

Regulatory Bulletin

RB 37-30Handbook: **Examination**Subject: **Asset Quality****Section: 210****Income Property Lending**

Summary: This bulletin provides new Examination Handbook Section 210, Income Property Lending. We rescind TB 16, Environmental Risk and Liability, with the issuance of Handbook Section 210.

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SUMMARY OF CHANGES**210 Income Property Lending**

This Handbook Section addresses income property lending activities. This new handbook section replaces part of the former Thrift Activities Handbook Section 212, Real Estate Lending. Based on examiner suggestions, we separated single family residential lending and income property lending into two handbook sections. We issued Examination Handbook Section 212, which addresses one- to four-family residential lending in June 2005, and revised it in March 2007. New Section 210 provides OTS examiners and savings association personnel with updated and expanded guidance on: income property lending in general, the different types of income properties financed, the risks associated with income property lending activities, and supervisory expectations regarding these lending activities. The main topics of this handbook section are:

Income Property Lending: Discusses the entire spectrum of income property lending operations from underwriting (including market analysis, property analysis, and borrower analysis considerations), loan terms, documentation requirements, credit administration, and portfolio concentrations. It provides specific guidance related to multifamily residential real estate lending and commercial and other property lending (including specific discussions about lending on hotels and motels, assisted-living facilities, religious organization facilities, and office and retail space).

Concentrations: Discusses the responsibility for institutions to assess and manage their concentration risks for commercial real estate lending. Discusses the examiner's role in evaluating the adequacy of such measures. References OTS guidance, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 14, 2006 as CEO Letter 252.

Environmental Risk and Liability: Discusses risks that a lender can face as a result of environmentally contaminated property and steps it can take to assess and manage those risks. We revised the guidance on environmental risk and liability and subsequently rescinded TB 16.

Supervisory and Regulatory Considerations: Discusses warning signs for troubled real estate loans and environmental risk and liability. Addresses risk assessment and classification as well as ALLL and capital considerations.

Appendix A: Financial Analysis – provides additional guidance on assessing property cash flow and debt service analyses, and financial statement ratio analysis.

Appendix B: Environmental Risk and Liability.



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Income Property Lending

As the name implies, income property lending involves loans secured by real estate that generates income, and includes loans on both **multifamily residential and nonresidential real estate**. Loan repayment primarily comes from the cash flows generated by the operation or leasing of the real estate but may be supplemented by other sources of cash. For purposes of this section, income property lending includes the permanent (non-construction) financing of multifamily residential properties and nonresidential properties. One- to four-family residential real estate lending activities, including investor owned properties, are covered in Examination Handbook Section 212. Commercial loans to finance commercial or industrial business activities other than for the acquisition or holding of real estate and construction loans are discussed in [Sections 213](#) and [214](#) of the Handbook, respectively.

L I N K S

 [Program](#)

 [Appendix A](#)

 [Appendix B](#)

Multifamily residential real estate lending includes permanent financing of apartment buildings, five or more dwelling units, retirement homes, and student housing. Section 1464(c)(1) of the Home Owner's Loan Act (HOLA) authorizes federal savings associations to invest in residential real estate loans, including multifamily residential real estate loans, without limit.

Nonresidential real estate lending includes permanent financing of shopping centers, hospitals, hotels, offices, stores, farms, nursing and convalescent homes, churches, and other commercial properties. HOLA limits a savings association's investment in nonresidential real property loans (including commercial and other nonresidential real estate loans) to no more than 400 percent of total capital, unless it obtains prior written approval from the OTS.

This handbook section covers the risks associated with income property real estate lending, and highlights supervisory expectations regarding the proper underwriting, management, monitoring, and control of this activity.

INCOME PROPERTY LENDING

There are many types of income-producing properties with unique characteristics and risks that are affected differently by economic and business cycles and trends. Local supply and demand conditions are key economic factors affecting these real estate markets. Multifamily housing is influenced by homeownership availability and affordability, vacancy rates, and local employment conditions. Office space is often dependent on white-collar employment, while retail, hospitality, and industrial real estate are affected by consumer spending, among other things.

Income property lending presents significantly different issues and risks compared with one- to four-family (1-4 family) residential real estate lending. For example:

- Commercial real estate and multifamily residential mortgage loans can be more susceptible to economic cycles and may experience higher default rates and loan losses during recessions.
- Underwriting analysis and credit evaluation is usually more complex for income property loans than for single-family residential mortgages.
- Appraisals are more complex and property valuations are more susceptible to price fluctuations.
- Lending risks are more concentrated among fewer, larger loans, which can have greater impact on the association's earnings and capital in the case of default.
- Environmental and special purpose property risks are generally more prevalent in income property lending.

In establishing an income property lending activity, an association should address the factors discussed in [Section 201](#) of the Handbook, which include:

- How does income property lending fit into the association's strategic goals and business plan?
- Is this lending consistent with the association's risk profile and risk appetite?
- Is the lending activity part of a well-diversified lending strategy or is there a significant concentration in this one line of business? Has the association adequately addressed this concentration risk?
- Do management and the lending staff have sufficient expertise for this type of lending activity?
- Has the association established adequate loan policies and procedures?
- Does the association have an adequate and appropriately staffed credit administration and work-out functions?
- How are the risks of these types of loans managed – individually and across portfolios? Is the risk management function adequate?

Underwriting Income Property Loans

The discussion of underwriting standards in the Interagency Real Estate Lending Standards (RELS)(12 CFR § 560.101) applies to income property loans. Prudently underwritten real estate loans should reflect an analysis of all relevant credit factors, including:

- The capacity of the borrower, or income from the property, to adequately service the debt.
- The value of the mortgaged property.

- The level of equity investment in the property.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements.

Savings associations must establish clear written underwriting standards for income property loans. Specific underwriting criteria will depend on the property being financed, the creditworthiness of the borrower, and the source(s) of loan repayment. Savings associations must also establish clear requirements for documenting its analysis of the borrower's financial capacity, the borrower's creditworthiness and experience, and the value of the collateral. (Refer to the discussion on the five "Cs" of credit and loan documentation in [Handbook Section 201](#).) The association must have underwriting criteria and documentation standards related to its specific type of income property lending activities. Moreover, the institution should establish prudent and appropriate loan terms for each loan type.

Market Analysis

Performance of income producing property depends in large part on local and regional economic conditions. As set forth in the RELS rule (12 CFR 560.100-101), a lender should monitor conditions in the real estate markets in its lending area so it can consider factors affecting the supply and demand for income producing properties in lending decisions and in monitoring loan performance after a loan is made. Such factors include:

Performance of income producing property depends in large part on local and regional economic conditions.

- Demographic indicators, including population and employment trends, such as the job market, trends in job growth, sector growth, and the financial condition of local employers.
- Zoning requirements, including pending changes.
- Current and projected vacancy, construction, and absorption rates.
- Current and projected lease terms, rental rates, and sales prices, including concessions.
- Current and projected operating expenses for different types of properties.
- Proposed and approved projects, including local development, approved development, and permits issued.
- Economic indicators, such as the local economy, community needs, interest rates, consumer spending patterns, and lending trends.
- Valuation trends.

Understanding the market is key in being able to better manage the risks associated with uncertainty and the cyclical nature of real estate markets.

Property Analysis

In evaluating the real estate, the lender should consider:

- Income capacity and stability.
- Condition and location of the real estate
- Quality and experience of management
- Fair market value
- Price stability
- Borrower equity
- Convertibility of the property.

Because the property serves as both the primary source of repayment of the loan and as collateral in the event of default, the lender must carefully analyze and document the property's value and its ability to generate sufficient revenue to service the debt over the life of the loan, given current and anticipated market conditions. In conducting its underwriting analysis, a lender will usually look at several factors, including income capacity (or debt service coverage), collateral value, and loan to value.

Income Capacity. Assessing the ability of the property's net operating income (NOI) to cover debt service requirements is key when relying on this income as the primary source of loan repayment. Typically the lender uses a debt service coverage ratio (DSCR) to make this assessment. The DSCR is the ratio of NOI divided by projected annual debt service. NOI is calculated as the gross revenue, minus a vacancy factor, minus operating expenses (including capital expenditures but excluding debt service). Some properties do not achieve stabilized occupancy until well after the initial lease-up or interest only periods. Also, many properties are leased with special incentives, such as rent free periods. For these reasons, DSCRs should be determined and evaluated using both current and stabilized rents and occupancy.

Savings associations must carefully evaluate NOI by evaluating the nature and stability of income, operating expenses, and rates of occupancy over time compared with market rates. Lenders should verify NOI information by obtaining borrower and property financial statements/tax returns, rent rolls, financial information on the major tenants, leases, and other relevant information, as well as comparative market data. Savings associations should assess the adequacy of a borrower's reserves relative to operating expenses and ensure that projected NOI reflects necessary contributions to reserves for maintenance and improvements to ensure their adequacy over time. An association should determine the level of stabilized occupancy and income based upon reasonably expected market conditions, taking into consideration historical experience and current market conditions.

The higher the DSCR, the better the ability of the property to generate sufficient income to service the loan. For example, a 1.32 DSCR provides a 32 percent buffer to cover higher than predicted rates of vacancy, unexpected maintenance and repairs, or increased costs. A lender may require a DSCR of 1.2x or higher, depending on the type of property and the stability/predictability of the NOI, although a ratio as low as 1.1 may be acceptable to a lender for projects with guaranteed rent features, such as a government office building. Note: Prudently underwritten multifamily mortgages may qualify for the 50 percent risk weight with a DSCR as low as 1.15 percent. See the discussion on property analysis in [Appendix A](#).

Collateral Value. An assessment of the value of the property is also important. The method of valuation used will depend on the type of property being valued. This highlights the need for reliable appraisals or evaluations in accordance with OTS's appraisal regulations (12 CFR Part 564) and [Handbook Section 208](#).

When estimating the value of income-producing property, the appraiser generally relies on the income approach to valuation rather than the comparable sales or cost approach. The income approach converts all expected future NOI into present value terms, using a variety of analytical methods. One method is the direct capitalization method, which estimates the present value of a property by discounting its NOI at an appropriate capitalization rate (commonly referred to as the cap rate). The direct capitalization method is appropriate for use in valuing properties with stabilized rents and occupancy. Another method is the discounted cash flow method, which discounts expected future cash flows at an appropriate discount rate to ascertain the net present value of a property. This method is appropriate for use in estimating the values of newer properties that have not yet reached stabilized occupancy, or for properties that are experiencing fluctuations in income.

The discount and cap rates used in estimating property values should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used.

Management must review the reasonableness of the assumptions and conclusions underlying each appraisal and should question any assumptions that appear to be too optimistic or pessimistic. When considering the reasonableness of facts and assumptions associated with the value of the collateral, lenders should consider:

- Current and projected vacancy and absorption rates.
- Lease renewal trends and anticipated rents.
- Volume and trends in past due leases.
- Effective rental rates and sales prices.
- Outstanding leases.
- Net operating income of the property compared with budget projections.

- Discount rates and capitalization rates.

Lenders should consider each of those factors under normal and stressed conditions. As real estate incomes and prices rise in periods of rapid economic growth, lenders should stress test cap rates and DSCRs to determine whether a property will be viable during a period of economic stress.

Nonresidential real estate may be designed for unique and specialized uses that could render it difficult to liquidate should the borrower default. This lack of liquidity presents an increased risk to the lending institution, particularly if it is forced to sell the property during periods of real estate market weakness. Marketing and holding costs, and the cost to convert the property to alternative uses with greater market demand, increases the difficulty of valuing such properties and presents additional risks to lenders who make loans on highly specialized properties.

Loan-to-Value Ratio. Residential and nonresidential loans are subject to 12 CFR § 560.100-101, the Real Estate Lending Standards Rule, including the attached interagency guidelines. The rule requires savings associations to maintain prudent written lending standards for its real estate loans, including standards for loan-to-value (LTV) limits. The LTV ratio is the ratio of the loan commitment amount divided by the lower of the purchase price or appraised value of the property at the time of origination. These requirements are discussed in more detail in [Examination Handbook Section 212](#). Loans on improved property are subject to an 85 percent supervisory LTV limitation, although some lenders set LTV limits for nonresidential real estate loans at or below 75 percent. Aggregate loans in excess of the supervisory LTV limits, including 1-4 family mortgages, should not exceed 100 percent of the association's total (tier 1) capital. Within that 100 percent of capital limit, nonresidential and multifamily mortgages should not exceed 30 percent of the association's total capital.

A savings association's internal policies should establish appropriate standards for the type and amount of borrower equity by setting maximum LTV ratios pursuant to 12 CFR § 560.100-101. The lower the LTV ratio, the greater the borrower's equity or investment in the property. Borrower equity provides a cushion to the lender against loss in the event of borrower default. Also, the more cash equity a borrower has in a project, the more likely the borrower will remain committed should cash flows decline.

Other security. Lenders often secure all business-related assets of a company so they can sell the building and all related furniture and equipment in the event of foreclosure. Also, a lender may obtain an assignment of rents for the security property, a cross-collateralization agreement covering the principal's other business real estate, and chattel agreements for related business property. A lender may also take other measures to enhance its positions in the event of borrower default. Not only is the lender in a better collateral position in the event of default, but default on the one loan would trigger default on the borrower's other projects. This may provide extra incentive for the borrower's continued commitment to the project.

Borrower analysis

Underwriting criteria and analysis will depend on the borrower's legal status and the primary source of loan repayment. The borrower may be an individual, individuals, corporation, or partnership. Owners of closely held companies may rely on personal income and assets to service the debt, in addition to income from the real estate.

Underwriting criteria and analysis will depend on the borrower's legal status and the primary source of loan repayment.

For businesses less than three years old, lenders should obtain personal guarantees from the principals and evaluate their credit history. For corporations with a proven track record, lenders should evaluate business performance and credit ratings and determine if the business is strong enough to support the loan without guarantees. Lenders should view guarantors as secondary repayment sources and fully evaluate their ability and willingness to repay the loan in the event of a default. When the borrower is a shell company or entity whose only or primary asset is the real estate securing the loan, the association should consider obtaining personal endorsements or guarantees from the principals and requiring additional collateral to reduce net credit exposures. The reliability of the operating and cash flow information on the real estate take on increased importance in these instances.

History and Experience. Associations should thoroughly investigate a borrower's experience with similar real estate projects to determine if the borrower has the expertise and resources necessary to manage the project profitably and successfully during unexpected economic or other setbacks. Borrower history and track record are an indication of character, competence, and ability. It is also important that the borrower demonstrate a history of timely and accurate financial reporting and performance on other loans with the association as well as with other lenders. It is important for the institution to review the borrower's nonbank creditors and trade accounts as well as credit bureau and Dun and Bradstreet credit reports to assess the borrower's credit standing. A review of several months of checking account activity is also useful to determine the cash needs of the borrower/business and give indications of borrower liquidity.

Financial Capacity. Depending on the borrower, the lender may analyze personal financial statements and tax returns, or corporate financial reports. Current and accurate financial statements are integral to making informed and sound lending decisions, so a lender should insist on complete and signed statements. The lender should obtain current and accurate borrower financial statements, two to three years of current business or personal tax returns, and profit/loss and cash flow statements on the business or security property. It is important to compare financial statements and tax returns detailing the borrower and the property's financials over time to look for consistency, financial strength, and reliability of information. For partnerships and similar entities, it is important that tax returns include k-1s when there are partnership entities on the balance sheet. Without those, cash flows will be inaccurate.

When the borrower is a corporation or business entity, financial capacity is generally determined by conducting an analysis of its current financial statements. Net working capital (current assets minus current liabilities) show borrower liquidity. The debt to equity ratio (borrowed funds divided by net worth) shows reliance on outside financing indicating leverage. Return on assets and return on equity

show profitability and management efficiency. Borrower ratios can be compared with average ratios for similar businesses. Ratio analysis is important to help determine the borrower's financial strength and management capabilities. Similarly, a thorough understanding of the borrower's current and projected cash flows is essential. See [Appendix A](#) for a more detailed discussion on financial analysis.

A review of corporate documents such as corporate borrowing resolutions, articles of incorporation, and certificates of good standing, are also appropriate. With larger income property loans, lenders should have a loan approval memorandum (or memoranda) in the loan file that documents the underwriting analysis, the strengths and weaknesses of the proposed transaction, and the approving officer's reasons for approving the loan request.

Loan Terms

Granting nontraditional mortgage terms in the financing of commercial and multifamily real estate properties can substantially increase the risk of the commercial real estate portfolio if not underwritten prudently. Nontraditional payment terms and features include interest only loans, discounted initial payments, option ARMS, and extended terms. Interest only periods are often granted for construction and lease-up periods. Such terms should only be granted in cases where the underwriting analysis demonstrates that they are appropriate for both the borrower and the association. Moreover, debt-to-income ratios should be calculated based on fully indexed, amortizing payments. When a borrower does not qualify for a loan without the discounted or liberal payment terms, the borrower could be exposed to payment shock when the loan is recast or refinancing is required, thereby exposing the institution to default and potential loss.

Loans to borrowers who do not have repayment capacity from sources other than the sale or refinancing of the collateral pledged are generally considered unsafe and unsound. Loans where property cash flow provide the primary repayment source is acceptable, provided that such income, together with other borrower income, is sufficient to repay the loan. However, when repayment is solely dependent on the sale or the refinancing of the property, the loan is collateral dependent. Institutions originating collateral-dependent mortgage loans may be subject to higher capital requirements, criticism, and corrective action.

Loan Policy Exceptions

The board of directors should establish specific safe and sound policies and procedures for the approval of loans that fall outside the limitations of the savings association's approved loan policy. Approval authority should be detailed by officer and loan amount. The nature of the exception and the amount of the loan should dictate the level of approval required with higher level approval required for more significant exceptions and larger loans. It is also important for associations to establish reporting and enhanced monitoring procedures for exception loans.

Loan Purchases and Participations

When lenders purchase income property loans from or participate in loans with other lenders they should perform and document an underwriting/due diligence analysis that is as thorough and complete as when they originate the loan. A participant must perform its own independent credit analysis in order to determine that the borrower is creditworthy and the participation is prudent. Participants

should not rely on information provided solely by the originator. Participation documents should show that the participant is exercising independent judgment concerning the borrower's financial strength and the valuation of collateral. Moreover, participants should obtain copies of all relevant loan documents, including security agreements, appraisals, financial statements, credit reports, loan approval memoranda, disbursement sheets, title and recording documents, and periodic financial statements and payment reports generated after loan closing.

Savings associations that purchase participations must enter into participation agreements that are structured to allow them to protect their own interest if a participated loan defaults. Participation agreements should be structured to clearly outline the obligation of the originator to furnish timely credit information and to provide notification of material changes in the borrower's status. Agreements should also outline the terms under which the originator can modify the loan, guaranty, or security agreements, and what role the participant will play in such decisions. Participation agreements should also include the ability of the participant to require action related to all risk areas, including property maintenance, loan modifications, and work out arrangements. Finally, the participant is responsible for ongoing monitoring of the loan's performance and the financial condition of the borrower commensurate with the size and complexity of the loan.

Documentation

An association should base its documentation requirements for income property loans on prudent industry practices and OTS regulation 12 CFR § 560.170. That regulation states that:

Each savings association and service corporation should establish and maintain loan documentation practices that:

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

Income property loans (whether originations or participations) are generally more complex than other real estate loans and therefore require more documentation, which will vary on the size of the loan, the property type and use, and the borrower/guarantor's legal structure. Typical documentation may include:

- Credit memorandum or form supporting the loan decision and documenting approval.

- Application signed by borrower(s)/guarantor(s).
- Sales or construction contract, if applicable.
- Appraisal and appraisal review.
- Feasibility study.
- Comprehensive current financial statements for all borrowers and guarantors, signed by the borrowers/guarantors, including loan covenants that require this.
- Federal, state and local tax returns for all signatories.
- Appropriate business licenses.
- Credit and Dun and Bradstreet reports for borrower and guarantors.
- Rent rolls, as appropriate.
- Assignment of rents.
- Corporate/Partnership organizational documents and corporate resolution, as appropriate.
- Insurance policies (hazard, liability, business interruption, key employee).
- Title insurance.
- Title recording documents.
- Mortgage or deed of trust, promissory note, security agreement.
- Environmental risk assessment.

Credit Administration

As discussed in [Handbook Section 201](#), associations must have a loan or credit administration function with experienced staff and strong internal controls. Associations should conduct the following activities as part of the credit administration function:

- Loan closing and disbursement, including preparing appropriate legal documents, recording appropriate documents, and disbursing funds per the terms of the loan agreement.
- Payment processing, including collecting and applying loan payments.

- Escrow administration, including the timely collection and payment of insurance premiums and property taxes.
- Collateral administration, including maintaining documents to reflect the status of the lien, the value of the collateral and the protection of the collateral (e.g., insurance).
- Loan payoffs.
- Collection and foreclosures.
- Claims processing.
- Property inspections.

One key aspect of credit administration is the ongoing monitoring of the borrower's financial condition, and the financial status and physical condition of the income property. Such monitoring is essential to evaluating the loan portfolio, revising lending standards as needed, and effective risk management. Such activities should be appropriate to the size and risk of the portfolio. Lenders should require at least an annual submission of financial and property information and conduct property inspections as needed to verify its condition and ensure proper maintenance. Lenders should document the results of on-going monitoring activities in the loan file.

In addition, a savings association should have an experienced and knowledgeable collections and workout staff to address problem loans.

Concentrations

Concentrations of income-property loans and participations can present additional risks for lenders. It is essential that management identify concentrations within its portfolio (by geography, loan type and industry). Management should ensure that the level of risk associated with these loan concentrations is

Concentrations of income-property loans can present additional risks for lenders. It is essential that management identify concentrations within its portfolio.

consistent with its risk appetite, its risk limits, the sophistication of its risk management function, and its level of capital and reserves. Ongoing monitoring of the loans, controlling concentrations through effective MIS reporting, ongoing assessment of market

trends, and stress testing of the portfolio to assess the impact of adverse economic scenarios, are all essential risk management techniques, especially when concentrations of risk exist.

On December 14, 2006, OTS issued *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, as [CEO Memo 252](#). The primary focus of the guidance is that savings associations actively engaged in CRE lending, especially those that are entering or rapidly expanding CRE lending, should do both of the following:

- Perform an internal self-assessment of exposure to concentration risk; continually monitor potential exposure to such risk; and report any such identified concentration risk to senior management and the board of directors.
- Implement risk management policies and procedures appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risks, to monitor and manage those risks effectively.

The guidance also reminds savings associations that they are subject to a 400 percent of capital statutory investment limit on nonresidential real estate lending, which does not include loans secured by multifamily residential properties. In addition, through existing guidance and practice, OTS expects savings associations to continuously assess and manage all concentration risk.

As part of its ongoing supervisory monitoring processes, OTS uses certain criteria to identify savings associations that may have CRE concentration risk. These include savings associations that:

- Are approaching their HOLA investment limits.
- Have experienced rapid growth in CRE lending.
- Have notable exposure to a specific type of or high-risk CRE.
- Were subject to supervisory concern over CRE lending during preceding examinations.
- Have experienced significant levels of delinquencies or charge-offs in their CRE portfolio.

These supervisory monitoring criteria serve as high-level indicators to identify savings associations potentially exposed to CRE concentration risk. For a savings association that exhibits any of these risk elements, determine whether its internal concentration risk assessment and resulting risk management practices are commensurate with of the level and nature of its CRE exposure.

The effectiveness of an institution's risk management practices will be a key component of the supervisory evaluation of its CRE concentration risk. Evaluate the association's internal CRE analysis to assess CRE exposure levels and risk management practices. In evaluating the level of risk, consider the association's own analysis of its CRE portfolio including the presence of mitigating factors, such as:

- A successful track record of managing the risks in CRE concentrations.
- Portfolio diversification across property types.
- Geographic dispersion of CRE loans.
- Portfolio performance.
- Underwriting standards.

- Level of pre-sold units or other types of take-out commitments on construction loans.
- Portfolio liquidity (ability to sell or securitize exposures on the secondary market).

Multifamily Residential Real Estate Considerations

The availability of affordable rental properties is a critical need in many communities across the country. Savings associations play an important role in providing financing for these properties in their communities. Because of the large size of many multifamily loans, default risk can pose a greater danger to an association's profitability and solvency. Lenders must manage the multifamily credit risk exposure by adopting lending standards that include concentration limits, and prudent LTV and debt service coverage ratios.

The risk inherent in multifamily loans depends on:

- The ability of the property to generate sufficient cash flow to service the debt.
- The ability of the borrower to effectively market, manage, and maintain the property.
- The borrowers' character and financial strength (i.e., ability and willingness to repay the loan), and financial strength to weather economic downturns.
- The collateral support provided by the real property over the anticipated life of the loan.
- Loan terms.
- Local demographic and economic conditions, including demand for rental property.
- Location and condition of property.

Renters are much more mobile than homeowners. Because of the high turnover associated with multifamily properties, investors must constantly work to keep their units rented. Vacancy rates can increase dramatically. Lenders should closely monitor vacancy rates and trends, and the owner's efforts to keep properties rented.

Undercapitalized borrowers may neglect needed maintenance when cash flows are inadequate. This is called "milking" the property, which can cause accelerated deterioration. Borrowers with troubled properties may "milk" much of the value out of the property before defaulting and turning the property over to the lender. This will significantly decrease the value of the property at foreclosure. Therefore, it is important that lenders monitor property maintenance and improvements to ensure they are timely and appropriate and that the condition of the property does not deteriorate. Lenders should also ensure that maintenance reserves are adequate to provide for necessary improvements and upgrades over time.

Older properties may require substantial rehabilitation and investment to keep them economically viable. However, the borrower may be able to take advantage of community investment tax incentives and government subsidies to finance improvements. Before an institution relies on these incentives and

subsidies to determine if the borrower qualifies for financing, it should insure that the incentives would survive foreclosure.

Lenders should regularly monitor market factors that can influence the demand for multifamily housing over time, including work force composition, employment trends, competition, availability and affordability of local housing, and regulatory trends, to anticipate and address potential problems.

Commercial and Other Income-Producing Property Lending Considerations

Commercial and other nonresidential real estate lending is essential for the economic development of our communities. When commercial real estate loans are prudently underwritten and the risks properly managed, such loans can be a profitable business activity. However, financing commercial real estate can present a high degree of credit risk. As with multifamily loans, the larger loans can have a more serious impact on capital and earnings in the event of default. The loans are susceptible to changes in economic and demographic conditions, sensitive to fluctuations in interest rates, and can be affected by:

- Competitive market factors that cause a property to not achieve or sustain its income according to plan.
- Changes in the regulatory environment, such as zoning regulations, tax laws, and environmental regulations.
- Lease terms and the inability to rollover leases as they expire.
- Changes in interest rates, particularly when the debt carries a floating rate and the leases carry fixed rates.

Associations must understand the risks associated with the types of properties financed and use the underwriting process to mitigate those risks upfront. As with multifamily residential lending, a lender must assess:

- The ability of the property to generate sufficient net operating income to service the debt. This includes assessing the stability/volatility of income and vacancy rates given:
 - Current and expected market conditions and trends.
 - The ability of the borrower to market, manage and maintain the property.
 - The adequacy of reserves.
 - The stability of operating expenses.

— Consideration of borrower and/or property cash flow declines or diversions away from loan payments.

- The financial strength and character of the borrower, and the borrower's ability to weather setbacks.
- The financial strength and stability of the major tenants for office and retail space.
- The fair market value of the collateral.
- The quality and location of the property.
- The need for additional reserves, additional collateral or guarantors on the loan.
- The need for specific loan covenants addressing such things as default, remedies, monitoring and reporting requirements, insurance, reserves, and other items to protect the lender.

Lenders must also understand the unique risks and considerations of various special purpose properties, establish underwriting standards that address these unique risks, and employ staff that have experience with the specific type of loans.

Hotels and Motels. The hospitality industry is highly dependent on trends in leisure and vacation spending and business travel. There is less income stability compared with other types of real estate. When financing hotels or motels, lenders should consider:

- Trends in local tourism and convention bookings and cancellations.
- Revenue sources, including identification of the primary clientele and factors that affect revenue generated from this clientele.
- The local labor pool and elasticity of wages.
- Stability and expertise of management.
- Ratings by the Automobile Association or industry groups.
- Average room rates and occupancy compared to industry averages.
- Zoning and alternative uses for the property.
- Adequacy of insurance coverage.

In assessing the financial capacity of the hotel, lenders should review income statements for a five-year period, given the unpredictability of revenues, and compare financial performance of the borrower with industry averages. Lenders should also ensure the adequacy of expenditures for maintenance and

repairs. In assessing the borrower's ability to repay the loan, lenders should evaluate the borrower's earnings before interest and taxes. Given the seasonality and greater instability in revenues, lenders often require a coverage ratio of up to 175 percent, and may require the establishment of a sinking fund to cover debt payments in the event of cash flow problems or unforeseen capital or maintenance expenditures. In addition, loans generally do not exceed 55 to 60 percent of the value of the hotel. Loan covenants should address events of default, insurance coverage, maintenance, and reporting requirements. Lenders should regularly monitor the financial and physical health of the real estate.

Assisted-Living Facilities. Assisted-living facilities are real estate with a business component of services ranging from meals, housekeeping and transportation, to activities of daily living and medical care. The demand for assisted living facilities is strongly correlated to the demographics: the older the population in the community, the greater the demand for assisted living facilities. Income from assisted living facilities tends to be more stable and less cyclical than for other types of real estate; however, the payor mix can be important. Success of the operation of the assisted living facility, however, depends on the quality, reputation, and experience of management and staff; the condition and location of the facility; and the quality of care. Lenders should also carefully evaluate these and other factors, including: local demographic patterns, the supply of qualified staff, labor trends and costs, competition, turnover, breakeven occupancy rates, and convertibility of the property.

Religious Organization Facilities. Religious organizations are non-profit, corporate entities that are either owned by the membership or part of a denominational hierarchy. Loans to religious organizations are generally for expansion of facilities to support growing membership, increased community programs or school activities, kitchen facilities, etc. Lending to churches, synagogues, and other religious organizations can provide a financial institution with a lending relationship as well as community goodwill and an opportunity for increased deposit and other business relationships with the organization and its members.

Underwriting a loan to a religious organization involves an assessment of the trend, level and stability of income and expenses, and a determination of the amount of net operating income available for debt service. Primary income generally consists of tithes, offerings, other ongoing contributions or giving, and other sources of revenue such as school or day care income. Nonrecurring income, such as special one-time gifts and income from fund drives or capital campaigns, is generally regarded as secondary sources of income. A lender should assess a religious organization's primary income over at least a three-year period and be particularly aware of any significant variances. Fixed expenses generally consist of general and administrative expenses, debt expenses and clergy and staff expenses. Discretionary expenses include ministry, outreach and mission program related expenses. In conducting its financial analysis, a lender should consider the ratio of the loan amount to the gross annual receipts and the ratio of proposed annual debt service to gross annual receipts.

In conducting its due diligence, a lender should consider:

- History of the organization and membership trends.
- History or prior experience with building programs.

- Stability and experience of clergy, staff, and lay member leaders.
- Hierarchical structure and governance in order to assess other obligors and assets available to support the loan.
- Level of commitment from the members.

The collateral, loan terms, and interest rates on the loans will probably vary depending on the nature of the religious organization and its business. Institutions should conduct ongoing monitoring of trends in revenues, expenses, and membership.

A recent trend is where religious organization facilities are not special purpose use properties, but can be used for other business or commercial purposes. A lender's overall assessment should give proper consideration to the risks and benefits of such use.

Office and Retail Space. For office space, a lender should consider job growth and employment trends, existing office supply and vacancy rates, lease rollovers, market rents, local competitions, office space absorption rates, and rental rates and concessions. For retail, lenders will want to assess consumer spending patterns, local competition, financial health of local retailers, and alternative uses for space.

Environmental Risk and Liability

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors in evaluating real estate transactions and making loans secured by real estate. Environmental hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its real estate loans and investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems, or oil and gas wells.

Lender problems with pollution and hazardous waste contamination have grown as federal, state, and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for environmental cleanup. Lenders must be aware of and concerned with regulations that impose clean-up liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Environmental hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its real estate loans and investments.

Risks that a lender can face as a result of environmentally contaminated property include:

- The value of the collateral securing a real estate loan may be drastically reduced after discovery of the existence of hazardous waste contaminates.

- The borrower cannot repay the loan if he or she must also pay for the cost of cleaning up the contaminated property. The cost for cleanup can be significant and may exceed the institution's encumbrance on the property.
- Foreclosed properties could become a dumping ground for waste unless proper oversight of such properties is maintained.
- The real estate loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up hazardous waste contaminates may have priority over a lender's mortgage.
- The lender may be liable to the extent of any credit extended to any debtor who has operated property containing hazardous wastes, has generated such waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous waste.
- The lender may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property or becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the disposal of toxic or hazardous waste.
- The lender may not be able to pursue his or her foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could necessitate charging off the loan balance.
- The borrower does not maintain collateral or property with an environmental risk potential in an environmentally sound manner.
- Aside from the statutory liabilities that can be imposed for toxic waste contamination, the potential liability for personal injury or property damage.

Environmental Risk Policy

The most expeditious means by which a lender may commence protective action against environmental risks and liabilities is to develop and implement a written environmental risk policy. Such a policy will serve several critical purposes, including establishing:

- A level of due diligence in all real estate loan transactions.
- Risk thresholds or a method of identifying environmental risk in properties being considered as collateral for acquisition and for refinance, and determining, given the association's risk thresholds, whether the property or site is considered low or high risk.
- Loan amount thresholds for determining when and what type of due diligence is required.

- Due diligence methods to use depending on the type of loan, the amount of the loan and the risk category, including borrower questionnaire or screening, site visit, government records review, historical records review, testing or inspections using qualified professionals, Phase I environmental assessment (ASTM standards), and Phase II environmental assessment.
- Appraisal requirements for disclosing and taking into consideration any environmental risk factors.
- Criteria for evaluating environmental risk factors and costs in the loan approval process.
- Criteria for determining the circumstances in which the lender may decline loan requests due to environmental factors.
- Environmental provisions for incorporation into transaction documentation:
 - For commitment letters: extent of due diligence required, borrower costs, approval contingencies, reporting obligations, documentation requirements, etc.
 - For loan documentation: reps and warranties, inspection requirements, reporting requirements, lien covenants, indemnification provisions, provisions allowing for the acceleration of the loan, and refusal to extend funds under a line of credit or exercise other remedies in the event of foreclosure.
- Collateral monitoring and periodic property inspection requirements throughout the loan term.
- A means of evaluating potential environmental liability risk and environmental factors that could impact value in the event of a foreclosure.
- Guidelines for avoiding owner/operator liability and for qualifying for innocent landowner defense under CERCLA (the Comprehensive Environmental Response, Compensation and Liability Act).
- Guidelines and controls to ensure the institution's adherence to safety and soundness principles.

Please see [Appendix B](#) for guidance on measures that a savings association should consider in identifying and managing environmental risks and liability from its real estate lending activities.

SUPERVISORY AND REGULATORY CONSIDERATIONS

Warning Signs for Troubled Real Estate Loans

While some real estate loans may become troubled because of a general downturn in the market, others become troubled because of unsound or uneconomic underwriting practices. The existence of certain lending practices may be cause for supervisory concern. You should investigate the extent and impact of such activities on the asset quality and consider the need to cite such activities and concerns in the

report of examination and to seek corrective action. The following lending practices may be cause for supervisory concern:

- Projects with inadequate income or cash flow.
- Borrowers with inadequate equity and, thus, inadequate incentive to stay with the project.
- Borrowers with little or no experience in the area of business related to the loan.
- Loans or additional advances to borrowers with whom the institution has had an unsatisfactory lending relationship or where the borrower has a poor credit history with other creditors.
- Modification or refinancing of loans, payments, or terms to mask delinquency.
- Reliance on stated but unverified financial or credit information.
- Loans with inadequate or unsigned financial statements or inadequate financial analysis.
- Loans to borrowers with inadequate financial resources or cash flows to justify and service the debt.
- Loans where junior liens create imprudent additional debt service requirements on the borrower.
- Loans resulting in imprudent concentrations by borrower or loan type.
- Loans where institution staff does not have expertise in underwriting or servicing the loans.
- Inadequate due diligence for the type of loan or property.
- Limited ongoing monitoring of loan performance, market trends, property and borrower financials, and property condition.

When evaluating an association's real estate loan portfolio, you should also look for:

- Inadequate or incorrect loan monitoring reports to senior management and the board of directors.
- Weakness in the real estate markets, such as declining rents or sales, increasing vacancy rates, tenant lease incentives.
- Declining revenues or increasing expenses where the causes do not appear to be temporary or reversible.

- Increased unemployment rates, declining absorption rates, declining business activity, etc., in geographic areas or industries where the association has exposure.
- Concentrations of risk not adequately identified or managed by the association.
- Loans with:
 - Rent, lease or other concessions or sales discounts that cause the borrower to have less cash flow than originally projected.
 - Delinquent lease payments from major tenants.
 - Tax arrearages.
 - Deferred property maintenance.
 - Lack of improvements or inadequate reserves for needed improvements.
 - Land values that assume future rezoning.
 - Environmental problems.

Risk Assessment -- Classification Guidelines

When evaluating income property loans for possible classification, you should apply the uniform classification definitions found in [Handbook Section 260](#), Classification of Assets.

The following guidelines for classifying troubled collateral-dependent real estate loans apply when repayment of the debt will be provided solely by the disposition of the underlying real estate collateral, and there are not other reliable sources of repayment available.

For a troubled collateral-dependent real estate loan, as a general rule, any portion of the loan balance that exceeds the fair value of the collateral, less cost to sell, should be classified “loss.” The amount of the loan balance in excess of the fair value of the collateral, or portions thereof, may be classified “doubtful” when the potential for full loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified “substandard.”

ALLL and Capital Considerations

Savings associations should maintain an adequate Allowance for Loan and Lease Losses (ALLL) for the losses inherent in their income property loan portfolios in accordance with generally accepted accounting principles and OTS policies and guidelines. See [Handbook Section 261](#), Adequacy of Valuation Allowances, for additional guidance on the ALLL.

Capital levels should reflect the risk inherent in the portfolio. Most income property loans are risk weighted at 100 percent; however, when an institution has high concentrations of higher risk income property loans, capital levels above the minimum requirements may be warranted.

Multifamily real estate loans generally possess less risk than other income property loans and savings associations have historically invested in these loans successfully. While concentrations in income property loans may produce increased supervisory oversight and additional capital expectations, concentrations in performing multifamily loans do not generally present a supervisory concern, provided concentration risks are properly managed and underwriting, structure, and risk management are performed in a safe and sound manner.

Qualifying multifamily mortgage loans are risk weighted at 50 percent. The term qualifying multifamily mortgage loan means a loan secured by a first lien on multifamily residential properties consisting of five or more dwelling units provided that:

- Principal and interest amortization does not exceed 30 years.
- The original minimum maturity for repayment of principal is no less than seven years.
- All principal and interest payments for the preceding year were made on a timely basis.
- The loan is performing and is not 90 or more days past due.
- The loan is made in accordance with prudent underwriting standards.
- The loan balance does not exceed 80 percent of value for fixed rate mortgages and 75 percent for adjustable rate mortgages.
- DSCR for the most recent fiscal year is not less than 120 percent for fixed rate mortgages and 115 percent for adjustable rate mortgages.
- DSCR is calculated based on payments for a fully-indexed, amortizing loan.

In addition, multifamily loans that on March 18, 1994 were secured by a first lien on a 5-36 unit property with an initial LTV ratio of not more than 80 percent and an average annual occupancy of 80 percent that existed for at least one year (and continue to meet the criteria) are “grandfathered” in the 50 percent risk-weighting category.

All other multifamily residential and nonresidential real estate loans are risk-weighted at 100 percent.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

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

Code of Federal Regulations (12 CFR)

- Part 560 Lending and Investment
 - § 560.170 Records for Lending Transactions
- Part 561 Definitions
 - § 563.41 Transactions with Affiliates
 - § 563.43 Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders
 - § 563.170 Examinations and Audits; Appraisals; Establishment and Maintenance of Records
- Part 564 Appraisals
 - § 567.1 Capital Definitions

Office of Thrift Supervision Guidance

CEO Memos

- No. 252 Office of Thrift Supervision Guidance on Commercial Real Estate (CRE) Concentration Risks

Thrift Bulletins

- TB 78a Investment Limitations Under the Home Owners' Loan Act
- TB 79a Lending Limits Pilot Program

Handbook Sections

Section 201	Lending Overview
Section 208	Appraisals
Section 209	Sampling
Section 211	Loans to One Borrower
Section 212	One- to Four-Family Residential Lending
Section 260	Classification of Assets
Section 261	Adequacy of Valuation Allowances

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies
No. 34	Capitalization of Interest Cost
No. 58	Capitalization of Interest Cost in Financial Statements that Included Investments Accounted for by the Equity Method
No. 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects
No. 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
No. 114	Accounting by Creditors for Impairment of a Loan

American Institute of Certified Public Accountants Pronouncement

Statement of Position 78-9, Accounting for Investments in Real Estate Ventures (SOP 78-9)

Income Property Lending Program

EXAMINATION OBJECTIVES

To determine the adequacy of the association's policies, procedures, and internal controls regarding income property real estate mortgage activities.

To assess management's and lending personnel's conformance with established guidelines.

To evaluate the quality and performance of the association's income property loans.

To ensure compliance with applicable laws and regulations.

To initiate corrective action where supervisory concerns exist.

EXAMINATION PROCEDURES

You should use the following examination procedures in conjunction with [Handbook Section 201, Lending Overview](#). Where an association has multiple loan departments (e.g., segregated by lending type(s)), you will typically review each area separately and bring the evaluations and conclusions reached from these separate reviews to the examiner-in-charge (EIC) or assisting examiner responsible for Asset Quality. Avoid duplication of efforts by exchanging information and results with examiners reviewing the other asset quality sections.

LEVEL I

WKP. REF.

1. Review the preceding report of examination (ROE) and all of the lending related exceptions that were noted. Determine if the association has taken the appropriate corrective action. Discuss any significant uncorrected items with management and consider commenting on these unresolved issues in the ROE.

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2. Review Examination [Handbook Section 201](#), Level I findings.
-

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3. Discuss income property lending activities with management. Inquire whether the association has begun any new activities, had an increase in lending volume, changed policies or underwriting standards, experienced higher delinquencies or had any other problems in this area. Review management's due diligence prior to initiating new loan products during the review period.
-

4. Determine if the institution:

- Is approaching its HOLA investment limit for nonresidential real estate loans.
- Has experienced rapid growth in its CRE lending.
- Has notable exposure to a specific type of CRE lending.
- Was subject to supervisory concern during preceding examinations.
- Complies with the 400 percent of capital HOLA investment limit for nonresidential real estate lending.

Note: these steps will normally be performed during the examination scoping process.

5. For institutions actively engaged in CRE lending, review the association's assessment of its CRE concentration risks, and determine if the association has adequately:

- Performed an internal self-assessment of exposure to concentration risk.
 - Continually monitors potential exposure to such risk.
 - Reports any such identified concentration risk to senior management and the board of directors.
 - Has implemented risk management policies and procedures appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risks, to monitor and manage those risks effectively.
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6. Review the adequacy of the association's real estate lending policies, procedures, and practices pertaining to income property lending. The review should focus on whether the policies and procedures address LTV ratio limits, appraisals and evaluations (12 CFR Part 564), and documentation, and whether underwriting guidelines are in accordance with OTS regulation 12 CFR §§ 560.100-101.

7. Review internal classification reports or other MIS reports that relate to income property loans to evaluate their accuracy, adequacy of board and management reporting, and the quality (i.e., risk characteristics, concentrations, and performance) of the income property loan portfolio.

8. Review loan portfolio performance and trends and determine whether further review is needed to assess performance concerns. The use of the electronic loan data (ELD) to perform portfolio analysis is often useful.

9. Discuss the association's appraisal and evaluation policies and procedures relating to income property lending with management. Determine that the association adheres to the appraisal and evaluation requirements of 12 CFR Part 564 and Examination [Handbook Section 208](#). In conjunction with the Level I review of Handbook Section 208, verify that the association has an adequate appraisal review function.

10. Evaluate the adequacy of the association's internal asset review function related to income property lending.

11. Determine that the association's loan administration function is adequate and that it:

- Clearly designates the specific activities to perform for each loan type/size depending on the risk. This could include:

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- ⇒ Sending letters to the borrower requesting property P&L data.
- ⇒ Reviewing periodic borrower supplied data such as rent rolls, vacancy, and operating statements for large commercial and multifamily real estate loans.
(For small, well-seasoned loans with low LTV ratios, the review need only focus on performance.)
- ⇒ Performing inspections of the collateral.
- Clearly indicates the measures to take if the borrower fails to provide the requested information.

12. Verify that the association obtains a valid security interest, hazard insurance, property tax information, current operating and financial statements, and annual property inspections for all its income property real estate loans, consistent with its policies and procedures.

13. Determine that the institution calculates loan to value ratios for all covered real estate loans and tracks loans in excess of the supervisory LTV limits. (See the Real Estate Lending Standards Guidelines of 12 CFR §§ 560.100-101.)

14. Determine that management reports to the board of directors at least quarterly, and at a minimum, the aggregate amount of high LTV, non-one- to four-family real estate loans and limits these loans to 30 percent of capital.

15. Review the association's Environmental Risk Policy. Coordinate review with the examiner responsible for the review of [Handbook Section 208, Real Estate Appraisals](#). If the association does not have a formal Environmental Risk Policy, review formal and informal controls in place to address such risk.

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16. Obtain a listing of real estate income property loans and select loans for review in accordance with OTS policy. Use minimum cut-off or dollar proportional and judgmental sample selection to select a sample of loans for review. The judgmental sample should primarily focus on loans made during the review period but should also include loans from other review periods that you may want to select for review because of risk factors such as their large size, payment irregularities, classification, refinance or modification during the review period.

17. Obtain the association's credit files on the loans selected for review. Test for compliance with the association's written policies, procedures, and controls. Also, consider the following during your review:

- The credit quality of the loan, including the adequacy of the primary and secondary sources of repayment.
 - Debt service capacity of the subject property.
 - The quality and liquidity of the security property and the adequacy of the appraisal.
 - The adequacy and timely receipt and review by institution staff of borrower financial statements and financial information on the security property.
 - Property inspections.
 - Loan covenants.
 - Internal credit memoranda and loan correspondence.
 - The financial information on and the adequacy of guarantors, if any.
 - Compliance with OTS polices and procedures and applicable laws and regulations.
-

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18. Look for the following areas of supervisory concern:

- Inadequate cash flow.
- Property maintenance problems and/or inadequate reserves.
- Income or expenses trends that compare unfavorably with historical trends and budget projections.
- Lending limit violations.
- The lack of current, complete, and signed financial information or the lack of review by association staff.
- Deficient collateral documentation.
- Absence of on-going monitoring of the property and the borrower.
- Borrower noncompliance with provisions in the loan agreement or loan covenants.
- Lack of adherence to loan officer and “team” lending authorities.
- Conflicts of interest to affiliated parties.
- Excess debt ratios.
- Conflicts of interest in the approval or appraisal process.
- Modification of troubled loans done primarily to bring the loans current.
- Inappropriate loan structures.

19. Update (or develop) Loan Review Line Sheets or create electronic line sheets from the electronic loan data (ELD) for appropriate loans. The information should include the current balance, past due, nonaccrual, or problem status.

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20. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.
-

LEVEL II

1. Review the underwriting, structure, and safety and soundness of significant loan purchases and participations, as appropriate.
-
2. Investigate any significant problem loans sold immediately prior to the examination, as appropriate.
-
3. Investigate any collateral release relating to delinquent loans that weakens the association's security position.
-
4. Ensure that your review has met the objectives of this handbook section. State your findings and conclusions, as well as appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages. Obtain management responses, and update programs and the continuing examination file (CEF) with any information that will facilitate future examinations. File exception sheets in the general file.
-

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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FINANCIAL ANALYSIS

A. Property Analysis

Assessing a borrower's ability to repay the loan is critical to income property lending. Because cash flow from the property is generally the primary source of repayment of the loan, the lender will generally use debt service coverage and cash flow analyses to make this assessment.

Debt Service Coverage Ratio

The debt service coverage ratio (DSCR) is a reliable tool for determining whether income from the property is sufficient to service the loan. DSCR is net operating income (NOI) divided by total debt service.

NOI is the total income of the property net of operating expenses. For example, assume we have a rental property being sold for \$9 million with a \$6.3 million loan request. The property generates the following rental income:

Gross Scheduled Rent	\$1,000,000
Less 5% vacancy & collection loss	\$50,000
Effective gross income:	\$950,000
<i>Less operating expenses:</i>	
Real estate taxes	63,000
Insurance	18,000
Repairs & maintenance	45,000
Utilities	Net
Management	50,000
Replacement reserves	80,000
Total operating expenses:	\$256,000
Net operating income	\$694,000

Lenders should first verify that the stated income and expense data are accurate, supported and reasonable. When actual vacancy numbers are atypically low, lenders should factor in higher "market" vacancy and collection rates. Similarly, even if the owner manages the property, the lender should include typical property management fees in the analysis. This is because the institution will have to pay for property management and vacancy rates could increase if the lender had to foreclose on the property.

Total debt service includes the principal and interest payments of all outstanding or proposed loans on the property. To calculate the debt service coverage ratio, divide the NOI by the total mortgage payment(s). For the sake of simplicity, let us assume that there is only one mortgage on the property:

\$6,300,000 (70% LTV) first mortgage

7.5% Interest, 30 years amortized

Annual Payments (Debt Service) = \$528,606

NOI: \$694,000

DSCR = NOI/TDS = 1.31

A 1.31 DSCR is considered good and acceptable to most lenders, provided the borrower and property meet the lender's other underwriting requirements. These include credit history, net worth, business experience, and property appraisal requirements, and verification that the income and expenses for the property are stabilized. In a receding economy, vacancy and collections could easily go from a typical 3 percent to 5 percent to 10 percent or higher.

Breakeven analysis:

The breakeven ratio is operating expenses plus debt service (before vacancy) divided by gross income. A low breakeven ratio means a cushion and lower risk for the lender and a greater likelihood the borrower will perform as agreed on the loan. For the above project, the breakeven ratio is calculated as:

$\$256,000 + \$528,606 / \$1,000,000 = \$784,606 / \$1,000,000 = 78.5\%$

That means that vacancy can increase from 5 percent to 22 percent before the project experiences a loss. Alternatively, expenses could increase by \$50,000 and vacancy could increase to 15 percent before the project would experience a loss.

Loan size:

The borrower typically seeks as large a loan as possible, but the higher payment will decrease the DSCR. If the net operating income and expenses remain the same, and the loan size and loan payments increase, then the DSCR will decrease. For example, if the borrower requested an 85 percent LTV loan of \$7,650,000, the payment would be \$641,879 and the DSCR would be 1.08. This is less than the typically required 1.2, and would place the borrower at greater risk of default should income drop or expenses increase.

Savings associations generally require a stabilized DSCR of 1.20 or higher, depending on the type of property and the stability of income, but may accept a stabilized DSCR as low as 1.10 for properties with long-term contracts, such as a government building or post offices, where vacancy is not a risk factor.

For example, a lender may establish a minimum DSCR at origination of 1.2 in its underwriting standards and allow DSCR as low as 1.1 when other credit strengths mitigate the higher risks presented by the low DSCR. Often, such exceptions must go to the full board or a designated committee for approval.

Stress testing

Raising interest rates or reducing NOI will also lower the DSCR. If the loan in our 85 percent LTV example were an adjustable rate loan that started out at 6.5 percent then adjusted to 9.5 percent after two years, the initial payment would be \$580,238 and the DSCR would be 1.20. After two years, however, the payment would increase to \$771,904, and the DSCR would drop to 90 percent, indicating a negative cash flow.

In our example, if NOI drops by 10 percent down to \$624,600, the DSCR will drop to 1.19 in the first, 70 percent LTV example. Lenders should establish a minimum DSCR at origination based on the contractual rate. If the rate increases, the minimum acceptable DSCR should be prudent under the planned higher rate scenarios. Moreover, lenders should also consider setting minimum DSCR under stressed conditions.

Should a lender allow a DSCR below 1.10 on a property without stable income and expenses, a drop in net income could result in a negative cash flow. That would require the borrower to make payments from other sources to keep the project afloat. This might be acceptable from an underwriting standpoint under stressed scenarios if the borrower has sufficient net worth, income, and cash flows to support the loan. However, a negative DSCR is unacceptable at origination. Should the lender have to foreclose on and operate the property, it will experience the same negative cash flows, once it factors in the opportunity costs from the lost interest income. Therefore, lenders should avoid making negative cash flow income property loans unless they have additional collateral or a reliable guarantee from a financially responsible principal or third party.

Cash flow analysis

DSCR analysis focuses on income from the property to repay the loan. However, income property borrowers may generate other income from businesses that do not directly generate real estate income. For example, office buildings, shopping centers, apartment complexes, and government buildings generate income directly from the rental or leasing of the income properties. Other businesses, such as auto dealerships, restaurants, convenience store/gas stations, manufacturers, may be leased or they may be owned directly by the business and financed with mortgages. In such cases, a lender must evaluate the cash flows from the business to determine if the business has sufficient cash flow to repay a proposed loan. The following credit analysis discussion focuses on other ratios that are important in evaluating credit quality.

B. Financial Statement Ratio Analysis

Financial statement ratio analysis helps lenders analyze the financial health of their loan applicants, when the borrower is a corporation or other business entity, and when business income in addition to property income is used to repay the loan.

The following ratios, derived from a company's financial statements, are widely used for analysis of various aspects related to financial health of a business. Financial statement ratios are best used when comparing the company's ratios in prior years and with companies in similar industries.

Liquidity ratios:

Liquidity ratios measure the ability to turn assets into cash and meet current obligations.

Current ratio = current assets / current liabilities

Current assets are cash and cash equivalents, accounts receivable, inventory, and prepaid items. Current liabilities are short-term notes and parts of long term notes due within a year, accounts payable, and accrued expenses. The ratio shows a company's ability to turn assets into cash and pay its obligations with a margin of safety. A current ratio of 2 to 1 is considered acceptable.

Quick (acid test) ratio = cash and equivalents/ current liabilities

The quick ratio shows a company's ability to quickly pay its obligations from cash and cash equivalents. By excluding inventories, it concentrates on liquid assets, so if sales were to fall off, the company would still be able to pay its bills. Typically a ratio of 1 to 1 is considered acceptable and a ratio of less than 1 means the company does not have sufficient cash and cash equivalent assets to repay its current obligations without selling inventory.

Profitability ratios:

Net income / gross revenues

This ratio measures how profitable an enterprise is and should be measured against industry averages.

Risk ratios:

Financial Risk = percent change in net income / percent change in operating income

The higher the ratio is, the greater the volatility of income and risk to the business.

Operating leverage = percent change in operating income/ percent change in sales

Business risk = standard deviation of operating income/ mean operating income

The smaller the variance in income, the lower the business risk will be. For example, if operating income were \$100,000, and the standard deviation around the mean over a five-year period was \$12,000; the business risk would be a very low 12 percent. However, if the income fluctuates widely, and the standard deviation was \$62,000, the business risk would be a very high 62 percent.

Debt Utilization Ratios:

Leverage ratio = total liabilities / equity

Indicates the extent the business relies on debt to finance its operations. The higher the ratio is, the greater the risk. Typically banks prefer ratios of 100 percent or less, but that will depend on the business. Companies that require a large investment in capital equipment, such as a real estate or heavy

machinery, will typically be more highly leveraged than other businesses. In such cases, where asset values and property income are stable, a ratio of up to 200 percent would be desirable and ratios up to 300 percent are usually acceptable.

Total debt to assets = total debt / total assets

This ratio is similar to the leverage ratio but a desirable ratio would be 50 percent or less, meaning that 50 percent of the company's assets are financed by equity and 50 percent are financed by debt. Ratios of 67 percent and 75 percent would equate to leverage ratios of 200 percent and 300 percent, respectively, as discussed above.

Income Analysis:

The following ratios are used to measure profitability:

Gross Margin Ratio = Gross Profit/ Net Sales = (Net Sales - Cost of Goods Sold) / Net Sales

This ratio measures the percentage of sales dollars remaining (after obtaining or manufacturing the goods sold) available to pay the overhead expenses of the company.

Net Profit Margin Ratio = Net Profit Before Tax / Net Sales

This ratio is the percentage of sales dollars remaining after subtracting the cost of goods sold and all expenses, except income taxes. It is calculated before income tax because tax rates and tax liabilities vary from company to company for a wide variety of reasons, making comparisons after taxes much more difficult.

Management Ratios:

Other important ratios, often referred to as management ratios, are also derived from Balance Sheet and Statement of Income information.

Inventory Turnover Ratio = Net Sales / Average Inventory at Cost

This ratio shows how efficient management uses inventory. The more often a business can turn over inventory, the more profitable the business.

Accounts Receivable Turnover (in days) = Accounts Receivable / Daily Credit Sales

$$\text{Daily Credit Sales} = \text{Net Credit Sales Per Year} / 365 \text{ (Days)}$$

This ratio indicates how well accounts receivable are being collected. If a business's customers pay their receivables slowly, there may be potential credit losses and the company's liquidity could be impaired.

Return on Assets = Net Profit Before Tax / Total Assets

This measures how efficiently a company uses its assets in generating profits. The ratio will vary greatly between industries so it is most useful when it is compared with the ratios of firms in a similar business. A ratio of less than 1 percent is generally considered poor.

Return on Investment (Equity) = Net Profit before Tax / Total Equity

The Return on Investment (ROI) is the percentage return on a company's equity capital. This ratio is important because it shows how profitable the business is in relation to the funds invested. This ratio can easily be compared to other investment alternatives, such as bonds or stock in other companies. If a business' ROI is less than the return on an alternative, lower-risk, investment, there are inherent problems with the business, which should be a red flag to the lender.

ENVIRONMENTAL RISK AND LIABILITY

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors in evaluating real estate transactions and making loans secured by real estate. Environmental hazards can be a source of high risk and potential liability to a savings association and its subsidiaries (institutions) in connection with its real estate loans and investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems, or oil and gas wells.

Possible problems with pollution and hazardous waste contamination have grown as federal, state, and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for environmental cleanup. Institutions must be aware of and concerned with regulations that impose clean-up liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Risks that a lender can face as a result of environmentally contaminated property include:

- Collateral for a real estate loan or property to be acquired may be drastically reduced in value after discovery of a release of hazardous substances and/or petroleum products.
- The borrower may not be able to repay the loan if he or she must also pay for the cost of cleaning up the contaminated property. The cost for cleanup can be significant and may exceed the institution's encumbrance on the property.
- The real estate loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up contamination may have priority over a lender's mortgage.
- The lender may be liable to the extent of any credit extended to any debtor who has operated property at which hazardous substances or petroleum products have been released, has generated such hazardous waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous substances and/or petroleum products.¹
- The lender may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property, becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the handling of toxic or hazardous substances and/or petroleum products.

¹ Even if the lender were not directly liable, it would be at risk if the borrower was unable to repay the loan and the value of the property was impaired due to environmental liability.

- The lender may not be able to pursue his or her foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could necessitate charging off the loan balance.
- The borrower may not maintain collateral or property with an environmental risk potential in an environmentally sound manner.
- Aside from the statutory liabilities that can be imposed for toxic waste contamination, the potential liability for personal injury or adjacent property damage.

To address these potential risks and liabilities, institutions should develop a risk management program to evaluate, identify, measure, monitor, and control environmental risk and liability for all real estate loans.

Environmental Laws and Regulations

In January 2002, the Congress amended CERCLA (the Comprehensive Environmental Response, Compensation and Liability Act) to establish, among other things, additional protections from cleanup liability for a new owner of a property. The bona fide prospective purchaser provision establishes that a person may purchase property with the knowledge that the property is contaminated without being held potentially liable for the cleanup of contamination at the property. The prospective purchaser must meet certain statutory requirements and, prior to the date of acquiring the property, undertake “all appropriate inquiries” into the prior ownership and uses of a property. In November 2005, the Environmental Protection Agency (EPA) promulgated its “Standards and Practices for All Appropriate Inquiries” final rule, which establishes the standards and practices that are necessary to meet the requirements for an “all appropriate inquiry” (AAI) into the prior ownership and uses of a property. The AAI Rule became effective on November 1, 2006.

An environmental evaluation of the property that meets the standards and practices of the EPA AAI Rule may provide the borrower with added protection from CERCLA² cleanup liability, provided the borrower satisfies other requirements for Landowner Liability Protections. This protection, however, is limited to CERCLA and does not apply to the Resource Compensation and Recovery Act (RCRA), including liability associated with underground storage tanks, and other Federal environmental statutes, and, depending on state law, state environmental statutes. In addition, such an environmental evaluation may provide a more detailed assessment of the property than an evaluation that does not conform to the EPA All Appropriate Inquiry Rule.

² Note: AAI is not required for lender protection under CERCLA and that lesser investigations may be adequate to protect a lender from related business risks.

Guidelines for an Environment Risk Program

An institution that is actively engaged in real estate lending (including loans to finance nonresidential and multifamily properties, as well as construction and acquisition and development loans) should assess its exposure to related environmental risks and liabilities. Such institutions should develop and maintain an environmental risk program that:

- Identifies, evaluates and monitors potential environmental risks associated with its lending operations.
- Establishes procedures to determine the extent of due diligence necessary to protect the institution's business interests.
- Assesses the potential adverse effect of environmental contamination on the value of real property securing its loans, including any potential environmental liability associated with foreclosing on contaminated properties.

The environmental risk program should provide for staff training, set environmental policy guidelines and procedures, require an environmental review or analysis during the application process, include documentation standards, and establish appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

The program should be commensurate with the size and complexity of the institution's operations. Institutions that have a heavier concentration of loans to higher risk industries or localities of likely contamination should implement a more elaborate and sophisticated environmental risk program than other institutions. The board of directors should review and approve the program and designate a senior officer knowledgeable in environmental matters responsible for program implementation.

Environmental Risk Policy

When environmental risk exposure is material, the institution should develop and implement written policies and procedures to manage environmental risk. The institution's policies and procedures should reflect adequate consideration of the Environmental Protection Agency's (EPA) "All Appropriate Inquiry Rule." Such a policy should incorporate several key elements, including:

- An analysis of current environmental laws and due diligence requirements for borrowers and the institution.
- A level of due diligence internally required in all real estate loan transactions.
- Risk thresholds based on property type, use and loan amount for determining when and what type of due diligence is required.
- Varying due diligence methods depending on the type of loan, the amount of the loan and the risk category, including borrower questionnaire or screening, site visit, government records review, historical records review, testing or inspections using qualified professionals, Phase I

environmental assessment (ASTM standards), and Phase II environmental assessment.

- The potential for significant impact resulting from the presence of hazardous building material such as asbestos and lead-based paint
- Appraisal requirements for disclosing and taking into consideration any environmental risk factors.
- Criteria for evaluating environmental risk factors and costs in the loan approval process.
- Criteria for determining the circumstances in which the institution would normally decline loan requests based on environmental factors.
- Environmental provisions for incorporation into transaction documentation:
 - For commitment letters: extent of due diligence required, borrower costs, approval contingencies, reporting obligations, documentation requirements, etc.
 - For loan documentation: reps and warranties, inspection requirements, reporting requirements, lien covenants, indemnification provisions, and provisions allowing for the acceleration of the loan, refusal to extend funds under a line of credit, or exercise other remedies in the event of foreclosure.
- Collateral monitoring and periodic inspection requirements throughout the loan term for properties with higher environmental risk.
- A means of evaluating potential environmental liability risk and environmental factors that could impact the ability to recover loan funds in the event of a foreclosure.
- Guidelines for maintaining lender liability exemptions, avoiding owner/operator liability, and for qualifying for Landowner Liability Protections under CERCLA and AAI if the institution acquires ownership of the property.
- Guidelines and controls to ensure the institution's adherence to safety and soundness principles.

In addition, with appropriate legal assistance, institutions should revise mortgages, guarantees, indemnities, contracts, and other loan documents to mitigate the risks of potential environmental hazards.

Training. The environmental risk program should incorporate training sufficient to ensure that the program is properly implemented and followed and that appropriate personnel have the knowledge and experience to determine and evaluate potential environmental concerns that might affect the institution. Whenever the complexity of the environmental issue is beyond the expertise of the institution's staff, the institution should consult legal counsel, environmental consultants, or other qualified experts.

Preliminary Environmental Risk Analysis. A preliminary environmental risk analysis should be conducted during the application process. An appropriate analysis should allow the institution to avoid loans that result in substantial losses or liability and provide the institution with information to minimize potential environmental liability on loans that are made. Much of the information needed for the preliminary environmental risk analysis may be gathered by the account officer when interviewing the loan applicant concerning his or her business activities. It is also useful for an institution to develop an environmental risk questionnaire that is completed and signed by the buyer. The questionnaire should be designed to obtain relevant environmental information, such as the present and past uses of the property and the occurrence of any contacts by Federal, state or local governmental agencies about environmental matters. Federal, state and local records are often a good source of information about the property, prior owners, and whether any environmental liens or letters have been issued.

It may also be necessary for the loan officer or other representative of an institution to visit the site to evaluate whether there is obvious visual evidence of environmental concerns.

The preliminary analysis should identify high risk sites on which additional environmental due diligence is warranted. Performing an AAI Phase I analysis affords environmental liability protections to the borrower, which would protect their cash flow in the event of a mandated environmental cleanup.

An AAI Phase I to an institution is no different from any other form of environmental due diligence in that it is done for business risk purposes. Lending institutions typically reserve the Phase I for large balance and higher risk CRE transactions in order to be competitive on small balance deals. When they begin dealing with higher risk properties and large transactions they will typically require a Phase I because it is comprehensive and environmental liability protections are made available to the property owner/borrower. The institution should ensure that the Phase I analysis is performed to the new AAI standard.

Structured Environmental Risk Assessment. Whenever the application, interview, or visitation indicates a possible environmental concern, a more detailed structured investigation by a qualified individual may be necessary. This assessment may include any or all of the typical components of phase I and phase II assessments including, surveying prior owners of the property, researching past uses of the property, inspecting the site and contiguous parcels, and reviewing company records for past use or disposal of hazardous materials. A review of public records and contact with Federal and state environmental protection agencies may help determine whether the borrower has been cited for violations concerning environmental laws or if the property has been identified on Federal and state lists of real property with significant environmental contamination.

As part of its environmental risk analysis of any particular extension of credit, an institution should evaluate whether it is appropriate or necessary to obtain additional environmental due diligence and possibly require an environmental evaluation that meets the standards and practices of the EPA AAI Rule. This decision involves judgment and may be made on a case-by-case basis considering the risk characteristics of the transaction, the type of property, and the environmental information gained during an initial environmental risk analysis.

The decision to require the borrower to perform a property assessment that meets the requirements of the AAI Rule should be made in the context of the institution's overall environmental risk program. An

environmental risk program should be designed to ensure that the institution makes an informed judgment about potential environmental risk and considers such risks in its overall evaluation of all risks associated with the extension of credit. The decision concerning when and under what circumstances to obtain additional environmental due diligence should be tailored to the needs of the lending practices of the institution. Individuals involved in administering an institution's environmental risk program should become familiar with these statutory elements. One source for information concerning the EPA All Appropriate Rule is the EPA website at <http://www.epa.gov/brownfields/regneg.htm>.

Monitoring. Institutions should consider ongoing assessment of the environmental risks during the life of the loan by monitoring the borrower and the real property collateral for potential environmental concerns. The institution should be aware of changes in the business activities of the borrower that result in a significant increased risk of environmental liability associated with the real property collateral. If there is a potential for environmental contamination to adversely affect the value of the collateral, the institution might exercise its rights under the loan to require the borrower to resolve the environmental condition and take those actions that are reasonably necessary to protect the value of the real property.

Loan Documentation. Loan documents should include language to safeguard the institution against potential environmental losses and liabilities. Such language might require that the borrower comply with environmental laws, disclose information about the environmental status of the real property collateral and grant the institution the right to acquire additional information about handling and the potential release of hazardous substances and/or petroleum products by inspecting the collateral for environmental concerns. The loan documents might also provide that the institution has the right to call the loan, refuse to extend funds under a line of credit, or foreclose if the release of hazardous substances and/or petroleum products is discovered at the real property collateral. The loan documents might also call for an indemnity of the institution by the borrower and guarantors for environmental liability associated with the real property collateral.

Involvement in the Borrower's Operations. Under CERCLA and many state environmental cleanup statutes, an institution may have an exemption from environmental liability as the holder of a security interest in real property collateral. In monitoring a loan for potential environmental concerns, and resolving those environmental situations as necessary, an institution should evaluate whether its actions may constitute "participating in the management" of the business located on the real property collateral within the meaning of CERCLA. If its actions are considered to be participation in the management, the institution may lose its exemption from liability under CERCLA or similar state statutes.

Foreclosure Considerations. An institution's exposure to environmental liability may increase significantly if it takes title to real property held as collateral. An institution should evaluate the potential costs and liability for any release of hazardous substances and/or petroleum products in conjunction with an assessment of the value of the collateral in reaching a decision to take title to the property by foreclosure or other means. Based on the type of property involved, the institution should consider including as part of this evaluation of potential environmental costs and liability an assessment of the property that meets the requirements of the EPA AAI Rule.