



LENDING *Update*

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Use of Stress Testing to Help Management Understand the Impact of Risk

By: Tom Scudiere, Associate Consultant
 and Rob Grope, Consultant

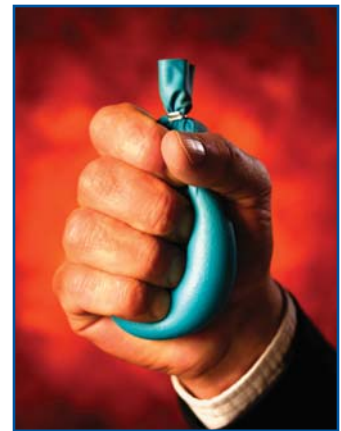
Stress testing in banking is a form of analysis that may be used to determine the stability of an individual loan or portfolio. It involves testing beyond normal operational capacity, often to a breaking point, in order to observe the results. This can assist management in comfort level of risk as well as capital adequacy issues.

Stress testing shows the sensitivity of a portfolio to a particular shock. It measures the change in value in response to changes in the underlying risk factors. The assumed changes are usually made large enough to impose some stress but not so large as to be considered implausible.

It is important early on to determine which factors are most critical in the credit assessment in order to understand what components are most likely to cause the biggest influence. Factors to consider can be interest rates, collateral value, and economic factors which affect debt service coverage (DSC). Many lenders employ their own models to rank potential and existing loan customers and then apply appropriate strategies.

Regulations such as Basel II reinforce the desire for more robust stress testing. However, regulators have tried not to over-specify the type and nature of stress tests. Industry and regulatory dialogue has thus far failed to establish consensus on the best practice and policy.

Recent accounting discussions have improved disclosures about valuation but public disclosures about liquidity are either insufficiently detailed or cannot be updated rapidly enough. You need to know early on



which component is most vulnerable and requires close attention and how a default could affect you.

In designing stress testing a financial institution should:

- Consider a full range of extreme outcomes
- Cover both full loss as well as loss-generating risk factors
- Use judgmental as well as statistical based methodologies

Testing individual loans can help identify problems before trouble happens. This can be employed during the initial underwriting as well as the ongoing monitoring of credits. By decreasing sales or gross margins, discounting collateral values, or increasing interest rates, the impact can be shown in the deterioration of DSC, net worth, or even collateral coverage. Regulators consider this a reactive approach.

It is recommended by regulators that financial institutions shift to a portfolio view.

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Need to Know Basics of OREO

By Fran Samson, Consultant

Delinquency increases and subsequent foreclosures on commercial real estate and residential housing loans should prompt financial institutions to review their procedures and the regulatory guidelines for “other real estate owned” (OREO).

Start With an Environmental Check

Determine the environmental status of the property before taking ownership of the property. Be sure that you are in total compliance with the Comprehensive Environmental Response, Compensation, and Liability Act in order to avoid environmental liability and potential cleanup costs.

Taking Ownership of the Property

Real property becomes other real estate owned through:

- Purchases at sales under judgments, decrees, or mortgages when the property was security for debts previously contracted.
- Conveyance in satisfaction of debts previously contracted.

FRB Makes Available New Mortgage Resource for Consumers

In a continued effort to keep consumers more informed about their banking needs, the Federal Reserve Board announced recently the availability of a new online resource to help consumers when they are considering refinancing their home. “A Consumer’s Guide to Mortgage Refinancing” is available at <http://www.federalreserve.gov/pubs/refinancings/default.htm>. The Web site assists consumers in determining when refinancing makes sense, what the possible costs could be in connection with their loan, and what type of mortgage might be best for their situation.

For more information about FRB’s new resource go to <http://www.federalreserve.gov/newsevents/press/other/20080828a.htm>. □

- Purchase to secure debts previously contracted.
- Relocation of banking premises or abandonment of plans to use real estate acquired for future expansion for banking premises.

Monitoring Current Value

The financial institution shall develop a prudent real estate collateral evaluation policy that allows the bank to monitor the value of each parcel of OREO in a manner consistent with prudent banking practice.

Covered Transactions

In addition, OREO include real estate sold by a financial institution in what is termed as a “covered transaction” defined as follows:

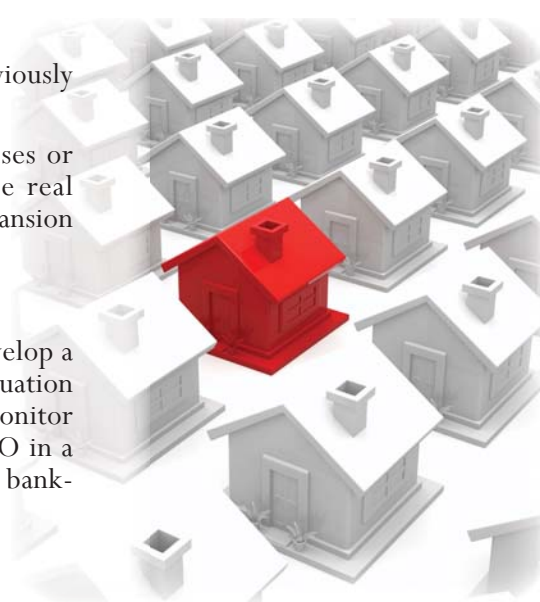
The sales of foreclosed properties are financed often by a loan at less than current market interest rates. In this situation, “generally accepted accounting principles” (GAAP) requires that the loan be discounted to bring its yield to a market rate. The effect of the discount will be either to increase the loss or to reduce the gain that results from the sales transaction. Interest income is then recognized at a constant yield over the life of the loan.

Banks may also facilitate the sale of foreclosed property by requiring little or no down payment. In these cases, GAAP requires that the profit on sales of the foreclosed property be deferred until an adequate down payment (depending on the type of property, up to 25 percent of the discounted sales price) has been received. However, losses should be recorded immediately.

A transaction ceases to be covered when those conditions no longer exist. A buyer can meet the 10 percent cash down payment requirement through use of private mortgage insurance or an equivalent guarantee and cash.

Allowable Holding Period and Documentation

Regulations permit a bank to hold OREO under certain circumstances



for a period no longer than five years. They also allow a bank to hold OREO up to an additional five-year period beyond the original one, with the approval of the institution’s primary supervisory agency. This agency may approve the additional holding period if the bank has made a good faith effort to dispose of property, or if disposal within the initial five-year period would be detrimental. If you are a State chartered bank, you will have to look at your State banking regulations to be sure.

Documentation reflecting the bank’s efforts to dispose of other real estate owned must be maintained. This should include a record of inquiries and offers made by potential buyers as well as advertising information.

Once the bank becomes the owner of the property, a “designated loan” in a flood area would no longer exist as the transaction is not a loan, and the flood requirements would not apply. However, from a safety and soundness perspective you may want to consider placing insurance on the property.

Be sure to review the instructions for IRS Form 1099A. This form is required whenever a lender takes an interest in real estate in partial or full satisfaction of a debt. Thus, every OREO property generates a 1099A. □



Acquisition, Development, and Construction Lending Increased Controls and Monitoring

By: Linda Young, Consultant

From the early 1990's until early in 2006, the U. S. benefited from strong economic growth and generally favorable real estate markets. As a result, financial institutions' investment in residential and commercial real estate acquisition, development and construction (ADC) lending grew substantially. However, job losses, the war in Iraq, oil price increases, and the sub-prime fiasco and the resulting decline in property sales and values, have all impacted not only economic growth but also the overall real estate market.

A highly specialized field with inherent risks, ADC lending, must be managed and controlled to ensure continued profitability. Bank management's ability to, through effective underwriting policies, systems and internal controls, identify, measure, monitor and control portfolio risk is crucial to a sound ADC lending program.

To limit risk and avoid costly mistakes, the bank should establish and implement sound policies and procedures. Although policies and procedures

should be tailored to different types of ADC lending undertaken by the bank, there are major elements that apply to all types of ADC lending.

Types of Acquisition, Development and Construction Loans

The bank lending policy should define the acceptable types of ADC loans, including limitations on aggregate ADC loans and for particular types of projects. It should also establish specific loan structure and repayment programs for the types of projects.

Acquisition and Development Loans

Acquisition and development loans (A & D) are usually a secured type of borrowing for the purpose of acquiring and preparing land for future construction. This type of loan is typically used to finance the development of the infrastructure, such as subdividing into building lots, grading, and installation of streets and utilities. Often, the loan may also include funds to purchase the land. A typical A & D loan will be repaid from the sale of the lots.

As a first step in effectively administering an A & D loan, the bank should require

the borrower to submit a business plan describing each step of the development. Such a plan should include feasibility of the project, costs for building and/or zoning permits, environmental impact statements, infrastructure costs and any off-site improvements required by the local building authority.

The repayment program should be structured to follow the project's development or sale program. There should be a sufficient spread between the amount of the loan and the estimated market value of the project to provide for unforeseen expenses. If the loan involves the periodic development and sale of portions of the secured property, each section of the project should be independently appraised and the release of collateral structured in a manner that maintains a reasonable margin.

Acquisition, Development and Construction Loans

Acquisition, development and construction (ADC) loans are secured loans for the purpose of not only acquiring and developing land but also providing funds for the construction of dwellings to be used as model homes and/or sold at a later date.

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Use of Stress Testing to Help Management Understand the Impact of Risk *(continued from page 1)*

They believe that the financial institutions will be better able to identify, measure, and monitor and then report on credit risk. Regulators consider this to be a proactive approach which is important to the anticipation of problems.

In light of the current economic conditions, it is important to address the need for quick responses to problems when they arrive, so as not to be "blind sided" by changing conditions. The employment of what-ifs is critical for management's controlling of downturns. One advantage of the advancement of information technology is it can assist in the rapid assembly of data to facilitate the stress test calculations.

The immediate focus in a down market is on minimizing risk and reducing losses. The ultimate objective of risk management is to ensure long-term earnings and build long-term value. If risk management processes were employed early, the events over the past year might have been controlled and the negative impact mitigated. The institutions which have invested in stress testing will be better prepared to act with greater confidence and exhibit flexibility and survivability.

Conclusion

While risk measurement has evolved rapidly, it is still common practice to apply stress tests in an isolated fashion. Although the practice is evolving quickly the regulatory agencies have not provided consistent guidance around stress tests. It is, therefore, important for banks to begin to consolidate this information and work toward the implementation and reporting process for the entire financial institution.

For more information on how your institution can begin to stress test loans and portfolios, please e-mail Tom Scudiere at tscudiere@younginc.com or Rob Grope at rgrope@younginc.com. □



Acquisition, Development, and Construction Lending

(continued from page 3)

It is common for banks to finance development and speculative (spec) or pre-sold construction work for large residential tract projects in several sections or phases. This structure allows the bank to control the risk and ensure that an oversupply of developed lots and spec homes does not occur.

Release prices for the lots in the early sections of the project should be set at a level that is sufficient to ensure a comfortable margin is maintained on the payout of the land development loan for the entire project. The release prices are most commonly set at figures sufficient to ensure a break-even or repayment point for the entire loan is reached with the sale of approximately two-thirds of the total available lots in the project, or when the project has achieved no more than 80 percent of the expected net sales proceeds. However, since an ADC loan will also include funds for construction repayment of the construction, funds will come from the sale of the completed structure.

A bank lending to residential tract builders should tailor control procedures to the individual project and/or builder. To avoid overextending the builder's capacity, the loan agreement should include a predetermined limit on the number of unsold units to be financed at any one time (usually two). For pre-sold homes, the lender should review the sales contract and the buyer's permanent financing commitment.

For large residential tract developments

that are financed in sections or phases, it is often required that a fixed percentage of units in the next section be under a firm sales contract before funds are released for its development. Appraisals should include estimated absorption rates; however, lenders should understand that rapid sales absorption following the opening of a new section does not necessarily indicate strong market acceptance.

Borrowers' Qualifications

Since the actual value of the real estate is questionable until the project is completed, a lender should assess the borrower's overall financial strength, investment in the project and development expertise. Additionally, it is recommended that the following be included in qualifying the borrowers.

Require borrowers to contribute and maintain hard money equity in their project. Limiting funds used for land acquisition and requiring a first lien on land, are the first steps in protecting the lender.

Provide for the satisfactory investigation of the character, expertise, and financial standing of all related parties to assure the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project being financed.

Require borrowers to provide a business plan that includes contingency repayment plans in the event the anticipated business plan is not met, and an on-going project status reporting process.



When guarantors are present or required, the underwriting process should include an analysis of the guarantors' ability to provide cash liquidity for the making of interest payments, both for the loan being originated and a global contingency cash flow analysis for all projects that the guarantor has financial responsibilities for payment. The depth of the analysis should include the purpose for requesting guarantor (secondary repayment source; conversion of assets, etc.) and the ability of the guarantor to make a payment if called upon (liquid assets, personal debt service coverage). Increased attention should be given to the support guarantors provide such as liquidity measured as cash, near cash assets and CADA over a 3-year period, the dollar amount of total contingent liabilities from all of the various guarantors signed; and if various enterprises are in the same industry, can the guarantor support all of the various enterprises under an economic stress test.

Appraisal Requirements

(OCC Bulletin 2005-32, September 8, 2005)

In the case of an A & D loan, a lending institution must obtain an appraisal of the entire tract of raw land or lots. The appraisal should reflect the value of the property in its current condition and existing zoning as well as the market value of the land upon completion of land improvements. Such improvements may include the construction of utilities, streets, and other infrastructure necessary for future development. It should also reflect a reasonable time-frame during which the development will occur. The market analysis in the appraisal should support the absorption period for the developed lots.

Small Business, Small Farm, Community Development Lending Data Available

Federal banking agency members issued a joint statement on July 31, 2008 announcing the availability of data on small business, small farm, and community development lending that has been reported by some commercial banks and savings institutions in compliance with the Community Reinvestment Act (CRA). In addition, the FFIEC has prepared an aggregate disclosure of small business and small farm lending for each metropolitan statistical area (MSA) and non-metropolitan counties in the United States.

The data is available in electronic form and at www.ffiec.gov/cra. □

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Outsourcing Your Mortgage Quality Control

It's a good idea!

By: Debra L. Werschey, Associate Consultant

Mortgage Quality Control is a system used to review mortgages that are closed to ensure they comply with the Department of Housing and Urban Development (HUD) and with company policies and procedures that are in place. Quality Control, or QC, is a cost effective way to minimize potential risks associated with financing, selling or buying mortgage loans. With financial scandals and savings and loan collapses, a sound quality control system is a key part of any loan process. Even though you trust and believe that employees will

operate by the rules, regulations and policies, an employee may fix files to ensure that all the documents are in order. This creates an environment that potentially could lead to lawsuits and huge penalties. Having documents reviewed by an outside company who remains up to date with all HUD requirements will ensure that nothing is overlooked.

Outsourcing has become extremely popular since lenders and loan officers realize the importance of documents and the potential consequences of bad paperwork. This allows lenders to concentrate on originating loans and not having to hire



experienced persons to handle quality control responsibilities. Most investors feel that a QC review is acceptable for measuring the quality of a loan and require that the review be preformed by knowledgeable mortgage professionals that are completely detached from the mortgage origination, processing or underwriting stages of the loan. Outsourcing is a way to effectively monitor internal production processes and find errors that may cause problems in the future. It will also help lenders identify areas for internal training and operational improvements which can minimize the cost of defects or errors.

HUD expects all quality control reports to be in writing for senior management review and done in a timely manner. When the quality control function is outsourced, the reviewer will prepare the written report and comply with all reverification requirements. The findings in the report will be candid and unbiased and will help improve the investment quality of the loans originated. Also, with a third-party service, all information obtained will be held in the strictest of confidence.

For most people the largest purchase they will ever make is a home and having the paperwork filled out properly is essential to that purchase. Your service to them needs to be dependable with accurate documents. The last thing you want to happen after you have closed on a house is to have to redo some of the documentation because it contains errors, or worse, is not legally binding. □

Acquisition, Development, and Construction Lending *(continued from page 4)*

For an ADC loan, in addition to the requirements stated for the A & D loan, appraisals for these properties must reflect deductions and discounts for holding costs, marketing costs and profit. In some cases, the lending institution may rely on an appraisal of the individual units(s) to meet appraisal requirements and to determine market value for calculating loan-to-value ratios.

For existing projects that have exceeded the original time-frame or are not following the original business plan, it is recommended that the appraisal be recertified to assure that the market value has not declined.

Risk Management

Due to current real estate market conditions and depending on the lending area of the bank, the bank should consider discounting the appraised value to 70-75 percent and basing the loan amount on the discounted value. Until market conditions improve, a 25-30 percent cushion is adequate to absorb deteriorating real estate values (15 percent devalue of collateral and 15 percent cost to liquidate).

Often, as part of the loan approval, a portion of the loan proceeds will be allocated to an interest reserve. This reserve should be clearly designated for payment of interest. In many cases, whether due to weather, delays in the issuances of permits, or market concerns, the interest reserves will be depleted and borrowers will request a time extension. In such cases the borrowers should replenish interest reserves to cover the additional time requested or provide additional collateral to cover the lending of additional funds for the establishment/replenishment of the interest reserves.

The progress of the projects should be monitored on a regular basis either by a licensed appraiser or experienced bank personnel. The percentage of progress should be documented in writing including photos. Disbursed funds should not exceed the percentage of completion unless authorized, in writing, by upper management.

Additionally, the project should be monitored to assure it is following the original business plan and that the contingency plan detailed in the business plan is still a viable alternative.

Acquisition, development and construction lending remains one of the more risky types of lending; however, with a few extra steps in underwriting the project and the borrower along with strong monitoring procedures, it can be profitable portion of a bank's portfolio. □



What Is an Abundance of Caution?

By: Pam Stone, Associate Consultant and
Linda Young, Consultant

An abundance of caution as defined by FIL9994, Interagency Guidance on High LTV Residential Real Estate Lending, states “that an abundance of caution exists when an institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral.”

By definition the value of the property is “low relative to the aggregate value of all other collateral.” With the decline in the real estate markets, in which some markets are seeing an upwards of a 25 percent decline in property values, banks need to be concerned with their abundance of caution loans.

The question the bank needs to really ask is “Are the Abundance of Caution Loans really an abundance of caution today?”

With the decline in real estate and the economy being a relevant factor today one has to begin to wonder if the collateral that they took as an abundance of caution at origination is still an abundance of caution today. Real

estate that was taken as an abundance of caution several years ago, most likely will not have the same value today. It is more important than ever to know your market and to know your borrower’s collateral.

What does this mean for Bank’s in today’s economy?

In today’s environment a bank needs to consider updating or reviewing appraisals that contain collateral taken as an abundance of caution. With a 25 percent decline in property values, on average, a bank needs to perform some due diligence and compare old appraised values to new appraised values on their properties. The volatility of the real estate markets have lent themselves to the useful life of an appraisal being good for, at times, less than one month. Therefore, it is important that the bank review appraisals that are received and continue to monitor the local real estate market to ensure that the LTV’s assigned to specific loans within the portfolio are still valid.

For collateral to be considered as a true “abundance of caution”, the credit must be underwritten without using the col-



lateral in calculating the loan to value. The underwriting approval should be based on the loan to value using the primary collateral only. If indeed the collateral taken as an abundance of caution is needed to improve the loan to value, it is not considered a true “abundance of caution” and an appraisal, insurance and title work would need to be obtained.

Additionally, for real estate that is taken as an abundance of caution, a standard form for determining whether a building or mobile home is located in an area identified as a special flood hazard area (The Standard Flood Hazard Determination Form), is required when a lender makes, increases, extends, or renews any loan secured by improved real property or a mobile home.

The laws apply to all loans that are secured by improved real estate or mobile homes, regardless of purchase, such as purchase money loans, construction loans, extensions, refinancing, home equity loans and home improvement loans.

Young & Associates Inc. recommends that a bank document and split out the collateral on its loan presentation sheets to clearly indicate the primary collateral which is reflected in underwriting, and indicate separately any additional collateral taken as an abundance of caution. □

FORBEARANCE

The rapid growth in the subprime and nontraditional mortgage market, in addition to the slow appreciation of home values has lead to increased foreclosures. These defaults may have been caused from loans originated over the past few years using adjustable rates and introductory teaser rates to borrowers who lacked financial reserves to weather setbacks. If payment shock or any meaningful change in circumstances occurred, some borrowers were not prepared and were not able to avoid default, foreclosure or possibly bankruptcy.

These circumstances have banks strategizing to find the best way to mitigate credit losses, preserve customer relationships, maintain stable neighborhoods and minimize the detrimental effects vacant properties can have on property values. One of many options is a forbearance agreement. The mortgage forbearance agreement offered by the lender gives defaulting borrowers a way to cure the delinquency over time while regularly paying mortgage payments. Some lenders may even offer a grace period with no mortgage payments as a way to help borrowers stay in possession of their properties. This restructure of financial terms helps achieve greater manageability for the borrower and still gives a rate of return to the lender.

Bankers realize that offering forbearance to restore delinquent borrowers to a current status on their loans is preferable to the potential losses inherent to foreclosure. □



Lending and QC Service Listing



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