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SRC

Insights

FEDERAL RESERVE BANK OF PHILADELPHIA

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IN THIS ISSUE

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SVP Commentary on…

2002 in Review and Expectations for 2003

When regulators and bankers in the northeast think back to events of ten years ago, we generally recall the weaknesses in commercial real estate that led to a record number of bank failures. What will we remember about banking ten years from now when we look back on 2002? Interest rate levels not seen since the 1950s and 1960s? Highly publicized failures in corporate governance? The disintegration of one of the Big Five accounting firms? Fraud, both inside and outside the banking industry? Increasing complexity in accounting and reporting requirements? The new legislation, regulations, and guidance as the country prepared to fight money laundering and terrorism through the USA Patriot Act and prepared to crackdown on breakdowns in corporate governance through the Sarbanes-Oxley Act? Or, will we remember that despite all the turbulence, preliminary indications are that 2002 was a year of continued strong earnings for the banking industry?

The Sarbanes-Oxley Act was signed into law on July 30, 2002 in response to the wave of misstatements, incomplete and/or mislead-

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Best Practices In Commercial Real Estate Lending

by David Fomunyam, Supervising Examiner and Eddy Hsiao, Senior Examiner

The Fourth Quarter 2002 issue of *SRC Insights* included an article titled "Trends in Commercial Real Estate," which discussed the overall quality of commercial real estate (CRE) loans in light of the soft economy. The article indicated that while CRE market conditions for the nation as a whole have been down, CRE loan quality for the Philadelphia region has been relatively stable. Credit risk management practices at Third District banks have been generally satisfactory based on the trend of nonaccrual and delinquent loans, although trends such as these tend to be lagging indicators of true portfolio quality. Nevertheless, the article went on to state that some institutions within the District have started to report increased levels of problem loans. This article serves as a follow-up to "Trends in Commercial Real Estate" and focuses on best practices in managing a CRE loan portfolio.

CRE loans can be profitable as long as the risk management practices that are unique and distinct to this type of lending are in place.

Credit Risk

Taking and managing credit risk is fundamental to the business of banking. Lending funds to borrowers to invest in income-producing properties–such as office buildings, shopping centers, apartments, warehouses, and hotels–on a sound and collectible basis is a good source of income for the benefit of shareholders. Such lending also serves the legitimate credit needs of the bank's community and, through collateralization, protects depositor funds. However, financing income-producing properties is a specialized type of lending due to its cyclical nature and the tendency of real estate values to fluctuate with economic swings. Commercial real estate business cycles tend to lag general economic cycles, which means that weak market conditions last longer in the CRE industry, particularly because repayment of the loan comes from sale or refinance of the property or income generated from leases.

Losses from CRE lending during the 1980s and early 1990s, which caused several bank failures, are sobering reminders that CRE lending is not for all financial institutions. When poorly managed, banks have incurred an inordinate level of losses from CRE lending compared to other segments of their loan portfolios. In fact, some institutions have concluded that the risks are too great and have opted out of CRE lending altogether.

CRE loans can be profitable as long as the risk management practices that are unique and distinct to this type of lending are in place. Accordingly, to effectively manage this risk, an institution must establish a structure that adequately identifies, measures, monitors, and controls the risks involved in its CRE lending activities. Furthermore, an institution's credit risk appetite must be tailored to the size and complexity of its operations. A fundamentally sound credit risk management program must include, but should not necessarily be limited to, some of the best practices discussed in the information that follows.

Board and Management Oversight

The board of directors should be actively involved in oversight of the risk management process. It should clearly articulate its credit risk tolerance limits and ensure that management implements a risk management process that includes adequate policies, procedures, and limits and sufficient risk measurement and monitoring mechanisms. In addition, accurate and timely management information reports and a sound internal control environment are essential for an effective credit risk management process. Some common credit risk management deficiencies frequently cited by examiners are listed in the exhibit, "Not-So-Best Practices," appearing at the end of this article.

Credit Risk Management Policy and Procedures

The CRE lending policy must represent an institution's best effort to establish guidelines for sound lending practices. The purpose of a bank's CRE lending policy is to establish the authority, rules, and framework to operate and administer the portfolio effectively, ensuring profitability while managing risk. The policy must serve as a framework that sets basic standards and procedures in a clear and concise manner. A sound loan policy promotes the institution's business and lending philosophy as it provides lenders with the necessary reference and clarity to minimize inconsistencies and confusion concerning lending guidelines and objectives.

Each bank's policy will differ, given the institution's strategic goals and objectives and factors such as the experience and ability of the lending personnel, economic conditions, and competition. The complexity and scope of the lending policy and procedures should be appropriate to the size of the institution and the nature of its activities and should be consistent with prudent banking practices and relevant regulatory requirements. At a minimum, the policy should be reviewed and approved annually to ensure that it is not outdated or ineffective. It should remain flexible and in alignment with the organization's strategic objectives. Tenets of a sound policy include adequate diversification standards, underwriting standards, due diligence, loan administration procedures, loan approval processes, and documentation standards.

Diversification Standards. Lending policies should state the permissible types of loans, geographic markets, and loan concentration limits. Concentrations are generally categorized by using the North American Industry Classification System (NAICS) and relating industry exposures to capital level, earnings at risk, or a percentage of outstanding loans. Some institutions track concentrations by geographic area, by terms, or by property type, such as apartment, office building, warehouse/industrial building, hotel/motel, retail, housing project, construction, and land development. Concentration limits must be established to ensure an institution's risk exposure to a particular economic sector in terms of earnings and capital at risk is within its accepted risk tolerance levels.

Underwriting Standards. Credit underwriting standards will vary for different types of income-producing properties and should reflect the inherent risks and characteristics of the project being financed. However, banks should adhere to certain core standards to effectively manage risk. Several practices, processes, and procedures stated in this article are self-explanatory and are prevalent in most lending policies. However, additional guidance is provided in areas that are considered critical to the risk management process.

Underwriting standards that are clearly measurable must be spelled out in the policy. Examples of clearly measurable standards include loan-to-value and debt-to-income ratios, overall credit worthiness of the borrower, financial information requirements, loan maturities by type of property, maximum advance rates, pricing structure, pre-leasing requirements, guarantee requirements, appraisal requirements, general terms and covenants for different types of loans, and charge-off standards.

The appraisal requirements must comply with Uniform Standards of Professional Appraisal Practices (USPAP) and regulatory guidelines, which clearly indicate when an appraisal or evaluation is required and who is approved or qualified to perform the appraisal or evaluation. An independent reviewer, other than the account officer, should attest to the quality of the appraisal report, the validity of the assumptions used, the appropriateness of the comparables and the capitalization rate, and the reasonableness of the lease-up period. The reviewer also should comment on the final value of the collateral and the quality of the report. Using an independent appraisal reviewer is essential to preclude any conflict of interest that may arise by an account officer attempting to meet production goals.

Understanding the competence of management of the borrower or business entity, while not easily "measurable," is also a fundamental component of the underwriting process. The borrower's management team must possess adequate knowledge and experience commensurate with the complexity of the company's business and the project presented for financing. The management team must demonstrate a successful track record of developing and completing similar types of projects on time and within budget.

Due Diligence. It is important for bank management to conduct proper due diligence before acquiring or approving a loan. Such due diligence should continue throughout the life

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Federal Reserve Simplifies Access to the Discount Window

by Vish P. Viswanathan, Vice President and Discount Officer

On January 9, 2003, two new discount window facilities, the primary and secondary credit programs, replaced the old adjustment and extended credit programs.[1] The below-market rate on adjustment credit has been eliminated and all discount window loans are now offered at rates above usually prevailing market rates for overnight interbank loans. The change to an above-market rate and accompanying changes in eligibility requirements make possible a substantial reduction in administration of discount window lending. Under the new program, requests for overnight loans by financially sound depository institutions normally will be approved on a "no-questions-asked" basis. Collateral requirements are unchanged; as before, every discount window loan must be secured to the satisfaction of the Reserve Bank extending the loan.[2] The seasonal credit program also continues unchanged.

The changes to the discount window credit programs do not imply any change in the stance of monetary policy as measured by the Federal Open Market Committee's (FOMC) target for the federal funds rate. Rather, the revisions aim to make the discount window a more effective monetary policy tool by making discount window credit more readily available and increasing depository institutions' willingness to borrow from the window when money markets tighten.

Under the new program, requests for overnight loans by financially sound depository institutions normally will be approved on a "no-questions-asked" basis.

Primary Credit Program

Primary credit will serve as the principal safety valve to ensure adequate liquidity in the banking system. Primary credit is available as a backup source of funds to depository institutions deemed to be in generally sound financial condition by Federal Reserve Banks. Eligibility is determined largely by the institution's supervisory examination rating and capital status; supplementary information such as public debt ratings and other market information and periodic input from bank supervisors/examiners may also be considered. Generally, institutions with a composite CAMELS rating of 1, 2, or 3 that are at least adequately capitalized are eligible for primary credit, unless supplementary information indicates their condition is not generally sound.[3]

Primary credit will be extended on a very short-term basis, typically overnight, to eligible institutions on a "no-questions-asked" basis. Primary credit may also be extended for up to a few weeks to small institutions in sound financial condition that cannot obtain temporary funds in the market at reasonable terms. Institutions need not seek alternative sources of funds before requesting occasional short-term advances from the primary credit program. There is no prohibition against using primary credit to fund sales of federal funds. Except in unusual circumstances, depository insti-

[1] The Board of Governors approved these and related technical changes by revising Regulation A, *Extensions of Credit by Federal Reserve Banks*, on October 31, 2002.

[2] Federal Reserve Banks accept a wide range of assets as collateral to secure the discount window loan. See the article by Kimberly R. Caruso (O'Grady), "A Behind the Scenes Look at How the Fed Values Collateral," in the Fourth Quarter 2001 issue of *SRC Insights*.

[3] A similar approach using the SOSA, ROCA, and combined ROCA ratings determines foreign banking organizations' eligibility. CRIS ratings are used for credit unions.

tutions will not be questioned about the reason for borrowing primary credit.

Initially, the primary credit rate was set at 2.25 percent, which is 100 basis points above the FOMC's target for the federal funds rate. In recent years, the rate for adjustment credit usually was 50 basis points below the targeted federal funds rate. Reserve Banks' Boards of Directors will establish the primary credit rate at least every two weeks through the same process they used to set the adjustment credit rate, subject to Board of Governors review and determination.

Given the above-market pricing of primary and secondary credit, the Federal Reserve anticipates that depository institutions will not find it advantageous to rely on the discount window as a regular source of funding.

With discount rates above usually prevailing market levels, there will be less need for Reserve Banks to administer discount window loans—especially primary credit loans to financially healthy institutions. The Federal Reserve expects that reduced administration will help eliminate the "stigma"—real or perceived—associated with discount window borrowing. With a "no-questions-asked" approach and no restrictions on the use of funds obtained through the primary credit program, the Federal Reserve expects that financially sound institutions will use the discount window as a backup source of funds more readily than in the past. In particular, institutions should be more willing to use the window when money markets tighten, thereby limiting the volatility of the federal funds rate. In other words, the primary credit rate will facilitate the implementation of monetary policy by creating a "cap" and limiting temporary upward

Primary vs. Secondary Credit at a Glance

Feature	Primary Credit	Secondary Credit
Rate	100 basis points above the FOMC's target for the federal funds rate, or 2.25% on January 9, 2003.	Primary credit rate plus 50 basis points, or 2.75% on January 9, 2003.
Term	Short-term, usually overnight, but can also be extended—ordinarily to very small institutions—for up to a few weeks if such credit cannot be otherwise obtained in the market on reasonable terms.	Short-term, usually overnight. Can be extended for a longer term if such credit would facilitate a timely return to reliance on market funding or an orderly resolution of a failing institution, subject to statutory requirements (FDICIA restrictions).
Eligibility	Depository institutions in generally sound financial condition; generally same as eligibility for daylight credit.	Depository institutions that do not qualify for primary credit.
Use	Generally no restrictions. May be used to fund sales of federal funds.	As a backup source of funding on a very short-term basis or to facilitate an orderly resolution of serious financial difficulties.
Administration	Ordinarily no questions asked.	Reserve Banks will collect information necessary to confirm that borrowing is consistent with regulatory requirements.

"spikes" in the federal funds rate.

Secondary Credit Program

Depository institutions that are ineligible for primary credit–including some weaker institutions that were eligible for adjustment credit–may be able to obtain discount window credit through the secondary credit program. The secondary credit rate was initially set at 2.75 percent, which is 50 basis points above the primary credit rate, and will have a higher level of Reserve Bank administration and oversight than primary credit.

Use the recently established toll-free number 1-800-372-2011 when calling the Federal Reserve Bank to request a discount window loan.

Secondary credit will be extended to institutions primarily to assist in their timely return to a reliance on market funding. Secondary credit may also be extended to assist in the orderly resolution of a troubled institution. Section 201.3(d) in the revised Regulation A provides that an institution cannot receive secondary credit as the medium or agent of another depository institution except with the permission of the Federal Reserve Bank extending credit. In other words, the Federal Reserve expects the borrower of secondary credit to use the funds to help resolve its own financial difficulties.

Communication, Contact, and Other Information

The Federal Reserve Bank of Philadelphia sent a letter summarizing the new discount window programs to each Third District depository institution in early December 2002. Institutions that have discount window borrowing agreements with the FRB of Philadelphia were informed about their eligibility for the primary or secondary credit program. Should the eligibility of an institution change, discount window staff will notify the institution immediately. Institutions that have a borrowing agreement with the Federal Reserve Bank of Philadelphia should use the recently established toll-free number **1-800-372-2011** when calling the Federal Reserve Bank to request a discount window loan.

Federal Reserve staff have begun to hold informational sessions with bank supervisors to explain the new discount window programs. In the opinion of the Federal Reserve, supervisors should view occasional use of primary credit as appropriate and unexceptional.

The discount window web site contains additional information about the new lending programs, including the Board's press release, which provides more detail about the new programs, the revised Regulation A, a PowerPoint presentation that summarizes the new programs, and responses to frequently asked questions (FAQs). This System website is accessible at <www.frbdiscountwindow.org>.

Third District institutions should feel free to contact Vish Viswanathan, Vice President and Discount Officer (vish.viswanathan@phil.frb.org) at (215) 574-6403 or Gail Todd, Manager (gail.todd@phil.frb.org) at (215) 574-3886 with any questions about the new discount window lending programs. Depository institutions that do not currently have borrowing agreements on file with the Federal Reserve may want to contact their Reserve Bank to discuss their eligibility to use the discount window, collateral requirements, and other administrative matters. ■

"2002 in Review" *continued from page 1*

ing disclosures, and outright defalcations that shook public confidence in the American markets. Among other goals, Sarbanes-Oxley sought to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws, legislating corporate accountability and responsibility, enhancing oversight of the accounting and auditing industry, ensuring auditor independence, and creating a structure for holding individuals and companies criminally and/or civilly accountable for their actions. The Federal Reserve Board has long endorsed the need for transparency in accounting and disclosures. In addition, the federal banking regulatory agencies recently have proposed disciplinary action rules for accountants and accounting firms performing certain audit services, building off of capabilities in FDICIA related to institution affiliated parties.

While Enron stands out as the epitome of corporate malfeasance, the banking industry did not emerge from 2002 unscathed. While Allied Irish subsidiary Allfirst Financial's loss of $691 million due to fraud captured the headlines, the bank was in sound enough financial condition to absorb the losses. However, ten commercial banks and one thrift did fail in 2002, and one failure in particular was attributed to a multi-million dollar fraud committed by the bank's CEO.

These losses have highlighted the importance of internal controls and operations risk, an area that was once perceived by many as something for the back-office staff to be concerned about. While neither banks nor bank examiners can ignore credit risk, a difficult lesson learned is that operations risk can cripple a bank or a company as easily as credit losses.

Despite the recent strength in banking industry earnings, pockets of weakness remain, with new areas emerging. During the 2002 review of Shared National Credits (SNC)–an interagency loan review program that covers any loan or loan commitment of at least $20 million that is shared by three or more supervised institutions–the dollar amount of classified credits increased for the fifth consecutive year, reaching a level of $157.1 billion, or 8.4 percent of total commitments, up from 5.7 percent in 2001 and 3.2 percent in 2000. At the same time, loans listed for special mention rose to 4.2 percent of total commitments, from 3.7 percent in 2001 and 1.9 percent in 2000. Deterioration was largely driven by the pronounced problems in the telecommunication sector, alleged corporate fraud, weakness from the recent recession, and the after-effects of September 11th. Certain market segments exhibited moderate improvement, including the professional, scientific, financial, insurance, and other service sectors.[1]

While the SNC review is of extremely large loan commitments, its findings are symptomatic of weaknesses in smaller credits. In the third quarter of 2002, the percentage of commercial and industrial noncurrent loans to loans was 3.01 percent, the first time this measure crossed the 3.00 percent threshold since 1993. While the severity of the problem was not consistent across banks of all sizes, and was in fact highest at banks greater than $10 billion, this measure was over 1.50 percent in all three categories of banks under $10 billion. The loss rate on credit cards remains high, as charge-offs in the third quarter were above 6.00 percent for the fourth consecutive quarter.[2] Notwithstanding the high level of charge-offs, noncurrent and delinquent credit card outstandings continued to increase, indicating that a return to lower charge-off levels in the near term is not likely.

While these issues reflect weakness in both the commercial and consumer loan sectors, the weakness is significantly less severe than the profile we faced ten years ago. In addition, implementation of effective risk man-

[1] See the complete October 8, 2002 press release *Bank Regulatory Agencies Find Adversely Rated Syndicated Loans Continue to Increase in 2002, but at Slower Rate than Previous Year* on the Board of Governors' web site at <www.federalreserve.gov//BoardDocs/Press/bcreg/2002/20021008/default.htm>.

[2] See the FDIC's Quarterly Banking Profile, Commercial Bank Performance, Third Quarter 2002 at <www2.fdic.gov/qbp/2002sep/qbpcom.html>.

agement practices and lessons learned from the 1990s have served to protect the industry's balance sheets.

A review of recent SR Letters and interagency guidance provides an indication of what was on regulator's minds in 2002. Last year, the Federal Reserve issued five SR Letters related to various aspects of the USA Patriot Act and, as the Treasury Department promulgates additional guidance, even more SR Letters should be forthcoming. Accounting issues were also high on the regulatory radar screen, as three SR Letters and one interagency proposal were released to address accounting and audit issues, and three SR Letters were issued to address securitizations.

A steep yield curve and a return to basic banking activities characterized 2002, driven largely by robust consumer business. This combination of factors has placed the industry in a strong financial position for the future. In fact, strong deposit growth and wider net interest margins will likely produce strong profits for 2002. Nevertheless, concentrations and the potential for weakness in commercial real estate should be watched closely. In addition, high debt levels, delinquencies, and bankruptcies could portend problems in the consumer sector, particularly without employment growth. Banks will likely find that maintaining revenue growth will be challenging, particularly since consumer spending, which has been one area of strength, may begin to slow. Moreover, downward trends in capital markets will likely remain evident in the early part of the year.

Regulators will continue to assess the adequacy of banks' internal and accounting controls and the strength of quality assurance programs. Banks should also ensure that they maintain strong risk management processes around the introduction of new products. While these and other operational risk areas will receive increased attention, credit quality concerns will remain front and center. To mitigate the likelihood of further credit deterioration, banks should know their customers and should understand their business models. Regulators will carefully monitor underwriting practices and will watch closely for one of the newest areas of concern–mortgage fraud involving inflated appraisals.

Finally, regulators and bankers will continue to make progress toward the implementation of a revised Basel Capital Accord, as capital regulation and risk management practices evolve. The ultimate goal of Basel II is to improve safety and soundness in the financial system by placing more emphasis on banks' own internal capital allocation and management, the supervisory review process, and market discipline (the three pillars). This focus would move both regulatory capital requirements and risk management into the future, shedding the prescriptive one-size-fits-all capital levels of the 1988 Basel Capital Accord.

All in all, 2002 was a good year for the banking industry, particularly in the Third District. I hope that we recall the good times when we look back from ten years in the future, and can honestly say that we successfully overcame the challenges that were handed to us in 2002. That is my challenge to you. ■

Recent Supervision and Regulation Letters*

SR 03-02 *Adoption of Regulation W Implementing Sections 23A and 23B of the Federal Reserve Act* (January 9, 2003)

SR 03-01 *Account Management and Loss Allowance Methodology for Credit Card Lending* (January 8, 2003)

SR 02-24 *Suspicious Activity Report Filing Requirements for Nonbank Subsidiaries of Bank Holding Companies and State Member Banks* (December 24, 2002)

SR 02-22 *Interagency Advisory on Accounting Treatment of Accrued Interest Receivable Related to Credit Card Securitizations* (December 4, 2002)

SR 02-20 *The Sarbanes-Oxley Act of 2002* (October 29, 2003)

SR 02-19 *Use of Statistical Sampling in the Review of Commercial and Industrial Loans and Commercial Real Estate Loans during On-Site Safety and Soundness Examinations of Community Banks* (October 29, 2002)

*SR Letters can be found on the Board of Governors' public web site at <www.federalreserve.gov/boarddocs/srletters/>.

"Commercial Real Estate" continued from page 3

of the loan. Management should regularly obtain and analyze timely and accurate financial and economic data as well as credit report information on borrowers, guarantors, and other related parties. For construction lending, background and financial information on the developer should be evaluated to ascertain the ability and competence of the borrower to manage construction of the project. Reviewing project schedules; cost breakdowns; copies of approvals, surveys, specifications, licenses, contracts, and permits; pro forma statements; and projections are all important elements of the due diligence process. Property information–such as current environment reports, insurance, appraisals, and lease agreements –is necessary to help management monitor the value of the underlying collateral.

Loan Administration Procedures. The loan administration function is a critical element in the credit risk management process and should be separate from the lending unit. It is noteworthy that the regulatory rating for asset quality takes into consideration the effectiveness of a bank's credit administration practices and not just its underwriting practices. Banking institutions should have adequate procedures to ensure segregation of duties for loan closing and disbursement processes, payment processing, escrow administration, collateral administration, loan payoffs, collections and foreclosure, and claims processing.

Loan Approval Process. The loan officer is responsible for collecting data, performing due diligence, analyzing the appropriateness of the request, and submitting a clear and detailed presentation to appropriate officers and/or committees for approval. The presentation at a minimum should include discussions about the borrower; a description of the project; a financial analysis, including the project budget; a project feasibility analysis; a review of market conditions; a discussion of repayment sources; a risk summary, stating both strengths and weakness; the presence of security agreements; and the officer's recommendations.

Documentation Standards. Credit documentation requirements for CRE loans will differ depending on the risks, characteristics, and type of project being financed. However, banks must adhere to certain core standards to effectively manage risk. The lending policies should indicate required documentation and record retention periods for loan applications; loan approval and rejection notices; loan agreements and promissory notes; loan reviews; documents creating and perfecting a security interest; appraisal reviews; guaranty and subordination agreements; insurance policies; financial, tax, and credit information; loan reports; and committee and board meeting minutes.

Risk Measurement and Monitoring The continuous monitoring and reviewing of a credit during its life is just as important as the initial analysis performed during the approval process. Some institutions fail to reinforce the importance of on-going monitoring of a credit after it is booked, which can result in deterioration of the loan portfolio. Some of the important areas that warrant ongoing monitoring include the condition of the economy and local markets, the borrower's business, and the underlying collateral.

Economic and Local Market Conditions. Population, demographics, and employment trends are all good measures that might indicate a potential impact on borrowers' operations and the demand for and supply of CRE. Sale price decreases, rent concessions, absorption declines, and vacancy rate increases are warning signs of potential weakness in real estate markets that might affect the underlying quality of the loan portfolio. Changes in rules and regulations of local municipalities (e.g., zoning requirements) or financial or operational deterioration in major employers or companies in the local markets are other factors to consider when evaluating potential and existing credits.

Borrower's Business Condition. For office buildings, it is very important to obtain current rent rolls and/or updated lease agreements to determine the stability of loan repayment sources. For retail or manufacturing businesses, it is essential to conduct regular visitations to observe the borrower's business activity, staff turnover, and inventory levels and conditions to determine the overall business condition. To obtain current knowledge on a borrower's financial condition, it is imperative to have an adequate tracking system in place to ensure that required financial information is on file. Some institutions also conduct stress tests to evaluate cash flow, debt service capacities, and loan-to-value ratios under various interest rate scenarios.

Collateral Condition. Regular visitations to the underlying CRE sites are necessary to ensure that properties are maintained in proper condition and are being utilized and/or occupied as the borrower indicated. Environmental concerns and hazardous conditions near the collateralized property are other factors that might potentially disrupt the collection of loan payments.

Comprehensive Internal Controls Reporting Process. An adequate reporting process is one of the key elements in a comprehensive internal controls system. Proper controls should be established throughout the life of a loan, from acceptance of the application to the collection of the final loan payment or foreclosure on the collateralized property. Management information systems should be capable of generating accurate and timely loan information by individual loan, by loan type, by market, by classification, by delinquent status, and the like. Each report must be adequately reviewed and approved by the appropriate level of management.

Loan Review. An independent loan review function is another key to early detection of potential credit problems. While each lending officer is the first line of defense to identify potential credit problems, loan reviews often provide more objective and unbiased analyses of the portfolio. Depending on the size and complexity of the institution, the loan review function can be established in-house, outsourced to a vendor, or a combination of internal coverage and outsourcing. Some of the best practices noted in the loan review function include:

- Scope, coverage, and frequency are reviewed and approved by the entire board of directors or a committee thereof.
- A risk-focused approach is applied, with more effort devoted to credits with higher risk.
- A loan is not reviewed by the same individual every year.
- The loan review function has sufficient expertise and experience in reviewing appraisals.
- Loan ratings are reconciled to regulatory classifications.
- Final loan review findings are reported directly to senior management and the board of directors.

Internal Audit. Although internal audit does not normally examine the quality of the loan portfolio, it should test for internal policy and regulatory compliance. Internal audit should also assess the effectiveness of appraisal review, loan review, and loan approval processes.

Capital and Allowance for Loan and Lease Losses

Regardless of how strong a credit risk management process is, incurring credit losses is inevitable. A good complement to sound credit risk management is the maintenance of adequate levels of capital and allowance for loan and lease losses (ALLL). Both levels are considered in many of the loan-related calculations and policy parameters. Setting lending strategies without taking these levels into account could be deemed an unsafe and unsound banking practice.

Regulatory guidelines on capital adequacy for state member banks are outlined in appendices A, B, and E of the Federal Reserve's Regulation H, *Membership of State Banking Institutions in the Federal Reserve System*. Guidelines for bank holding companies are set forth in appendices A, B, D, and E of the Federal Reserve's Regulation Y, *Bank Holding Companies and Change in Bank Control*. Banking institutions also should follow the guidance in the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* issued on December 21, 1993 and in the *Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions* issued on July 2, 2001 to determine the adequacy of ALLL methodology and documentation. These statements are included as attachments to the Federal Reserve's SR Letters 93-70 and 01-17, respectively.[1]

Final Thoughts

External factors such as economic conditions, CRE market conditions, competition, and regulatory changes may affect a bank's CRE credit quality. However, internal factors such as the adequacy of credit risk management processes are the primary determinants of the quality of the CRE loan portfolio. A sound credit risk management program contains four major elements: active board and senior management oversight, adequate policies and procedures, sufficient risk measurement and ongoing monitoring, and comprehensive internal con-

[1] SR Letters can be found on the Board of Governors' public web site at <www.federalreserve.gov/boarddocs/srletters/>.

trols and reporting processes. Many of the control elements mentioned in this article may appear to be basic or obvious to a sophisticated and experienced management team. Nevertheless, some institutions have overlooked the fundamental risk management processes and thereby increased the credit risk in their CRE loan portfolios. If you have any questions on commercial real estate lending best practices, please contact your institution's primary federal banking regulator. If you are supervised by the Federal Reserve Bank of Philadelphia, please contact your institution's central point of contact at the Reserve Bank. Alternatively, you can contact David Fomunyam (david.fomunyam@phil.frb.org) at (215) 574-4128 or Eddy Hsiao (eddy.hsiao@phil.frb.org) at (215) 574-3772. ■

Not-So-Best Practices or Common Credit Risk Management Deficiencies

Construction Lending

- Inadequate policies and procedures
- Lack of experienced lenders
- No permanent loan commitment
- Low borrower equity in the project
- Advanced draw requests without adequate inspection
- Inadequate on-going monitoring of or visitation to the construction project
- Failure to ensure all required permits are in place
- Additional advances requested due to frequent changes in budget or plans

Policies

- Lack of diversification standards
- Policies not sufficiently detailed to provide adequate guidelines and limitations on each CRE lending product
- Authorization, delegation, review, approval, and reporting processes not clearly identified

Appraisals

- No or inadequate appraisal review processes
- Invalid appraisals
- Use of unqualified or non-board-approved appraisers
- Questionable appraisal values without adequate reconciliation and/or justification

On-going Monitoring

- Unorganized credit files
- Lack of documentation (e.g., correspondence between lenders and borrowers, current financials, insurance, and tax returns)
- Inadequate onsite visitation and outdated financial and operational analyses on borrower
- Unfamiliarity with or lack of analysis of external factors, such as economic conditions, industry trends, and regulatory changes

Information Systems

- Inadequate exception tracking system
- Insufficient loan concentration or stratification monitoring
- Inability to create detailed loan reports

Internal Controls

- Inadequate loan review scope and frequency
- Internal audit and/or loan review do not report directly to the board or a designated committee

Others

- Extending credit to locations significantly outside the bank's designated markets
- Making unwarranted character loans without proper analysis
- Inadequate procedures to ensure collateral position

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