Office of Inspector General

May 6, 2003
Supplement to Audit Report No. 03-008, dated January 3, 2003

Examiner Assessment of Commercial Real Estate Loans

**** This is not an audit report. ****

This supplement contains copies of correspondence between the Office of Inspector General (OIG) and the Division of Supervision and Consumer Protection (DSC) subsequent to the issuance of Audit Report No. 03-008, dated January 3, 2003. The intent of this supplement is to show progress made on the resolution of matters that were unresolved at the time the OIG issued the final report.

OFFICE OF INSPECTOR GENERAL
DELIVERING QUALITY TIMELINESS VALUE
OFFICE OF AUDITS

TABLE OF CONTENTS

I. OIG Assessment of Management Response to the Final Report

Memorandum dated February 10, 2003, from the Assistant Inspector General for Audits to the Director, Division of Supervision and Consumer Protection

II. Management Response to the Final Report

Memorandum dated February 3, 2003, from the Director, Division of Supervision and Consumer Protection to the Assistant Inspector General for Audits

I. OIG Assessment of Management Response to the Final Report

Federal Deposit Insurance Corporation
Washington, D.C. 20434

Office of Audits
Office of Inspector General

DATE: February 10, 2003

MEMORANDUM TO: Michael J. Zamorski, Director
Division of Supervision and Consumer Protection

FROM: Stephen M. Beard
for Russell A. Rau
Assistant Inspector General for Audits

SUBJECT: Assessment of DSC Response to Final Report Entitled *Examiner Assessment of Commercial Real Estate Loans* (Audit Report No. 03-008)

We have reviewed your February 3, 2003 memorandum replying to our request for DSC management to reconsider its response to unresolved recommendations 1-3, 5 and 6 contained in the subject audit report. We recognize that DSC firmly believes its examination workforce is employing appropriate risk-focused examination procedures to accurately assess the risks that may be associated with commercial real estate loans, and we appreciate DSC's reconsideration of our recommendations. According to your office, the good ratings history of the institutions in our sample, when combined with the size of the institution and the capabilities of the institutions' management, was an important factor among several others that would have affected the risk-scoping process and the level of documentation required for examination workpapers.

Based on your memorandum and the results of a meeting between our offices on February 4, 2003, we have agreed that examiner training programs and upcoming DSC initiatives may bring resolution to the unresolved recommendations. However, the decision on resolution for each recommendation will not be possible until we see how they are addressed. Specifically, our analysis of DSC's response to the five unresolved recommendations is set forth below after the pertinent recommendations:

(1) Remind examiners to verify institution compliance with Part 365 by using the lesser of the acquisition cost or the appraised value when computing the LTV ratio.

(2) Clarify the division's expectations for examiners regarding the evaluation of appraisals of commercial real estate, including guidance on when it would be appropriate to update appraisals with new financial information.

(3) Request DSC regional offices, as part of their current cycle of field office reviews, to specifically address whether the extent of examiners' review of appraisals is sufficient for high-risk CRE loans.

OIG Analysis: These three recommendations pertain to our observations on examiner review of appraisals. While DSC did not concur with these recommendations, DSC did concur with recommendation 4 to provide additional training to examiners on the adequate evaluation of appraisals. Consequently, if the training provided to examiners addresses the concerns covered by recommendations 1-3, we may accept that training as an alternative action to the recommendations.

Also, as described in DSC's February 3 memorandum, the division is undertaking two initiatives that may address the concerns cited in our report. First, the DSC Atlanta Region will soon be commencing a pilot program regarding commercial real estate loans in the Atlanta metropolitan area. Second, within the next several months the division will commence a process improvement review that will focus on the issue of examination workpaper documentation. This review will be designated "Process Redesign IV" and will include representatives from other divisions and offices. For both initiatives, DSC has invited the OIG's input, which we will provide as part of the process for resolving the open recommendations. If the DSC initiatives address the concerns covered by the recommendations, we may accept these initiatives as alternative actions to the recommendations. At this time, however, the recommendations remain unresolved, undispositioned, and open.

(5) Provide guidance reminding examiners of the importance of performing cash flow analysis and computation of the debt service coverage ratio for income-producing loans based on the risk level of the asset.

(6) Reinforce to examiners the need to document technical exceptions (TEs) on the loan line sheets when financial statements are outdated or not available and to retain a record of TEs provided to bank management.

OIG Analysis: These last two recommendations pertain to our observations on examiner review of borrowers' cash flow. As described above, the division is undertaking two initiatives that may address the concerns cited in our report: a pilot program regarding commercial real estate loans in the Atlanta metropolitan area and a process improvement review that will focus on the issue of examination workpaper documentation. If these DSC initiatives address the concerns covered by the recommendations, we may accept these initiatives as alternative actions to the recommendations. At this time, however, the recommendations remain unresolved, undispositioned, and open.

No further response is required from DSC management at this time. We will continue to monitor implementation of these actions. To indicate we have agreed that examiner training programs and upcoming DSC initiatives may bring resolution to the unresolved recommendations, we will include this memorandum and your February 3 memorandum along with the final report summary in the materials provided to the FDIC Audit Committee in advance of the February 18 meeting. If you have any questions concerning the report, please contact me at (202) 416-2543 or Mike Lombardi at (202) 416-2431. We appreciate the courtesies extended to the audit staff.

cc: Lynn B. Dallin, DSC
Michael MacDermott/Corrine Watts, OICM

II. Management Response to the Final Report

Federal Deposit Insurance Corporation
550 17th St. NW Washington DC, 20429
Division of Supervision and Consumer Protection

February 3, 2003

MEMORANDUM TO: Russell A. Rau
Assistant Inspector General for Audits
Office of Inspector General

FROM: Michael J. Zamorski
Director
Division of Supervision and Consumer Protection

CONCUR: John F. Bovenzi
Deputy to the Chairman and
Chief Operating Officer

SUBJECT: Audit Report: Examiner Assessment of Commercial Real Estate Loans (Audit Report No. 03-008)

Thank you for the opportunity to provide further comment with regard to our December 5, 2002, response to the Office of Inspector General (OIG) draft audit report regarding examiner assessment of commercial real estate loans. We reviewed your final report, including your response to our comments. We have very carefully reconsidered the audit findings and your recommendations. The Division of Supervision and Consumer Protection (DSC) believes that our original response was comprehensive and continues to convey DSC's position on your recommendations. In addition, we offer the following comments.

Regarding the overall risks of commercial real estate lending, the economic briefing recently provided to the FDIC Board indicated that, despite certain areas of strain, the number of highly concentrated commercial real estate lenders is significantly lower today compared to that of the 1980s. We believe the lessons learned by bank managers as well as effective supervision have had a positive impact on the lending behavior of our insured institutions as overall underwriting and diversification practices have improved.

DSC agrees that commercial real estate lending is a potentially high-risk area and that thorough examiner assessment of this area is critical. We are committed to proactive, vigilant, and effective examination processes to monitor and mitigate those risks in the institutions we supervise. We continue to assess, through onsite and offsite examination programs, potentially

high-risk situations and we have a high degree of confidence in the effectiveness and efficiency of our supervision of the institutions involved.

In Inspector General Gaston Gianni's memorandum to the Audit Committee of the FDIC's Board of Directors, the following comment is made:

> *"At issue is whether there is a correlation between the quality of the examination procedures supported by evidence in the working papers and the quality of the examinations themselves. It is our position that the two are inseparable. Moreover, when sufficient evidence does not exist to support that examiners followed DSC's policy requirements, a determination on the adequacy of the examination cannot be made."*

We agree that there is a correlation between the quality of the examination procedures and the quality of examinations themselves. However, DSC and OIG have differing views on the level of documentation necessary to support that appropriate examination procedures were followed. DSC believes the analyses and conclusions presented in our Reports of Examination are appropriately supported by our work papers. Most of our processes have been developed on an interagency basis, and our policies, procedures and examination findings have been upheld in numerous administrative proceedings and supervisory appeals. This, along with the validation of our risk assessments over time, is a good indicator of the quality of our examination program.

DSC firmly believes that its examination workforce is employing appropriate risk-focused examination procedures to accurately assess the risks in financial institutions, and in particular those risks that may be associated with commercial real estate loans. The essence of a bank examination is the exercise of sound judgment regarding highly variable fact situations. Our examiners' use of sound judgment, based upon considerable experience and training, should be given extensive weight in assessing the quality of our examinations and the extent of work paper documentation needed. It is our view that existing work paper standards provide reasonable assurance that examination policies and procedures are followed.
Over the past few years, DSC has undertaken various process redesign projects (broad-based initiatives to refine and improve examination processes). DSC is currently exploring subsequent initiatives that will further refine and improve the examination program. DSC is especially interested in the effective supervision of commercial real estate lending programs as well as financial institutions with high-growth lending programs. As an example, in our Atlanta Region, we will soon be commencing a pilot program regarding commercial real estate loans in the Atlanta metropolitan area. DSC invites OIG's review of the pilot program and seeks any input that it may wish to offer on the study. In regard to the issue of work paper documentation, there have been many discussions within DSC, with the other banking regulators, and with the OIG. In fact within the next several months we intend to commence a new initiative, which we will designate Process Redesign IV (in our continuing series of process improvement reviews), that will focus on the issue of examination work paper documentation. We will invite OIG to participate in this process along with representatives from other Divisions and Offices of the FDIC as we have in past process improvement initiatives. This initiative will allow a broader review of the examination documentation issue.