



Office of Thrift Supervision
Department of the Treasury

1700 G Street, N.W., Washington, D.C. 20552 • (202) 961-5500

Director

Any attachments to this document are rescinded only as they relate to national banks and federal savings associations.

June 11, 1993

MEMORANDUM FOR CHIEF EXECUTIVE OFFICERS

FROM: Jonathan L. Fiechter
Acting Director

SUBJECT: Credit Availability and Fair Lending Initiatives

On June 10, 1993, the four Federal bank and thrift regulatory agencies (Office of Thrift Supervision [OTS], Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve Board) issued interagency statements on credit availability and fair lending.

The statements released on credit availability are intended to improve the ability of small businesses and consumers to gain access to credit. The agencies' policy statements address six specific issues and establish the following policies:

- **In-Substance Foreclosures (ISF):** Under the new policy, loans that meet the existing ISF criteria need not be reported as real estate owned (REO) until the institution actually takes possession of the collateral (though the loan should still be written down to the fair value of the collateral).
- **Returning Nonaccrual Loans to Accrual Status:** Under the new policy, institutions are given two methods by which they can return certain nonaccrual loans to accrual status: (1) the use of troubled debt restructurings that involve multiple notes and (2) when borrowers have resumed paying the full amount due and the institution expects to collect all principal and interest due (along with some other conditions).
- **Reporting Requirements for Financed Sales of REO:** Under the new policy, the minimum down payment requirement previously in place for financed sales of REO is removed and, instead, thrifts and banks can report financed sales of REO as "sales" so long as the GAAP criteria established in FAS 66 is met. The OTS will implement this change through a revision to the instructions to the June 30, 1993 Thrift Financial Report.
- **Reaffirmation of the November 7, 1991 Policy Statement:** This statement reaffirms the agencies' support for the policies announced in 1991 on the review and classification of commercial real estate loans.

- **Supervisory Definition of Special Mention Assets:** This policy statement establishes a uniform definition of the Special Mention designation and sets forth several other related new policies.
- **Coordination of Holding Company, Thrift and Bank Examinations:** This policy statement outlines a program for coordinating examinations of institutions and their holding companies so as to minimize disruption and avoid duplicative examination efforts and information requests, whenever possible.

Attached are a press release that summarizes these initiatives and the interagency policy statements that discuss the initiatives in greater detail.

The agencies also announced on June 10 several initiatives we will pursue to enhance our ability to detect lending discrimination, to improve the level of education we provide to the industry and to our examiners, and to strengthen fair lending enforcement. Attached is a copy of the interagency policy statement that discusses these initiatives.

Please contact your Regional office if you have any questions about the initiatives and Policy Statements.

Attachments

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

**Federal Regulators Announce
Additional Credit Availability Initiatives**

June 10, 1993

The four federal regulators of banks and thrifts today announced six additional initiatives to implement the President's March 10 program to improve the availability of credit to businesses and individuals. These initiatives include changes to regulatory reporting requirements and the issuance of joint policy statements on the valuation of real estate collateral, use of the "Special Mention" category in reviewing loans, and improved coordination of examinations. The changes to regulatory reporting requirements are consistent with generally accepted accounting principles (GAAP).

The agencies noted that these latest actions bring to a close the first phase of the President's credit availability program. However, all four agencies emphasized that they are continuing efforts to reduce the paperwork and regulatory burden that impedes the flow of funds to creditworthy borrowers.

The actions announced today cover these areas:

■ **In-Substance Foreclosures**

In the past, the agencies' rules required certain loans to be reported as in-substance foreclosures. In the revised guidance issued today, the agencies make it clear that a collateral dependent real estate loan need not be reported as foreclosed real estate unless the lender has taken possession of the collateral. However, appropriate losses must be recognized. This guidance is consistent with the approach taken by the Financial Accounting Standards Board (FASB) in its new standard on loan impairment.

■ **Returning Nonaccrual Loans to Accrual Status**

In the past, a loan that was partially charged off could not be returned to accrual status until all missed payments had been made up to bring the loan to current status and the institution expected to receive the full contractual principal and interest on the loan.

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This reporting requirement also applied in situations where the borrower showed a renewed ability and willingness to service the remaining debt. Accordingly, institutions sometimes found it difficult to work with borrowers who were experiencing temporary difficulties in a way that would maximize recovery on these troubled loans.

To address this problem, the agencies are making two revisions to their nonaccrual guidelines. First, banks and thrifts will be allowed to formally restructure troubled debt in a manner that will allow a portion of the debt to become an accruing asset, provided certain criteria are met. This revised reporting guidance makes the policies of the bank and thrift regulatory agencies consistent.

Second, in some cases, borrowers have resumed paying the full amount of scheduled contractual principal and interest payments on loans that are past due and in nonaccrual status. Under the guidance issued today, banks and thrifts will be allowed to return such past due loans to accrual status, provided the institution expects to collect all principal and interest due and the borrower has made regular payments in accordance with the terms of the loan over a specific period of time.

■ **Regulatory Reporting Requirements for Sales of Other Real Estate Owned (OREO)**

The agencies will separately issue guidance to banks and thrifts that generally conforms regulatory reporting requirements for sales of OREO with generally accepted accounting principles (GAAP), as set forth in FASB Statement No. 66. These changes delete certain requirements for minimum down payments for sales of OREO. Financial institutions and examiners should refer to FASB Statement No. 66 for a detailed discussion of the accounting principles that apply to sales of real estate.

■ **Review and Classification of Commercial Real Estate Loans**

The agencies are reaffirming their guidelines issued in November 1991 to ensure that examiners are reviewing commercial real estate loans in a consistent, prudent and balanced manner. Today's policy statement reiterates that the evaluation of commercial real estate loans is based on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the underlying collateral over time. The statement emphasized that it is NOT regulatory policy to value collateral that underlies real estate loans on a liquidation basis.

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■ **Supervisory Definition of Special Mention Assets**

The agencies are concerned that improper use of the "Special Mention" loan category in examiners' reviews of loan portfolios may inhibit lending to small- and medium-size businesses. Accordingly, all four agencies have adopted a uniform definition for this category.

The use of a common definition will lead to more consistent supervision among the four agencies. It will also enable examiners to more readily segregate Special Mention assets from those warranting adverse classification. The agencies have agreed to use classified assets, which by definition do not include Special Mention assets, as the standard measure in expressing the quality of a bank or thrift's asset portfolio.

■ **Coordination of Holding Company, Thrift and Bank Examinations**

The four agencies are issuing interagency guidelines to coordinate their supervision and examinations in order to minimize the disruptions and burdens associated with the examination process. Under the principles laid out in the guidelines, the agencies will work to eliminate duplication in examinations by multiple agencies. Examinations and inspections of a particular legal entity will be conducted by the primary supervisor for that entity. The agencies will increase coordination of examinations and will establish procedures to centralize and streamline examinations in multibank organizations.

The initiatives announced today follow a number of actions previously taken by the four agencies to implement the President's credit availability program. Those actions include:

- **Interagency Policy Statement on Documentation of Loans** (March 30, 1993)
- **Interagency Letter on Lending Discrimination** (May 27, 1993)
- **Proposed Rule on Revised Appraisal Requirements** (June 4, 1993)
- **Interagency Release on Joint Fair Lending Initiatives** (June 10, 1993)

The four agencies emphasized that they will continue their efforts to reduce paperwork and regulatory burdens and improve the ability of small businesses and consumers to gain access to credit. For example, in the coming months, the agencies expect to modify their procedures for corporate applications (e.g., applications for charters, mergers, and branches) to make them less duplicative and more uniform.

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Joint Statement

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

**Interagency Guidance on
Reporting of In-Substance Foreclosures**

June 10, 1993

On March 10, 1993, the four federal banking and thrift regulatory agencies issued an Interagency Policy Statement on Credit Availability. That statement indicated that the agencies would seek to clarify the reporting treatment for in-substance foreclosures (ISF) and would work with the accounting authorities to achieve consistency between generally accepted accounting principles (GAAP) and regulatory reporting requirements in this area.

Under existing accounting guidelines for determining whether the collateral for a loan has been in-substance foreclosed, a loan is transferred to "other real estate owned" (OREO or REO) and appropriate losses are recognized if certain criteria are met. Such OREO designations may impede efforts to improve credit availability and may discourage lenders from working with borrowers experiencing temporary financial difficulties.

The Financial Accounting Standards Board (FASB) recently issued Statement No. 114, "Accounting by Creditors for Impairment of a Loan," addressing the accounting for impaired loans. This Standard also clarifies the existing accounting for in-substance foreclosures. Under the new impairment standard and related amendments to Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (FAS 15), a collateral dependent real estate loan (i.e., a loan for which repayment is expected to be provided solely by the underlying collateral) would be reported as OREO only if the lender had taken possession of the collateral. For other collateral dependent real estate loans, loss recognition would be based on the fair value¹ of the collateral if foreclosure is probable. However, such loans would no longer be reported as OREO. Rather, they would remain in the loan category.

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¹ Fair value is defined in paragraph 13 of FAS 15.

Accordingly, the agencies have concluded that losses² must be recognized on real estate loans that meet the existing ISF criteria based on the fair value of the collateral, but such loans need not be reported as OREO unless possession of the underlying collateral has been obtained. The agencies believe that this interagency guidance, coupled with other agency actions currently being taken, will reduce impediments to the availability of credit.

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RESCINDED

² Consistent with GAAP, loss recognition would consider estimated costs to sell.

Joint Statement

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

**Revised Interagency Guidance on
Returning Certain Nonaccrual Loans to Accrual Status**

June 10, 1993

Introduction

On March 10, 1993, the four federal banking agencies issued an Interagency Policy Statement on Credit Availability. That policy statement outlined a program of interagency initiatives to reduce impediments to the availability of credit to businesses and individuals.

As part of that program, the agencies are making two revisions to existing policies for returning certain nonaccrual loans to accrual status. The revised policies should remove impediments to working with borrowers who are experiencing temporary difficulties in a manner that maximizes recovery on their loans, while at the same time improving disclosures in this area.

The first change conforms the banking and thrift agencies' policies on troubled debt restructurings (TDRs) that involve multiple notes (sometimes referred to as "A"/"B" note structures). The second change would permit institutions to return past due loans to accrual status, provided the institution expects to collect all contractual principal and interest due and the borrower has demonstrated a sustained period of repayment performance in accordance with the contractual terms.

The revised policies are effective immediately. Thus, institutions may elect to adopt such changes for purposes of the June 30, 1993, Consolidated Reports of Condition and Income (Call Report) and Thrift Financial Report (TFR). Revised Call Report and TFR instructions will be distributed as of September 30, 1993.

TDR Multiple Note Structure

The agencies are conforming their reporting requirements for TDR structures involving multiple notes. The basic example is a troubled loan that is restructured into two notes where the first or "A" note represents the portion of the original loan principal amount which is expected to be fully collected along with contractual interest. The second part of the restructured loan, or "B" note, represents the portion of the original loan that has been charged off.

Such TDRs generally may take any of three forms. (1) In certain TDRs, the "B" note may be a contingent receivable that is payable only if certain conditions are met (e.g., sufficient cash flow from the property). (2) For other TDRs, the "B" note may be contingently forgiven (e.g., note "B" is forgiven if note "A" is paid in full). (3) In other instances, an institution would have granted a concession (e.g., rate reduction) to the troubled borrower but the "B" note would remain a contractual obligation of the borrower. Because the "B" note is not reflected as an asset on the institution's books and is unlikely to be collected, the agencies have concluded that for reporting purposes the "B" note could be viewed as a contingent receivable.

Institutions may return the "A" note to accrual status provided the following conditions are met:

- (1) The restructuring qualifies as a TDR as defined by FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructuring," (SFAS 15) and there is economic substance to the restructuring. (Under SFAS 15, a restructuring of debt is considered a TDR if "the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.")
- (2) The portion of the original loan represented by the "B" note has been charged off. The charge-off must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. The charge-off must be recorded before or at the time of the restructuring.
- (3) The "A" note is reasonably assured of repayment and of performance in accordance with the modified terms.
- (4) In general, the borrower must have demonstrated sustained repayment performance (either immediately before or after the restructuring) in accordance with the modified terms for a reasonable period prior to the date on which the "A" note is returned to accrual status. A sustained period of payment performance generally would be a minimum of six months and involve payments in the form of cash or cash equivalents.

Under existing reporting requirements, the "A" note would be disclosed as a TDR. In accordance with these requirements, if the "A" note yields a market rate of interest and performs in accordance with the restructured terms, such disclosures could be eliminated in the year following the restructuring. To be considered a market rate of interest, the interest rate on the "A" note at the time of the restructuring must be equal to or greater than the rate that the institution is willing to accept for a new receivable with comparable risk.

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

Certain borrowers have resumed paying the full amount of scheduled contractual interest and principal payments on loans that are past due and in nonaccrual status. Although prior arrearages may not have been eliminated by payments from the borrowers, some borrowers have demonstrated sustained performance over a period of time in accordance with the contractual terms. Under existing regulatory standards, institutions cannot return these loans to accrual status unless they expect to collect all contractual principal and interest and the loans are brought fully current (or unless the loan becomes well secured and in the process of collection).

Such loans may henceforth be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met: (1) all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period, and (2) there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in accordance with the contractual terms involving payments of cash or cash equivalents. Consistent with existing guidance, when the regulatory reporting criteria for restoration to accrual status are met, previous charge-offs taken would not have to be fully recovered before such loans are returned to accrual status.

Loans that meet the above criteria would continue to be disclosed as past due (e.g., 90 days past due and still accruing for Call Report and TFR purposes), as appropriate, until they have been brought fully current.

Additional Guidance

The Financial Accounting Standards Board (FASB) recently issued Statement No. 114, "Accounting by Creditors for Impairment of a Loan," which establishes a new approach for recognizing impairment on problem loans and for recognizing income on such loans. In addition, the standard establishes new disclosure requirements for impaired loans for financial reporting purposes. In light of the significance of those changes, the agencies are reevaluating regulatory disclosure and nonaccrual requirements that will apply when the statement becomes effective, and expect to issue revised policies at a later date.

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This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated June 10, 1993) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

**Interagency Policy Statement on
Review and Classification of Commercial Real Estate Loans**

June 10, 1993

On March 10, 1993, the four federal regulators of banks and thrifts issued an Interagency Policy Statement on Credit Availability. This policy statement outlined a program of interagency initiatives to reduce impediments to making credit available to businesses and individuals.

One impediment to making credit available to commercial real estate borrowers may be problems in evaluation of real estate collateral. The federal bank and thrift regulatory agencies have been working with their examination staffs for some time to ensure that commercial real estate loans are evaluated in accordance with agency policy. In issuing today's policy statement, the federal bank and thrift regulatory agencies are reaffirming the guidelines in the November 7, 1991 Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans. The November 7, 1991 policy statement provides clear and comprehensive guidance to ensure supervisory personnel are reviewing commercial real estate loans in a consistent, prudent and balanced manner. A copy of that statement is attached.

The November 7, 1991 statement clarified regulatory policy on real estate valuation and classification. The evaluation of commercial real estate loans is based on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the underlying collateral over time. The value of collateral increases in importance as a loan becomes troubled and the borrower's ability to repay the loan becomes more questionable. The statement emphasizes that it is NOT regulatory policy to value collateral that underlies real estate loans on a liquidation basis. (See the discussion on "Examiner Review of Individual Loans, Including the Analysis of Collateral Value," beginning on page 3 of the policy statement.)

Furthermore, the policy statement discusses management's responsibility for reviewing appraisal assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.

This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated June 10, 1993) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

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Management should adjust any assumptions used by an appraiser in determining values that are overly optimistic or pessimistic. The policy statement also indicates that the assumptions used in a discounted cash flow analysis (such as discount rates and direct capitalization rates) should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Unrealistic or unsustainable high or low discount rates, "cap" rates, and income projections should not be used.

The use of appropriate assumptions in a discounted cash flow analysis is particularly important in determining the value of collateral for a troubled, project-dependent commercial real estate loan (involving income-producing property). The agencies use this valuation for determining the amount of the loan that is adequately secured by the value of the collateral. The November 7, 1991 Interagency Policy Statement indicates that generally, any portion of the loan balance that exceeds the amount adequately secured by collateral values and that can be clearly identified as uncollectible should be classified "loss." The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The policy statement also indicates that, when an institution has taken a charge-off in sufficient amount so that the remaining recorded balance of the loan (a) is being serviced (based on reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate.

The federal bank and thrift regulatory agencies will continue to ensure their examiners implement the policy statement appropriately and uniformly. Each agency has an appeals process for institutions with significant concerns about examinations, including any concerns relating to the supervisory treatment of commercial real estate loans.

Attachment: Interagency Policy Statement on Review and Classification of Commercial Real Estate Loans, November 7, 1991

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This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated November 7, 1991) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

**Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision**

**Interagency Policy Statement on the Review and
Classification of Commercial Real Estate Loans**

November 7, 1991

The recent decline in credit extended by depository institutions has been attributed to many factors. These factors include the general slowdown in the economy, the overbuilding of commercial real estate properties in some markets, the desire of some household and business borrowers, as well as some depository institutions, to strengthen their balance sheets, changes by lenders in underwriting standards, and concerns about the potential impact of certain supervisory policies or actions. To ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers, the four Federal regulators of banks and thrifts have taken a number of steps to clarify and communicate their policies. The attached policy statement is a further step in this effort.

On March 1, 1991, the four agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision — issued general guidelines that addressed a wide range of supervisory policies. Included in the March issuance were brief discussions of the workout of problems loans, lending by undercapitalized institutions, and a general statement on the valuation of real estate loans.

The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans.

The intent of the statement by the agencies is to provide clear and comprehensive guidance to ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance.

The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.

This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated November 7, 1991) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

The policy statement also provides guidance on how supervisory personnel analyze the value of collateral. In general, examiners consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and they review the major facts, assumptions and approaches used in determining the value of the collateral. Examiners seek to avoid challenges to underlying assumptions that differ in only a limited way from norms that would generally be associated with the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, examiners ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios;
- the indicators of troubled real estate markets, projects, and related indebtedness;
- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value;
- a discussion of approaches to valuing real estate, especially in troubled markets;
- the classification guidelines followed by the agencies, including the treatment of guarantees; and
- the factors considered in the evaluation of an institution's allowance for loan and lease losses.

This statement is intended to ensure that all supervisory personnel, lending institutions and other interested parties have a clear understanding of the agencies' policies.

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans¹

Introduction

This policy statement addresses the review and classification of commercial real estate loans by examiners of the federal bank and thrift regulatory agencies.² Guidance is also provided on the analysis of the value of the underlying collateral. In addition, this policy statement summarizes principles for evaluating an institution's process for determining the appropriate level for the allowance for loan and lease losses, including amounts that have been based on an analysis of the commercial real estate loan portfolio.³ These guidelines are intended to promote the prudent, balanced, and consistent supervisory treatment of commercial real estate loans, including those to borrowers experiencing financial difficulties.

The attachments to this policy statement address three topics related to the review of commercial real estate loans by examiners. The topics include the treatment of guarantees in the classification process (Attachment 1); background information on the valuation of income-producing commercial real estate loans in the examination process (Attachment 2); and definitions of classification terms used by the federal bank and thrift regulatory agencies (Attachment 3).

Examiner Review of Commercial Real Estate Loans

This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated November 7, 1991) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

¹ For purposes of this policy statement, "commercial real estate loans" refers to all loans secured by real estate, except for loans secured by 1 - 4 family residential properties. This does not refer to loans where the underlying collateral has been taken solely through an abundance of caution where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien.

² The agencies issuing this policy statement are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

³ For analytical purposes, as part of its overall estimate of the allowance for loan and lease losses (ALLL) management may attribute a portion of the ALLL to the commercial real estate loan portfolio. However, this does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

For savings institutions, the ALLL is referred to as the "general valuation allowance" for purposes of the Thrift Financial Report.

loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness. In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for — and the value of — new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated November 7, 1991) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.

- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.

This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated November 7, 1991) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.⁴

Examiner Review of Individual Loans, Including the Analysis of Collateral Value. The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with

⁴ As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.⁵ However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.⁶ Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.⁷ Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of

This Interagency Policy Statement on *The Review of Classification of Commercial Real Estate Loans* (dated November 7, 1991) was rescinded with the issuance of CEO 325, dated October 30, 2009 .

⁵ The treatment of guarantees in the classification process is discussed in Attachment 1.

⁶ Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R-0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AB05); Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90-1495).

⁷ Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

⁸ The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.⁹

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

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to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be

⁹ Attachment 2 includes a discussion of discount rates and direct capitalization rates.

given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Classification Guidelines

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3).¹⁰ In determining the appropriate classification, consideration should be given to all important information on repayment

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not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.¹¹

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics

¹⁰ These definitions are presented in Attachment 3 and address assets classified "substandard," "doubtful," or "loss" for supervisory purposes.

¹¹ Another issue that arises in the review of a commercial real estate loan is the loan's treatment as an accruing asset or as a nonaccrual asset for reporting purposes. The federal bank and thrift regulatory agencies have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (Call Reports) for banks, and in the instructions for the Thrift Financial Report for savings associations, and in related supervisory guidance of the agencies.

affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans.¹² The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss."¹³ The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

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(based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

¹² The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

¹³ For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

Guidelines for classifying formally restructured loans. The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable *modified terms*.¹⁴ Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

Review of the Allowance for Loan and Lease Losses (ALLL)¹⁵

The adequacy of a depository institution's ALLL, including amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well documented, and consistently applied analysis of the institution's loan and lease portfolio.¹⁶

The determination of the adequacy of the ALLL should be based upon management's consideration of all current significant conditions that might affect the ability of ~~the borrower (or borrowers, if any)~~ to fulfill their obligations to the institution. While

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ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and

¹⁴ An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a "cash flow" mortgage which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

¹⁵ Each of the federal bank and thrift regulatory agencies have issued guidance on the allowance for loan and lease losses. The following discussion summarizes general principles for assessing the adequacy of the allowance for loan and lease losses.

¹⁶ The estimation process described in this section permits for a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL in order to assure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. This examiner analysis will also consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems.

~~discussed in the previous section on classification guidelines, the value of the~~
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~~In assessing the~~
management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate anticipated loss on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (a) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems *and* (b) analyzed all significant factors affecting the collectibility of the portfolio, considerable weight should be given to management's estimates in assessing the adequacy of the ALLL.

Attachment 1

**TREATMENT OF GUARANTEES
IN THE CLASSIFICATION PROCESS**

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.¹ The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have *both* the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and²

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Considerations relating to a guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

Considerations relating to a guarantor's willingness to repay. Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified

¹ Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

² Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In

the guarantor's financial capacity and willingness to perform, it is expected

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phases of the project. The guarantor must be able to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

THE VALUATION OF INCOME-PRODUCING REAL ESTATE

Approaches to the Valuation of Real Estate

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property -- the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and were recently referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating the collateral for problem credits, the three valuation approaches are not equally appropriate.

1. **Cost Approach.** In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally

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transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.

3. **The Income Approach.** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.

The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate the present value of future income streams. For troubled properties, however, examiners typically utilize the more explicit discounted cash flow (net present value) method for analytical purposes. In that method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market

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but over time — offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high "capitalization" and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are *neither* highly speculative nor depressed for the type of property being valued and that property's location.

Technical Notes

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate. The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for this type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.¹

The Direct Capitalization ("Cap" Rate) Technique. The use of "cap" rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a "cap" rate is used as a short cut for computing the discounted value of a property's income streams.

The direct income capitalization method calculates the value of a property by dividing

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or return stated in terms of percentage. The "cap" rate is often considered a direct observation of the required earnings-to-price ratio in current income terms. The "cap" rate also can be viewed as the number of cents per dollar of today's purchase price investors would require annually over the life of the property to achieve their required rate of return.

The "cap" rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

¹ Regulatory policy of the Office of Thrift Supervision specifies that, for supervisory purposes, thrifts are to use discount rates that are consistent with generally accepted accounting principles for thrifts (which allow the use of an average-cost-of-capital-funds rate to calculate net realizable value) or discount rates that are consistent with the practices of the federal banking agencies.

This method alone is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A "terminal" "cap" rate is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

Differences Between Discount and Cap Rates. When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than "cap" rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, must be sufficient to compensate the investor for the depreciation of the property over its useful life.

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and "cap" rates is a key aspect of income analysis. Both in speculative transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

Holding Period vs. Marketing Period. When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the "holding period." The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period" — a term used in estimating the value of a property under the sales comparison approach

and in discussions of property value when real estate is being sold. The marketing period is the length of time that may be required to sell the property in an open market.

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Glossary

Appraisal. A written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Capitalization rate. A rate used to convert income into value. Specifically, it is the ratio between a property's stabilized net operating income and the property's sales price. Sometimes referred to as an overall rate because it can be computed as a weighted average of component investment claims on net operating income.

Discount rate. A rate of return used to convert future payments or receipts into their present value.

Holding period. The time frame over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income).

Market value. The most probable cash sale price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a

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3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Marketing period. The term in which an owner of a property is actively attempting to sell that property in a competitive and open market.

Net operating income (NOI). Annual income after all expenses have been deducted, except for depreciation and debt service.

Attachment 3

Classification Definitions¹

The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

Substandard Assets. A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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¹ Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners*, Section 215.1, "Classification of Credits;" Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual*, Section 215.1, "Classification of Credits;" Office of Thrift Supervision, *Thrift Activities Regulatory Handbook*, Section 260, "Classification of Assets;" Federal Deposit Insurance Corporation, *Division of Supervision Manual of Examination Policies*, Section 3.1, "Loans."

Joint Statement

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

For immediate release

**Interagency Statement on the
Supervisory Definition of Special Mention Assets**

June 10, 1993

The March 10, 1993 Interagency Policy Statement on Credit Availability indicated the federal banking and thrift regulatory agencies would issue guidance clarifying use of the Special Mention definition for regulatory supervision purposes. The four agencies have agreed on the definition of "Special Mention" as stated below. This definition should also be considered by an institution when performing its own internal asset review.

The definition of Special Mention is as follows:

A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

In the past, the agencies used different terminology and definitions for Special Mention. Supervisory reports and their contents also varied between agencies. The use of a common definition will lead to more consistent application of supervisory procedures. The definition will also enable examiners to more readily segregate Special Mention assets from those warranting adverse classification. It will also ensure that the Special Mention category is not used to identify an asset which has as its sole weakness credit data exceptions or collateral documentation exceptions that are not material to the repayment of the asset.

The agencies are in the process of developing examiner guidance explaining how the Special Mention category will be used in the assessment of the overall condition of an institution. The agencies have agreed to conform their policies and guidance to the following principles:

(more)

- Classified assets, which by definition do not include Special Mention assets, will be the standard measure used in expressing the quality of a bank or thrift's loan portfolio and other assets. The agencies will not express asset quality in terms of "criticized assets," a term that is generally recognized as including both Special Mention and classified assets.
- The agencies will ensure their policies, examiner guidance, and internal monitoring systems do not call for internal reporting of criticized asset totals or percentages. However, examiners will continue to consider the level and trends of assets categorized as Special Mention in their analysis as appropriate.
- In implementing Section 132 of the FDIC Improvement Act, Standards for Safety and Soundness, the agencies will use classified assets and not use criticized assets as a measure of asset quality.
- Special Mention assets will not be combined with classified assets in reports of examination or in corporate applications.

Each agency will make appropriate revisions to its examiner guidance, and all will work to ensure their guidance is consistent among the agencies. The guidance will emphasize that it is inappropriate to use the Special Mention category to capture loans solely because of their nature or type, such as small business lending or affordable housing lending.

Implementation of the revised definition will be effective immediately. Examiner guidance will be forthcoming shortly.

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Joint Release

**Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision**

For immediate release

**Interagency Policy Statement on
Fair Lending Initiatives**

June 10, 1993

The four financial institution regulatory agencies are announcing initiatives that they will pursue over the next several months to enhance their ability to detect lending discrimination, to improve the level of education they provide to the industry and to their examiners, and to strengthen fair lending enforcement.

Background

A number of interagency efforts are already completed or are under way to improve fair lending detection techniques, enforcement, and education. For example:

- The agencies have issued a joint statement to financial institutions that reaffirms their commitment to the enforcement of the fair lending laws and provides the industry with guidance and suggestions on fair lending matters.
- The agencies are working on a revised supervisory enforcement policy for dealing with violations of the Equal Credit Opportunity and Fair Housing Acts. This revised policy will replace a policy issued in 1981. The revised policy specifies corrective actions for several different substantive violations of the ECOA and FHA.
- The agencies are developing uniform fair lending examination procedures and training programs. The agencies believe these new procedures will significantly strengthen existing discrimination detection programs. These new examination procedures will be publicly available this summer.

New Initiatives

The four agencies will pursue the following new initiatives over the next several months:

(more)

1. **Fair Lending Training for Examiners**

The agencies will develop a new training program in fair lending for experienced compliance examiners that will be conducted on a regional basis. A pilot program could be held as early as Fall 1993.

2. **Fair Lending Seminar for Industry Executives**

The agencies will develop and sponsor regional fair lending programs for top level industry executives (chief executive officers and executive vice presidents) to explain their efforts to enforce fair lending laws and to foster additional sensitivity and awareness among lenders about discrimination issues, specifically subtle practices that impede the availability of credit to low-income and minority individuals. The first session of this program could be held later this year.

3. **Alternative Discrimination Detection Methods**

The agencies will explore statistically-based discrimination analysis models. These models may help identify loan applications files for review as part of the examination process. This will significantly enhance the agencies' abilities to identify loan applicants that may have received differential treatment.

4. **Stronger Enforcement of Fair Lending Laws**

Each agency will implement an internal process for making referrals to the Department of Justice for violations of the Equal Credit Opportunity Act. These internal procedures will ensure that appropriate cases are being put forth for consideration by senior management.

5. **Improved Consumer Complaint Programs**

The agencies believe that refinements to their consumer complaint systems can also better promote the broad availability of credit on a non-discriminatory basis. During the next few months, each agency will evaluate the effectiveness of its consumer complaint system in detecting and correcting credit discrimination, and alerting the agencies to industry practices that may inhibit the free flow of credit. Each agency will announce its own specific initiatives in these areas.

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