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STATEMENT ON

THE FDIC'S EXAMINATION AND SUPERVISORY FUNCTIONS
IN RELATION TO
APPRAISAL PRACTICES ON REAL ESTATE LENDING

PRESENTED TO the

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE

OF THE House

COMMITTEE ON GOVERNMENT OPERATIONS

~~UNITED STATES HOUSE OF REPRESENTATIVES~~

BY

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Good morning, Mr. Chairman and members of the Subcommittee. I am Robert Miailovich, Associate Director of the Division of Bank Supervision at the FDIC. I am pleased to be here in response to your invitation to Chairman Seidman to address the FDIC's examination and supervisory functions in relation to faulty and fraudulent appraisals and appraisal practices on real estate lending. Attached to my testimony are answers to the specific questions raised in your December 4 letter as well as a copy of the Guidelines for Collateral Evaluation and Classification of Troubled Commercial Real Estate Loans which you requested. The guidelines were recently distributed to examiners and insured State nonmember banks. They cover reviewing and classifying troubled commercial real estate loans as well as analyzing the underlying assumptions supporting the appraisal.

Today I will outline the FDIC's policy on the supervision of real estate lending activities, particularly as it relates to appraisal practices, and discuss our recommendations for addressing this area.

The FDIC does not have any rules and regulations pertaining to real estate appraisers or real estate appraisal practices nor do we think that the promolgation of such rules and regulations are appropriate for us at this time. Let me explain the reasons for this position. First, it has been our longstanding posture not to interfere in the management function of a bank by requiring specific requirements of all institutions unless we perceive a serious widespread problem which cannot be corrected in the normal course of supervision. Rather, our focus has been to emphasize the establishment of prudent policies and procedures by each bank's board of directors and implemented by its active management. Sound loan policies are essential to sound loan portfolio management if the bank is to be continuously operated in an acceptable manner. A review of loan and collection policies, the bank's adherence thereto, and an evaluation of individual loans are among the most important aspects of the examination process. To a great extent, it is the quality of a bank's loan portfolio that determines the overall risk to the deposit insurance fund. For this reason, examiners conduct a comprehensive review and evaluation of the loan portfolio and its administration by bank management.

In reviewing loans collaterized by real property, examiners are instructed not to place undue reliance upon a property's appraised value in lieu of an adequate initial assessment of a borrower's repayment ability. In short, it is the financial capacity and overall creditworthiness of the borrower which should take precedence. However, when collateral is necessary and taken on a loan, it also becomes an integral part of the overall evaluation of the credit. For a lender, liquidation of real property collateral should be a last resort. For these reasons, examiners are instructed to evaluate each loan on the basis of its own characteristics. Consideration is given to the risk involved in the project being financed; the nature and degree of collateral security; the character, capacity, financial responsibility and record of the borrower; and the feasibility and probability of the loan's orderly liquidation in accordance with specified terms. Review of the collateral appraisal is performed in this context since the examiner is instructed to not only identify problem credits but also ascertain the cause(s) of the problems. In general, a real estate appraisal by a qualified independent appraiser will serve as acceptable evidence of market value and, in the case of income producing property, as a check on the borrower's estimates of cash flow. Examiners are instructed to carefully review the underlying assumptions supporting an appraisal when calculating collateral values. This is especially critical in the case of commercial construction loans where the project is the sole or primary source of repayment. The Guidelines for Collateral Evaluation and Classification of Troubled Commercial Real Estate Loans is primarily aimed at this area. Any weaknesses in the institution's appraisal practices would be criticized and discussed with the bank's senior management and/or the directorate as well as documented in the examination report. Technical deficiencies in documentation of loans, including missing or incomplete appraisals, are brought to the attention of management for remedial action. If an excessive number of deficiencies are discovered they are also listed on a separate page in the examination report.

The more common types of problems with appraisals, to the extent they are encountered at all, include incomplete or missing appraisals, insider or borrower-related appraisals or appraisals based on future events which may or may not occur. The types of real estate problems encountered with troubled institutions generally involve management engaging in liberal lending practices by emphasizing collateral values over repayment ability of the borrower, overlending or not properly analyzing a borrower's repayment ability. In our experience, faulty or fraudulent appraisals have not been a significant factor in banks. However, when discovered, examiners are instructed to complete a Report of Apparent Criminal Irregularity (FDIC 6710/06) which is forwarded to the Regional Office with a copy also forwarded to the respective United States Attorney. Attached to my testimony is an update to the information in this area previously forwarded to the committee on November 14. In all cases, apparent violations are reported to the bank's board of drectors and recommendations made that they notify the institution's bonding company.

While we are not aware of any instances where the FDIC has initiated a formal enforcement action based solely on faulty, fraudulent or shoddy appraisal practices, we do, in the normal course of drafting both formal and informal corrective programs, address any major weaknesses in a bank's policies, including the correction of any loan documentation exceptions within a certain timeframe.

A fairly common request made by the FDIC of institutions of supervisory concern is to obtain current independent appraisals on all applicable classified credits. Clearly, the proper valuation of collateral takes on increasing importance to both bank management and bank supervisors, when there is evidence of deterioration in the credit quality of a loan. A current appraisal is generally defined as one no more than 12 months old. In this way, any additional losses can be recognized, thereby allowing for an accurate reflection of the bank's financial condition in financial reports, including an accurate assessment of the adequacy of the bank's loan loss reserve.

The FDIC examination process emphasizes bank managements' responsibility to develop prudent loan policies and procedures. The widely divergent circumstances of regional economies and the considerable variance in characteristics of individual loans precludes the establishment of standard or universal lending policies. Rather, we review a bank's loan policy, taking into consideration its portfolio composition and location. We believe this supervisory approach provides the means to address appraisal problems as they occur while at the same time allowing management the flexibility to establish prudent underwriting standards for their respective institutions.

Finally, may I point out that many of the individual States have laws which prescribe the amount and type of real estate lending in which State-chartered banks may engage. These laws frequently include appraisal standards. We at FDIC see no need to duplicate these rules for the institutions we supervise.

Mr. Chairman, I appreciate the opportunity to appear before your committee and would be pleased to respond to any questions you may have.

A. FDIC's supervisory experience and data on faulty or fraudulent appraisals:

1. Please describe the FDIC's supervisory experience and discuss available data on faulty or fraudulent appraisals uncovered by the FDIC. In responding, please discuss the most common types of problems encountered and elaborate on the response in FDIC's November 14, 1985 letter to the subcommittee.

The FDIC's supervisory experience with faulty or fraudulent appraisals leads us to conclude that such appraisals are not a widespread problem for State nonmember banks. We reach this conclusion after reviewing our criminal referral records and our consumer complaint records for 1983 to date. (The results of this review are more fully discussed in response to question A.2.) These two sources of data are the only recordkeeping systems which may contain information on faulty or fraudulent appraisals; however, these systems are established for broader purposes than noting appraisal problems. While these recordkeeping systems have broader purposes than the focus of your inquiry, the lack of any great number of referrals or complaints, and the lack of any pattern of referrals or complaints on this subject, are the basis for concluding that there is not a widespread problem with faulty or fraudulent appraisals.

Criminal referrals are generated as circumstances require as part of the onsite examination of a bank. The most common of the few problems that were noted in the review of our criminal referral records is the overvaluation of property for the purpose of inducing a bank to make a loan, to make a larger loan than would normally be warranted or to swap bank property or other property for property of supposedly equal value. In about one-half of the criminal referrals that we reviewed the inflated appraisal was done by an insider of the bank. In one instance a bank insider conspired with an appraiser to undervalue properties which were then purchased by the insider.

The problems noted in the review of our consumer complaint records were quite different from the problems found in the criminal referrals. Not surprisingly, the consumer complaint most often noted was that the appraised value was too conservative. Though this was the most frequent appraisal complaint found, it should be noted that there were only nine such complaints out of over 7,000 received.

Having reviewed the criminal referral and consumer complaint records, we reviewed the records of banks that had failed during 1985 to see if there were any trends or patterns of faulty or fraudulent appraisal practices. Of the failed banks which had exhibited some problem real estate practices, poor appraisal practices were not a major contributing factor to the failure of those banks. More typically in the failed banks, management would make loans based almost solely on the then accurately appraised collateral values, with little regard to the repayment ability of the borrower or the cash flow generated by the project. As subsequent economic and market conditions deteriorated, the marginal loans extended during more favorable times also deteriorated, contributing to the bank's failure.

2. Discuss the number and types of complaints received by the FDIC involving faulty or fraudulent appraisals for the years 1983-1985 (as listed in Exhibit 6 of the FDIC's November 14, 1985 letter), and describe any FDIC civil enforcement action and criminal referrals made. (Please determine the Justice Department's disposition of those referrals providing a status report.)

No criminal referrals or civil enforcement actions were made on any of the nine consumer complaints noted in A.1. above. Eight of these complaints were resolved with no evidence of wrongdoing by the bank or appraiser, and the ninth complaint will be reviewed at the next onsite examination. The number of criminal referrals made by the FDIC concerning appraisals is as follows:

	Open Banks	Closed Banks
1983	2	7
1984	6	11
1985	4	
Total	12	18

All of the above information was gathered from Reports of Apparent Criminal Irregularity which have been referred to the appropriate U.S. Attorney. These reports were generated by the FDIC during its onsite examination of the institutions. All of these criminal referrals allege that there was collusion between two or more parties to defraud the bank. As noted in the answer to question A.1., such collusion frequently included insiders of the bank and was generally for the purpose of inflating collateral values. The types of specific problems noted were: the lack of independent appraisals; incomplete or missing appraisals; appraisals based on improvements to the property which were never made; and appraisals based on overly optimistic assumptions.

While none of the criminal referrals in the table were the sole or primary reason for civil enforcement actions, the attendant unsatisfactory condition of some of the banks resulted in such actions. In such enforcement actions the focus of concern is, in part, the bank's lending policies. Corrective programs are designed to address our concerns about a bank's lending policies and will contain requests that current independent appraisals be obtained if the situation warrants.

After consulting with staff members of the subcommittee, we understand the status of the referrals will be considered subsequent to the hearings.

3. What are the aggregate total dollar values of real estate in the FDIC's portfolio, resulting from the FDIC's insurance activity, broken down by book value (if original appraised value is not available) and by reappraised value? (Would the book values closely approximate the original appraised values?)

This question is addressed in Associate Director Seelig's testimony of December 11 to the committee.

B. FDIC's general policies and requirements concerning appraisals and appraisers:

1. Briefly describe FDIC's policies and requirements concerning the existence and accuracy of appraisals. In responding, please indicate the FDIC's position on the role and importance of accurate appraisals in preventing or minimizing losses to a bank if there is a default on a real estate loan. Also, set forth the FDIC's requirements regarding appraisals for real estate loans and where these requirements are codified.

As we stated in our November 14 letter to the subcommittee, the FDIC does not have any rules, regulations or similar requirements pertaining to real estate appraisals or real estate appraisal practices. We do, however, focus on bank management's policies with regard to all lending activity. As such, we often recommend that the management of insured banks obtain appraisals which reflect current market conditions on all real property accepted as collateral for extensions of credit.

You have also asked for the FDIC's position on the importance of appraisals in "preventing or minimizing losses to a bank." We do not look to appraisals as a means of "preventing" loss, rather they represent one of the tools of bank management (and bank supervisors) for assessing risk of potential loss should debt repayment be questioned. It is important to focus upon the borrower's ability to service and to ultimately repay debt, not simply upon the value of pledged collateral. In the area of commercial property, we look to independent appraisals as a means of evaluating the projected income stream to judge if it is sufficient to justify the debt level and provide for repayment ability. Similarly, in the field of construction lending, independent appraisals of the sale price of the project (upon completion) can be a helpful indicator of potential value.

We believe, however, that placing an undue reliance upon a property's appraised value, in lieu of an adequate assessment of repayment ability, can be an unsound banking practice. The liquidation of collateral should be the last of many possible avenues pursued to achieve the repayment of debt. Accurate and timely appraisals are important, but they are only one component of a sound lending policy.

2. Unlike the Federal Home Loan Bank Board's Rule 41(b), which provides detailed guidelines to thrift institutions, the FDIC apparently does not require banks to obtain an appraisal for each real estate loan but only expects them to follow sound policies. Why doesn't the FDIC require appraisals in connection with each real estate loan, and specify acceptable appraisal methodology? Given the functions of an appraisal -- to establish the value of the collateral and help set loan limits -- wouldn't more specific appraisal requirements be more effective than the present policy of protecting FDIC-supervised or insured banks after the fact from losses due to nonperforming real estate loans?

The FDIC does not consider it appropriate to dictate detailed operating practices or procedural matters which are more properly the prerogative of bank management. Therefore, we refrain from specifying "acceptable appraisal methodology" to bankers. The FDIC does, however, consider a number of factors in determining the appropriateness of property appraisals. Material recently submitted to your subcommittee (by letter dated November 14) details a number of these. Also, within the appraisal profession there are standards of methodology, audit guides and other sources. We find these are adequate.

We are somewhat confused by the last portion of this question where the lack of specific appraisal "requirements" are apparently equated to, or suggested to be the cause of, "losses due to nonperforming real estate loans." There is no direct connection. Appraisals are a means of assessing exposure to potential loss should the borrower default or a means of evaluating cash flow as a source of debt service. The existence of or lack of an appraisal does not, in and of itself, affect the risk of nonrepayment of a loan. Forced liquidation of collateral is not intended as the primary means of repayment of any sound real estate loan, therefore, collateral appraisal is only an indicator of value. We believe our current standards are adequate to assure that losses are generally recognized in a timely fashion.

3. Do FDIC regulations provide examiners with specific authority to require banks to obtain reappraisals whenever there has been a deterioration in a real estate credit or there is doubt about the value cited in the original appraisal? If not, why not? What is the purpose of such a reappraisal?

The use of periodic appraisals of collateral securing debt is a part of the normal FDIC examination process aimed at identifying and assessing risk in insured institutions. To the extent that an appraisal reflects a current fair value of a property and the appraisal has been performed by a qualified individual utilizing reasonable assumptions, it can form a basis for estimating a bank's potential recovery (or, conversely, its loss) in situations where normal debt repayment is unlikely and the ability to judge whether repayment ability will continue.

The proper valuation of collateral takes on increasing importance, to both bank management and bank supervisors, when there is evidence of deterioration in the credit quality of a loan. While FDIC examiners do not "require" independent appraisals (or reappraisals) for specific loans, such documentation is considered to be a necessary part of an effective loan administration program in a well-managed bank. Where the lack of current appraisals represents an imprudent practice, bank management is appropriately criticized and subjected to necessary followup action as part of the FDIC's bank supervisory process.

4. What are the FDIC's supervisory requirements concerning acceptable appraiser qualifications and independence. Are those requirements codified and, if so, where? If there are no such requirements, why not?

As we indicated in our response to questions B.1. and B.2., the FDIC does not have, nor do we consider it appropriate, to set forth specific requirements concerning property appraisals or appraisal practices. Our examiners are expected to assess a bank's appraisal policies, the methods of valuation used, and the appropriateness of the existing appraisal in each individual situation under consideration. Some of the areas our examiners question when evaluating a bank's real estate appraisal policy follow.

- Are authorizations for designated appraisals noted in the board of directors' minutes or the minutes of an appropriate committee thereof.

- Do delegated appraisal authorities have limits on:
  a. the amount of the loan in question;
  b. the type of appraisal being made;
  c. the type of construction project being appraised.

- Are cost estimates and market studies that accompany the borrower's loan application withheld from the appraiser.

- Are appraisal fees the same amount whether or not the loan is granted.

- If staff appraisals are used, does the bank occasionally have test appraisals by independent appraisers to check the staff's knowledge of costing techniques and market trends.

- If appraisers who are not employees of the bank are used, does the bank investigate their quality and reputations.

- Are appraisals approved in writing by the permanent financier where construction loans are subject to a take-out commitment.

- Does the bank have an internal review procedure to determine whether construction appraisal policies and procedures are consistently being followed and that appraisal documentation supports the appraiser's conclusion.

The reasonableness of appraisals is also judged by examiners based on their expertise and personal knowledge of the area.

5. Set forth FDIC policies and requirements regarding out-of-area real estate loans by FDIC-supervised banks. When are such loans permissible? What procedures must lenders follow in making such loans (and do those procedures vary, depending on the size of the institution)? If there are no specific FDIC requirements, how does the FDIC assure the safety and soundness of such loans, particularly where the lender has no obvious familiarity with the geographical area involved and is less able to evaluate the accuracy of the appraisal?

The FDIC does not automatically assume that all "out-of-area" real estate based loans are inherently unsound or that banks engaging in such lending practices are exposed to excessive risk of loss. In fact, many highly regarded institutions purchase or participate in such credits originated and serviced by other banks or mortgage companies. This is viewed as a normal business practice which, among other potential benefits, will help them achieve a more diversified loan portfolio.

The standards for such lending clearly should be no different than those applied to loans granted to borrowers in a bank's more localized geographic market. This is true regardless of the size of the lending institution involved. Undue reliance upon the originator and/or servicer of a loan, in the place of the exercise of normal credit judgment, is considered to be an unacceptable and potentially dangerous banking practice. However, if reasonable care is taken by bank management and prudent lending policies are applied, the FDIC has no reason to take exception to reasonable out-of-area lending by insured banks. To assure the soundness of these loans, banks must have access to sound, on-the-scene agents who can monitor conditions of say a building project. There must be appropriate reporting and audit checks. FDIC satisfies itself in the examination process that these procedures are in effect. The bank's files must contain proper reports and documentation.

6.a. For those properties acquired by the FDIC in its insurance function, discuss your policies and procedures on the use of appraisers for establishing a property's market value at the time it moves into the Corporation's portfolio. Discuss the number of appraisals required and preferences for nondesignated appraisers), appraiser diversification, frequency of appraisals, and uniform instructions to appraisers.

6.a. This question is addressed in Associate Director Seelig's testimony of December 11 to the committee.

6. b. Should any of these policies and procedures be required of FDIC-supervised banks? Please discuss.

While many of the policies and procedures outlined by Associate Director Seelig in his testimony before the committee on November 11 could be applied to banks, it has been our longstanding posture not to interfere in the management function of a bank by requiring specific requirements of all institutions unless we perceive a serious widespread problem which cannot be corrected in the normal course of supervision. We believe the present supervisory process to be sufficient to address any problems which may arise while at the same time allowing management the flexibility to establish prudent underwriting standards for their respective insitutions.

7. Explain how the FDIC's draft policy statement on "Guidelines for Collateral Evaluation and Classification of Troubled Commercial Real Estate Loans" applies to the issue of accurate appraisals and adequate appraiser performance. (Please furnish a copy of the most recent draft prior to the hearing.) Describe input and participation by the Federal Reserve Board and the OCC in developing this document. Indicate how these guidelines will be incorporated in examiner directives.

Attached is a copy of the Guidelines for Collateral Evaluation and Classification of Troubled Commercial Real Estate Loans which was distributed to examiners on November 19. The guidelines are the result of an interagency working group that met in August to study the agencies' existing examination procedures and make recommendations to ensure that troubled real estate loans receive consistent treatment nationwide. The guidelines cover reviewing and classifying troubled commercial real estate loans and reviewing the underlying assumptions supporting the appraisal. The guidelines also instruct examiners to perform a comprehensive analysis of loans reflecting troubled characteristics to determine the bank's potential exposure and to criticize the bank in cases where current fair market appraisals are absent. In order to provide additional guidance to examiners in reviewing and analyzing appraisals on commercial property, an example of the income approach to appraising commercial real estate was included along with the guidelines. The example was designed for illustrative purposes only and was intended to point out only some of the concepts discussed in the policy statement since we recognized that a number of factors must be considered in evaluating appraisals and in determining an adverse classification.

In order to reiterate our belief that sound lending practices dictate that banks obtain appraisals that reflect current market conditions performed by independent qualified appraisers, a copy of the guidelines was distributed to all insured State nonmember banks (commercial and mutual) on December 3 (see attached).

C. FDIC examination requirements and practices concerning appraisals and real estate loans:

Section A (p. 3) of the FDIC's Manual of Examination Policies requires that FDIC examiners evaluate the overall mortgage lending and real estate administration policies of FDIC-supervised banks to ascertain the soundness of their mortgage loan operations, including bank policies involving appraisals.

1. Discuss (a) the frequency of such FDIC real estate examination evaluations, (b) the scope of such evaluations, and (c) whether these examination procedures are different for larger banks within FDIC's jurisdiction.

a. The FDIC will normally evaluate a bank's real estate lending operations during each examination. In addition, the FDIC makes periodic visitations between examinations to monitor specific problems in a given bank which would address real estate lending, if appropriate.

Normally, problem banks and other banks of supervisory concern are examined annually. Banks in satisfactory condition are examined less frequently, typically once every 36 months. All these schedules are subject to change based on individual circumstances and judgments of the respective Regional Director.

b. The scope of our examination of a bank's real estate operations is left to the judgment of the examiner-in-charge. In all cases the examiner considers the bank's policies including its appraisal practices, a sample of loans are reviewed, documentation is checked, and past due loans are reviewed. If problems are observed or if real estate lending is a major area of the bank's business, additional work would be performed.

c. Our examination procedures are not standardized according to bank size. Examiners are expected to become familiar with a bank's policies and procedures and then adopt appropriate examination techniques. While bank size, internal controls or other differences among banks may affect the scope of our work or the size of a sample of loans, it does not affect the basic approach of reviewing policy and procedures and examining a sample of individual credits.

2. (a) During FDIC examinations, how frequently are real estate loan files actually reviewed and how many are reviewed (provide a percentage)? How are loans selected for review? (b) Are the appraisals in the loan file examined and verified for accuracy? How frequently and under what circumstances is this done?

a. As indicated in the answer to question C.1., there are no absolute examination guidelines regarding how large a sample of real estate loans should be reviewed. Loans are selected for review in several ways: new and/or existing loans over a judgmentally determined dollar amount, real estate loans to a borrower whose total line of credit at the bank (real estate and non-real-estate) exceeded a judgmentally established amount, past due real estate loans or those identified by the bank's internal procedures as being a weak credit, and real estate loans adversely classified at the prior examination.

b. Appraisals are reviewed as a normal part of examining individual real estate loan documentation. This examination of documentation assists the examiners both in determining the quality of the particular credit and also as a check of bank procedures and compliance with bank policies regarding real estate lending. Appraisals are reviewed for independence of the appraiser, reasonableness of assumptions used in the appraisal, age of the appraisal, general common sense regarding values assigned and what the examiner knows of local markets and business conditions as an informed observer. If problems in appraisals appear to be a recurring deficiency in lending, the matter will be discussed with bank management and bank directors. Criticism will be made in the examination report and corrective action pursued.

3. Section 213.4 of the Office of the Comptoller of the Currency's Examiners' Handbook (the Internal Control Questionnaire) requires that (1) examiners observe or test the "type and frequency of the appraisal required" in reviewing a bank's written loan policies and (2) examiners obtain and document information on a bank's policies and practices regarding appraisals . . . The OCC's internal control questionnaire for reviewing a bank's policies, practices and procedures for making and servicing real estate <u>construction</u> loans (Section 214.4 of the OCC Handbook) sets forth additional questions regarding appraisers and appraisal practices. The Federal Reserve's manual tracks the very same language of both sections.

a. The FDIC's manuals/regulations apparently do not contain similar examination appraisal directives or checklists. Why not? (b) As to <u>each</u> of the above criteria, please explain what would constitute a deficiency or possibly a violation of FDIC regulations. How are any appraisal-related safety and soundness requirements communicated to examiners?

a. The FDIC manual is not designed or intended to be an examination procedures manual. It is a general reference source providing the examiners with guidance in FDIC policy, background information regarding different aspects of bank operations and some of the problems frequently found in different areas of bank examinations.

b. The FDIC has no rules or regulations addressing appraisals but does enforce the various State laws which may apply. The result of our examination may well result in indications of deficiencies in a bank's approach to obtaining or using real estate appraisals. Our criticism would be directed at practices we considered imprudent which would include areas addressed in the OCC's Examiner Handbook. Regarding the specific items listed in your question, we would expect appraisals to be signed and dated, loan information should be withheld from appraisers, fees for appraisers should be independent of the related loan approval or denial, staff appraisals should be periodically tested for reasonableness, appraisals should be updated as time passes and the expertise and reputation of outside appraisers are important. In addition to these items we would review the methods and assumptions used in the appraisal to see that they appear well-founded and reflect current market conditions.

The procedural aspect of examination techniques are learned by examiners through formal training at FDIC schools and through on-the-job experience. In addition, instruction and on-the-job training and the examination manual are supplemented through special purpose memorandums issued when circumstances are considered appropriate. The memorandum on evaluation of real estate loans submitted in response to question B.7. is an example.

D. FDIC's supervisory policies concerning real estate collateralizing mortgage-backed securities:

1.a. Please provide information presently available to the FDIC on the number of FDIC-supervised banks which hold as investments private conduit (i.e., non-FNMA/FHLMC/GNMA) mortgage-backed securities. Indicate the approximate aggregate dollar amount of such mortgage-backed securities and discuss any problems which the FDIC has uncovered with respect to the properties collateralizing them.

Information obtained from Reports of Condition filed by all FDIC-supervised commercial banks as of September 30, 1985 (information not available for savings banks), reveals that 174 of those institutions reported holdings of private (i.e., nongovernment-issued or guaranteed) certificates of participation in pools of residential mortgages. The aggregate book value of those holdings was $399,696,000 while the total market value was $396,378,000. This represents a small percentage of the banks and bank assets we are responsible for examining and such instruments have not resulted in widespread significant problems. However, we are aware of the problems of inflated property appraisals and fraudulent loans with respect to the mortgage-backed securities issued by National Mortgage Equity Corporation (NMEC).

b. Please describe FDIC's policy and practice for examining the appraisals on properties collateralizing private conduit mortgage-backed securities held by FDIC-supervised banks to determine their accuracy.

If a bank's investment in mortgage-backed securities was of an amount significant enough to warrant examination, the appraisal documentation, to the extent it is available in bank files, would be reviewed in the same manner as that documentation obtained for a direct real estate loan, i.e., underlying assumptions supporting the appraisal would be studied for their reasonableness. Since these obligations normally represent pools of many individual loans, individual loan documentation would normally not be available. Emphasis more typically would be on the credit standards applied by, and reputation of, the originating lender, the financial capacity of guarantors and the reputation and capacity of the trustees and escrow agents. Credit standards would address what percent of appraisal value is loaned and obtaining reasonable fair appraisals would be the responsibility of the originating lender. For this reason it is certainly important that banks limit their dealings to firms that are well-known to the bank and of good reputation within the financial community.

c. Indicate whether the FDIC examination evaluations of a bank's real estate loan practices, internal controls, etc., apply to properties collateralizing mortgage-backed securities, and, if so, how?

During an examination, we determine whether or not a bank's investments in the form of both loans and securities have been made in a safe and sound manner. As such, we would expect a bank which had invested in mortgage-backed securities to have available information and documentation which supported the creditworthiness of the asset. Such information should include financial statements of obligors and appraisals on the collateral properties. If this documentation is not maintained we would expect the bank to have researched and have available information regarding the qualifications of the broker packaging the securities and the underwriting standards to which it adheres. Additionally, if the mortgages are insured by another party, information on the financial capacity of the insurer should be available.

d. (i) How does the FDIC become aware of private conduit mortgage-backed securities held by FDIC-supervised banks prior to and during an examination. (ii) Was the FDIC aware, prior to September 1984, of the holdings by at least five FDIC-supervised banks (referenced in the subcommittee's November 26, 1985 letter to the FDIC) in the National Mortgage Equity Corporation packaged mortgages?

(i) All FDIC-supervised commercial banks report the book and market values of their holdings of private conduit mortgage-backed securities on the Reports of Condition which are submitted quarterly. During an examination, the presence of these securities would be noted as part of the review of a bank's investment portfolio.

(ii) Our response to the subcommittee's November 26 letter indicates that, to the best of our knowledge, only one of the five institutions named in that correspondence was an FDIC-supervised bank which had purchased NMEC packaged securities. We find no mention of that institution's investment in those securities in our files or reports of examination prior to September 1984. We are not certain of the date on which that bank originated its investment in the NMEC securities.

e. i.(a) Has the FDIC conducted any inquiry resulting from the defaults on the NMEC packaged securities? If so, describe it and summarize the findings.

(b) How have the defaults on these securities impacted these banks' financial conditions? How would your answer be different if Bank of America had not accepted liability for these losses?

i.(a) We maintained contact with the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency during their investigations into the NMEC-issued securities. Due to the apparent depth of those investigations and the absence of significant impact on FDIC-supervised institutions, we did not conduct an independent inquiry into the matter.

i.(b) The one FDIC-supervised institution known to have participated in the NMEC securities had purchased them through Bank of America and, as such, has incurred no loss from them. Had Bank of America not accepted the liability for these securities, that bank would have incurred a loss of $4,046,000. This would have resulted in a 14 percent decline in the institution's capital account with the capital/assets ratio declining from 3.9 to 3.4 percent.

e. ii. As to each FDIC-supervised bank holding the NMEC packaged mortgaged-backed securities (1) describe any FDIC reviews of bank internal controls, practices, etc., as they specifically relate to appraisals of property securing mortgage-backed securities and (2) any appraisal problems or deficiencies found and describe any FDIC responses thereto. (Your public statement need not identify the banks involved.)

ii. (1) Regular examination reports of the FDIC-supervised bank which held NMEC securities reflect a close review of the institution's internal routine and controls; however, they do not indicate a specific investigation into appraisals supporting mortgage-backed securities. At year-end 1984 those securities equaled only 0.5 percent of the bank's total assets.

ii. (2) No real estate appraisal problems or deficiencies were noted at the January 1984 or July 1985 examinations of the bank.

iii. Did FDIC examiners at any time between January 1981 and September 1, 1984 (the beginning of the defaults on these securities) ever review any documentation, including appraisals, concerning these pools of mortgage-backed securities in these banks' files? If so, please indicate the approximate dates of each examination or visit and specify the documentation reviewed. Set forth any and all deficiencies found, including those relating to the properties or principals involved, and any corrective action taken. (Once again, your public statement need not identify banks.)

Reports of Examination and file memoranda relating to NMEC securities do not reflect a specific review of bank-held documentation for the mortgage-backed securities. As mentioned previously, it is not definitely known when the institution first invested in the securities.

iv. Would the alleged failures by the FDIC-supervised banks regarding the NMEC packaged securities (including those where Bank of America was trustee/escrow agent), including any failures to inspect the properties, test the appraisals, or investigate the reputation or the character of the appraisers and principals, constitute unsafe and unsound practices?

Our Manual of Examination Policies describes engaging in speculative or hazardous investment policies as an example of an unsafe or unsound banking practice. With respect to mortgage-backed securities, a bank's failure to obtain adequate documentation to make and support a judgment regarding the credit quality of the investment would be imprudent and criticized as improper banking practice. Whether or not it was unsafe or unsound would depend on the magnitude of the investments and their impact on the bank's financial condition.

Regarding failure to perform the specific investigations mentioned in your question, our examination reports do not mention these items. The appropriateness of these items would depend very much on the nature of the bank's investment. An East Coast bank would have no realistic way to personally inspect properties or investigate appraisals or appraisers involved in a collateral mortgage obligation (CMO) originated in California. They would, however, be expected to satisfy themselves that proper procedures and precautions had been followed by the originating lender. A primary consideration in such investments is that banks would deal only with parties who are reputable and well-known to the investing bank. Investing in CMOs developed on out-of-area properties by an unknown lender would be inadvisable.