigation Strategies for Servicers of Residential Mortgages (September 4, 2007)
- 257, Statement on Subprime Mortgage Lending (July 10, 2007)
- 256, Interagency Guidance on Nontraditional Mortgage Product Risks (April 27, 2007)
- 255, Statement on Working with Mortgage Borrowers (April 17, 2007)
- 252, Office of Thrift Supervision Guidance on Commercial Real Estate (CRE) Concentration Risks (December 14, 2006)
- 222, Credit Risk Management Guidance for Home Equity Lending (May 16, 2005)

We support the vital role that thrift institutions play in meeting the credit needs of their communities in a safe and sound manner. This Bulletin serves as a timely reminder of good practices in credit risk management.

DISCUSSION

In light of the current housing and economic environment, institutions may need to increase attention towards business planning, risk analysis and monitoring, account management, and problem asset management.

Risk Analysis and Monitoring – Thrift institutions should have effective systems in place to analyze, monitor, and manage portfolios for adherence to underwriting standards and the early detection and monitoring of problem assets. Examples of items to monitor include:

For all loans:

- Credit concentrations (e.g., geographic, borrower/developer, common industry, employer, riskier products.)
- Pre- and post-closing quality control reviews to ensure adherence to underwriting standards.
- Undisbursed credit lines.
- Exposure to third-party mortgage insurers.
- Exposure due to recourse obligations.
- Lender liability.
- Risk layering.
- Collateral value.
- Demographic indicators, including unemployment levels in geographic lending areas.
- Economic indicators such as interest rates, consumer spending patterns, and lending trends.

For loans secured by 1-4 single family residences:

- Production and portfolio trends by product, loan structure, originator channel, credit score, loan-to-value (LTV), debt-to-income (DTI), lien position, documentation type, owner/investor, market, and property type.
- Delinquency and loss distribution trends by product and origination channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI).
- Vintage tracking.
- Performance of third-party originators (brokers and correspondents).
- Market trends by geographic area and property type to identify areas of rapidly changing housing values.
- Recast schedules for Pay Option ARMs.

For loans secured by income properties:

- Rent rolls, periodic operating statements, and property inspections.
- Borrower and guarantor financial condition.
- Current and projected operating expenses for different types of properties.
- Valuation trends.

For construction and development projects:

- Current and projected vacancy, construction, and absorption rates.
- Global borrower cash flow on all unfinished projects.
- Inspection progress reports.
- Current and projected lease terms, rental rates, and sales prices, including concessions.

Also, consider increasing the frequency of internal asset reviews for income properties, construction, and development loans, particularly if a loan or group of loans have higher risk characteristics (i.e., located in a deteriorating real estate market, borrower has other problem loans with institution, etc.)

As appropriate, stress test analysis should be utilized and address the following: increased delinquency rates; current LTVs (e.g., using automated valuation models); real estate value declines; interest capitalized; and changes in economic indicators (e.g., rental rates, commercial property vacancy trends, bankruptcy levels, unemployment rates, etc.)

<u>Business Planning</u> – The Board in conjunction with management should ensure that the institution's current business plan reflects current market risks and that the institution has appropriate policies and procedures relating to:

- Product types offered. Determine if changes are needed to product types offered and asset mix.
- Underwriting standards. Review underwriting standards in light of risk tolerance and consider whether standards such as loan-to-value ratios (LTVs), debt-to-income (DTI) requirements, credit scores, documentation standards, cash equity requirements (especially for land/construction/development loans), and risk layering are appropriate.
- Concentration limits. Review and update risk concentration limits as appropriate in light of changing circumstances.
- Quality and frequency of asset reviews. Ensure appropriate early warning systems are in place to timely identify problem assets. Consider expediting review timeframes for problem loans and those in significantly stressed markets.
- Appraisal standards. Ensure appraiser independence, conduct in-house review of outside appraisers, and confirm licensing and quality.
- Third party originations. Ensure appropriate policies and procedures are in place for brokers and correspondents including verifying licensing requirements are met, conducting background checks, implementing appropriate quality control standards, and monitoring loan performance.

- Capital support. Ensure appropriate strategies are in place to maintain capital levels and ratios commensurate with the institution's risk profile.

Account Servicing – Management should evaluate the effectiveness of credit management processes considering the current economic environment, including:

- Develop a matrix of early warning signals or triggering events and have a plan for addressing them.
- Establish criteria for changes in loan terms (e.g., line amount, renewal period, minimum payment amount, payment timing), including account freezing/termination. Ensure the established criteria are based on economically supportable factors and are not discriminatory. If revised criteria impact a broad spectrum of accountholders, ensure the criteria is based on economically supportable factors.
- Maintain compliance with consumer protection regulatory requirements, such as Regulation Z and Regulation B, if home equity lines are reduced or terminated.

Problem Asset Management – Management should establish loss mitigation strategies while enhancing, if necessary, systems and controls to manage increasing asset quality problems, including:

- Maintaining staffing levels and experience sufficient to handle the level of problem assets (i.e., servicing staff for increased delinquencies and asset management staff for loan modifications, real estate owned (REO), and loans in foreclosure.)
- Designating criteria for various loan modification options and respective qualification standards. Separately monitor the modified loan portfolio(s).
- Ensure the timely identification and appropriate on-going accounting for Troubled Debt Restructurings (TDRs) and REO. Some examples:
    - Determine whether loan modifications are TDRs.
    - For TDRs, require a loan level analysis to identify the loss to be recognized.
    - Institutions must ensure REO is initially recorded at fair value (less selling costs) and subsequently at the lower of that value or updated fair value (less selling costs). This includes the on-going determination of the REO fair value while in the disposition process.
- Develop criteria for REO decisions, such as:
    - Timing of property disposal (i.e. hold, lease, or sell analysis), and
    - Method of REO property disposition (i.e. sold through internal staff, real estate brokers, or auction).
- Provide ongoing internal asset review of REO and problem assets, including periodic evaluations or reappraisals.
- Establish risk management procedures for vendor relationships. Outside vendor fraud or vendor incompetence can result in significant losses to lenders.

To more fully address some of the questions and issues that have been raised, the West Region is conducting four Chief Credit Officer Credit Forums to be held in various locations throughout the West Region. See Regional Bulletin 08-03 for complete details.

Please share this memorandum with your Chief Credit Officers and Chief Lending Officers. You can contact your Assistant Director, or Regional Examiner David Henry at david.henry@ots.treas.gov for questions related to this Bulletin.

Sincerely,

Darrel W. Dochow
Regional Director