

**DEPARTMENT OF TREASURY**

**Office of the Comptroller of the Currency**

Docket ID OCC-2022-0017

**FEDERAL RESERVE SYSTEM**

Docket ID OP-1779

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**RIN 3064-ZA33**

**NATIONAL CREDIT UNION ADMINISTRATION**

Docket No. 2022-0123

**Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts**

**AGENCY:** Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and National Credit Union Administration.

**ACTION:** Final policy statement.

**SUMMARY:** The Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and National Credit Union Administration (NCUA) (the agencies), in consultation with state bank and credit union regulators, are issuing a final policy statement for prudent commercial real estate loan accommodations and workouts. The statement is relevant to all financial institutions supervised by the agencies. This updated policy statement builds on existing supervisory guidance calling for financial institutions to work prudently and constructively with creditworthy borrowers during times of financial stress, updates existing interagency supervisory guidance on commercial real estate loan workouts, and adds a section on short-term loan accommodations. The updated statement also addresses relevant accounting standard changes on estimating

loan losses and provides updated examples of classifying and accounting for loans modified or affected by loan accommodations or loan workout activity.

**DATES:** The final policy statement is available on [INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER].

**FOR FURTHER INFORMATION CONTACT:**

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*NCUA*: Naghi H. Khaled, Director of Credit Markets, and Simon Hermann, Senior Credit Specialist, Office of Examination and Insurance, (703) 518-6360; Ian Marenga, Associate General Counsel, Marvin Shaw and Ariel Pereira, Senior Staff Attorneys, Office of General Counsel, (703) 518-6540; or by mail at National Credit Union Administration, 1775 Duke Street, Alexandria, VA 22314.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background**

On October 30, 2009, the agencies, along with the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee and the former Office of Thrift Supervision, adopted the Policy Statement on Prudent Commercial Real Estate Loan Workouts (2009 Statement).<sup>1</sup> The agencies view the 2009 Statement as being useful for the agencies' staff and financial institutions in understanding risk management and accounting practices for commercial real estate (CRE) loan workouts.

To incorporate recent policy and accounting changes, the agencies recently proposed updates and expanded the 2009 Statement and sought comment on the resulting proposed Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts (proposed Statement).<sup>2</sup> The agencies considered all comments received and are issuing this final Statement largely as proposed, with certain clarifying changes based on comments received. The final Statement is described in Section II of the Supplementary Information.

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<sup>1</sup> See FFIEC Press Release, October 30, 2009, available at: <https://www.ffiec.gov/press/pr103009.htm>.

<sup>2</sup> See OCC, FDIC, NCUA, Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts, 87 FR 47273 (Aug. 2, 2022); Board Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts, 87 FR 56658 (Sept. 15, 2022). While published at different times, the proposed policy statements are substantively the same and are referenced as a single statement in this notice.

The agencies received 22 unique comments from banking organizations and credit unions, state and national trade associations, and individuals. A summary and discussion of comments and changes incorporated in the final Statement are described in Section III of the Supplementary Information.

The Paperwork Reduction Act is addressed in Section IV of the Supplementary Information. Section V of the Supplementary Information presents the final Statement which is available as of **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**. This final Statement supersedes the 2009 Statement for all supervised financial institutions.

## **II. Overview of the Final Statement**

The risk management principles outlined in the final Statement remain generally consistent with the 2009 Statement. As in the proposed Statement, the final Statement discusses the importance of financial institutions<sup>3</sup> working constructively with CRE borrowers who are experiencing financial difficulty and is consistent with U.S. generally accepted accounting principles (GAAP).<sup>4</sup> The final Statement addresses supervisory expectations with respect to a financial institution's handling of loan accommodation and workout matters including (1) risk management, (2) loan classification, (3) regulatory reporting, and (4) accounting considerations. Additionally, the final Statement includes

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<sup>3</sup> For purposes of this final Statement, financial institutions are those supervised by the Board, FDIC, NCUA, or OCC.

<sup>4</sup> Federally insured credit unions with less than \$10 million in assets are not required to comply with GAAP, unless the credit union is state-chartered and GAAP compliance is mandated by state law (86 FR 34924 (July 1, 2021)).

updated references to supervisory guidance<sup>5</sup> and revised language to incorporate current industry terminology.

Consistent with safety and soundness standards, the final Statement reaffirms two key principles from the 2009 Statement: (1) financial institutions that implement prudent CRE loan accommodation and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans with weaknesses that result in adverse classification and (2) modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the outstanding loan balance.

The agencies' risk management expectations as outlined in the final Statement remain generally consistent with the 2009 Statement, and incorporate views on short-term loan accommodations,<sup>6</sup> information about changes in accounting principles since 2009, and revisions and additions to the CRE loan workouts examples.

#### *A. Short-Term Loan Accommodations*

The agencies recognize that it may be appropriate for financial institutions to use short-term and less-complex loan accommodations before a loan warrants a longer-term

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<sup>5</sup> Supervisory guidance outlines the agencies' supervisory practices or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area. The agencies have each adopted regulations setting forth Statements Clarifying the Role of Supervisory Guidance. See 12 CFR 4, subpart F (OCC); 12 CFR 262, appendix A (Board); 12 CFR 302, appendix A (FDIC); and 12 CFR 791, subpart D (NCUA).

<sup>6</sup> See *Joint Statement on Additional Loan Accommodations Related to COVID-19*: SR Letter 20-18 (Board), FIL-74-2020 (FDIC), Bulletin 2020-72 (OCC), and Press Release August 3, 2020 (NCUA). See also *Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised)*: FIL-36-2020 (FDIC); Bulletin 2020-35 (OCC); Letter to Credit Unions 20-CU-13 (NCUA) and Joint Press Release April 7, 2020 (Board).

or more-complex workout arrangement. Accordingly, the final Statement identifies short-term loan accommodations as a tool that could be used to mitigate adverse effects on borrowers and encourages financial institutions to work prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress. The final Statement incorporates principles consistent with existing interagency supervisory guidance on accommodations.<sup>7</sup>

### *B. Accounting Changes*

The final Statement also reflects changes in GAAP since 2009, including those in relation to the current expected credit losses (CECL) methodology.<sup>8</sup> In particular, the Regulatory Reporting and Accounting Considerations section of the Statement was modified to include CECL references, and Appendix 5 of the final Statement addresses the relevant accounting and supervisory guidance on estimating loan losses for financial institutions that use the CECL methodology.

### *C. CRE Loan Workouts Examples*

The final Statement includes updated information about industry loan workout practices. In addition to revising the CRE loan workouts examples from the 2009 Statement, the proposed Statement included three new examples that were carried forward to the final Statement (Income Producing Property – Hotel, Acquisition, Development and Construction – Residential, and Multi-Family Property). All examples in the final Statement are intended to illustrate the application of existing rules, regulatory

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<sup>7</sup> *Id.*

<sup>8</sup> The Financial Accounting Standards Board's (FASB's) Accounting Standards Update 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and subsequent amendments issued since June 2016 are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 revises the accounting for allowances for credit losses (ACLs) and introduces the CECL methodology.

reporting instructions, and supervisory guidance on credit classifications and the determination of nonaccrual status.

#### D. *Other Items*

The final Statement includes updates to the 2009 Statement's Appendix 2, which contains a summary of selected references to relevant supervisory guidance and accounting standards for real estate lending, appraisals, restructured loans, fair value measurement, and regulatory reporting matters.

The final Statement retains information in Appendix 3 about valuation concepts for income-producing real property from the 2009 Statement. Further, Appendix 4 provides the agencies' long-standing special mention and classification definitions that are applied to the examples in Appendix 1.

The final Statement is consistent with the *Interagency Guidelines Establishing Standards for Safety and Soundness* issued by the Board, FDIC, and OCC,<sup>9</sup> which articulate safety and soundness standards for financial institutions to establish and maintain prudent credit underwriting practices and to establish and maintain systems to identify distressed assets and manage deterioration in those assets.<sup>10</sup>

### **III. Summary and Discussion of Comments**

#### A. *Summary of Comments*

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<sup>9</sup> 12 CFR part 30, appendix A (OCC); 12 CFR part 208 Appendix D-1 (Board); and 12 CFR part 364 appendix A (FDIC).

<sup>10</sup> The NCUA issued the proposed Statement pursuant to its regulation in 12 CFR part 723, governing member business loans and commercial lending, 12 CFR 741.3(b)(2) on written lending policies that cover loan workout arrangements and nonaccrual standards, and appendix B to 12 CFR part 741 regarding loan workout arrangements and nonaccrual policy. Additional supervisory guidance is available in NCUA letter to credit unions 10-CU-02 "Current Risks in Business Lending and Sound Risk Management Practices," issued January 2010, and in the Commercial and Member Business Loans section of the NCUA Examiner's Guide.

The agencies received 22 unique comments from banking organizations and credit unions, state and national trade associations, and individuals.<sup>11</sup>

Many commenters supported the agencies' work to provide updated supervisory guidance to the industry. Some commenters stated that the proposed Statement was reasonable and reflected safe and sound business practices. Further, several commenters stated that the short-term loan accommodation section, accounting changes, and additional examples of CRE loan workouts would be a good reference source as lenders evaluate and determine a loan accommodation and workout plan for CRE loans.

Comments also contained numerous observations, suggestions, and recommendations on the proposed Statement, including asking for more detail on certain aspects of the proposed Statement. A number of the comments addressed similar topics including: requesting examiners base any collateral value adjustments on empirical evidence; considering local market conditions when evaluating the appropriateness of loan workouts; clarifying the "doubtful" classification; addressing the importance of global cash flow and considering a financial institution's ability to support the calculation;<sup>12</sup> clarifying the frequency of obtaining updated financial and collateral information; clarifying and defining terminology; and emphasizing the importance of proactive engagement with borrowers. The following sections discuss in more detail the comments received, the agencies' response, and the changes reflected in the final Statement.

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<sup>11</sup> The agencies also received comments on topics outside the scope of the proposed Statement. Those comments are not addressed herein.

<sup>12</sup> Financial institutions use global cash flow to assess the combined cash flow of a group of people and/or entities to get a global picture of their ability to service their debt.



### *B. Valuation Adjustments*

Some commenters suggested that examiners should be required to provide empirical data to support collateral valuation adjustments made by examiners during loan reviews. The proposed Statement suggested such adjustments be made when a financial institution was unable or unwilling to address weaknesses in supporting loan documentation or appraisal or evaluation processes. For further clarification, the agencies affirmed that the role of examiners is to review and evaluate the information provided by financial institution management to support the financial institution's valuation and not to perform a separate, independent valuation. Accordingly, the final Statement explains that the examiner may adjust the estimated value of the collateral for credit analysis and classification purposes when the examiner can establish that underlying facts or assumptions presented by the financial institution are irrelevant or inappropriate for the valuation or can support alternative assumptions based on available information.

### *C. Market Conditions*

The proposed Statement referenced the review of general market conditions when evaluating the appropriateness of loan workouts. Several commenters stated that examiners should focus primarily on local and state market conditions, with less emphasis on regional and national trends, when analyzing CRE loans and determining borrowers' ability to repay. Considering local market conditions is consistent with the existing real estate lending standards or requirements<sup>13</sup> issued by the agencies, which

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<sup>13</sup> See 12 CFR 34.62(a) (OCC); 12 CFR 208.51(a) (Board); and 12 CFR 365.2(a) (FDIC) regarding real estate lending standards at financial institutions. For NCUA requirements, refer to 12 CFR part 723 for commercial real estate lending and 12 CFR part 741, appendix B, which addresses loan workouts, nonaccrual policy, and regulatory reporting of workout loans.

state that a financial institution should monitor real estate market conditions in its lending area. In response to these comments, the final Statement clarifies that market conditions include conditions at the state and local levels. Further, to better align the final Statement with regulatory requirements, the agencies included a footnote referencing real estate lending standards or requirements related to monitoring market conditions.

*D. Classification*

A commenter suggested wording changes in the discussion of a “doubtful” classification to clarify use of that term. The final Statement clarifies that “doubtful” is a temporary designation and subject to a financial institution’s timely reassessment of the loan once the outcomes of pending events have occurred or the amount of loss can be reasonably determined.

*E. Global Cash Flow*

Some commenters agreed with the importance of a global cash flow analysis as discussed in the proposed Statement. One commenter stated that the global cash flow analysis discussion should be enhanced. Another commenter noted that small institutions may not have information necessary to determine the global cash flow.

The proposed Statement emphasized the importance of financial institutions understanding CRE borrowers experiencing financial difficulty. Furthermore, the proposed Statement recognized that financial institutions that have sufficient information on a guarantor’s global financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) are better able to determine the guarantor’s financial ability to fulfill its obligation. Consistent with safety and soundness regulations, the agencies emphasize the need for financial

institutions to understand the overall financial condition and resources, including global cash flow, of CRE borrowers experiencing financial difficulty.

The final Statement lists actions that a financial institution should perform to not be criticized for engaging in loan workout arrangements. One such action is analyzing the borrower's global debt service coverage. The final Statement clarifies that the debt service coverage analysis should include realistic projections of a borrower's available cash flow and understanding of the continuity and accessibility of repayment sources.

#### *F. Frequency of Obtaining Updated Financial and Collateral Information*

Commenters suggested clarifying supervisory expectations for the frequency with which financial institutions should update financial and collateral information for financially distressed borrowers. Consistent with the agencies' approach to supervisory guidance, the final Statement does not set bright lines; the appropriate frequency for updating such information will vary on a case-by-case basis, depending on the type of collateral and other considerations. Given that each loan accommodation and workout is case-specific, financial institutions are encouraged to use their best judgment when considering the guidance principles in the final Statement and consider each loan's specific circumstances when assessing the need for updated collateral information and financial reporting from distressed borrowers.

#### *G. Terminology*

Some commenters requested that the agencies define certain terms used in the supervisory guidance to illustrate the level of analysis for reviewing CRE loans. Examples include when the term "comprehensive" described the extent of loan review activity and when "reasonable" described terms and conditions offered to borrowers in

restructurings or accommodations. Given that each loan accommodation and workout is case-specific, the agencies are of the view that providing more specific definitions of these terms could result in overly prescriptive supervisory guidance. Accordingly, the final Statement does not define these terms. Financial institutions are encouraged to use their best judgment when considering the principles contained in the final Statement and adapt to the circumstances when dealing with problem loans or loan portfolios.

A few commenters requested changes or more specific supervisory guidance on the definition of a short-term loan accommodation. The agencies are of the view that the scope of coverage on accommodations, as proposed, maintains flexibility for financial institutions. The proposed Statement discussed characteristics that can constitute a short-term accommodation and remained consistent with earlier supervisory guidance issued on the topic. Further, the agencies agree that the proposed Statement's discussion of short-term loan accommodations and long-term loan workout arrangements in sections II and IV, respectively, sufficiently differentiated short-term accommodations and longer-term workouts as separate and distinct options when working with financially distressed borrowers. Accordingly, the agencies have not included revisions related to guidance on short-term loan accommodations<sup>14</sup> in the final Statement.

#### *H. Proactive Engagement with Borrowers*

One commenter stated that the agencies should incentivize proactive engagement with borrowers. The agencies agree that proactive engagement is useful and have

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<sup>14</sup> For the purposes of the final Statement, an accommodation includes any agreement to defer one or more payments, make a partial payment, forbear any delinquent amounts, modify a loan or contract, or provide other assistance or relief to a borrower who is experiencing a financial challenge.

clarified in the final Statement that proactive engagement with the borrower often plays a key role in the success of a workout.

### *I. Responses to Questions*

In addition to a request for comment on all aspects of the proposed Statement, the agencies asked for responses to five questions.

The first question asked, *“To what extent does the proposed Statement reflect safe and sound practices currently incorporated in a financial institution’s CRE loan accommodation and workout activities? Should the agencies add, modify, or remove any elements, and, if so, which and why?”* Commenters noted that the Statement does reflect safe and sound practices and did not request significant changes to those elements of the Statement. Commenters generally agreed with the supervisory guidance and the revisions proposed and stated that the supervisory guidance is reasonable, clear, and useful in analyzing and managing CRE borrowers.

The second question asked, *“What additional information, if any, should be included to optimize the guidance for managing CRE loan portfolios during all business cycles and why?”* One commenter responded that the supervisory guidance was sufficient as written and that no additional changes were needed. Another commenter suggested the agencies add an appendix containing the components of adequate policies and procedures. The final Statement contains several updated appendices with references to pertinent regulations and supervisory guidance. The final Statement also includes footnotes to highlight the supervisory guidance contained in the existing real estate lending regulation.

The third question asked, “*Some of the principles discussed in the proposed Statement are appropriate for Commercial & Industrial (C&I) lending secured by personal property or other business assets. Should the agencies further address C&I lending more explicitly, and if so, how?*” A few commenters suggested including more detail regarding C&I lending in the final Statement, while one commenter stated that no expansion was needed. The agencies recognize the unique risks associated with CRE lending and acknowledge the several commenters who cited the usefulness of having supervisory guidance that specifically addresses CRE risks. Accordingly, the final Statement remains directed to CRE lending. The final Statement acknowledges that financial institutions may find the supervisory guidance more broadly useful for commercial loan workout situations, stating “[c]ertain principles in this statement are also generally applicable to commercial loans that are secured by either real property or other business assets of a commercial borrower.” In the future, the agencies may consider separate supervisory guidance to address non-CRE loan accommodations and workouts.

The fourth question asked, “*What additional loan workout examples or scenarios should the agencies include or discuss? Are there examples in Appendix 1 of the proposed Statement that are not needed, and if so, why not? Should any of the examples in the proposed Statement be revised to better reflect current practices, and if so, how?*”

Two commenters had specific recommendations for certain examples in Appendix 1. One commenter said the examples should contain more detail; another suggested the agencies either change or delete a scenario in one of the examples. The final Statement retains all of the examples and scenarios largely as proposed and includes additional detail clarifying the discussion of a multiple note restructuring.

The fifth question asked, “*To what extent do the TDR examples continue to be relevant in 2023 given that ASU 2022-02 eliminates the need for a financial institution to identify and account for a new loan modification as a TDR?*” The agencies received six comment letters on the accounting for workout loans in the examples in Appendix 1. The commenters asked the agencies to remove references to troubled debt restructurings (TDRs) from the examples, as the relevant accounting standards for TDRs will no longer be applicable after 2023. The agencies agree with the commenters and are removing discussion of TDRs from the examples. The agencies have also removed references to ASC Subtopic 310-10, “Receivables – Overall,” and ASC Subtopic 450-20, “Contingencies – Loss Contingencies,” and eliminated Appendix 6, “Accounting – Incurred Loss Methodology.” Financial institutions that have not adopted ASC Topic 326, “Financial Instruments – Credit Losses,” or ASU 2022-02 should continue to identify, measure, and report TDRs in accordance with regulatory reporting instructions.

Based on a commenter request, the agencies made clarifications to the accounting discussion in Example B, Scenario 3, and in Section V.D, *Classification and Accrual Treatment of Restructured Loans with a Partial Charge-Off*, as reflected in the final Statement. For the regulatory reporting of loan modifications, financial institution management should refer to the appropriate regulatory reporting instructions for supervisory guidance.

#### **IV. Paperwork Reduction Act**

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501–3521) states that no agency may conduct or sponsor, nor is the respondent required to respond to, an information collection unless it displays a currently valid Office of Management and

Budget (OMB) control number. The Agencies have determined that this Statement does not create any new, or revise any existing, collections of information pursuant to the Paperwork Reduction Act. Consequently, no information collection request will be submitted to the OMB for review.

## **V. Final Guidance**

The text of the final Statement is as follows:

### **Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts**

The agencies<sup>1</sup> recognize that financial institutions<sup>2</sup> face significant challenges when working with commercial real estate (CRE)<sup>3</sup> borrowers who are experiencing diminished operating cash flows, depreciated collateral values, prolonged sales and rental absorption periods, or other issues that may hinder repayment. While such borrowers may experience deterioration in their financial condition, many borrowers will continue to be creditworthy and have the willingness and ability to repay their debts. In such cases, financial institutions may find it beneficial to work constructively with borrowers.

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<sup>1</sup> The Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC) (collectively, the agencies). This Policy Statement was developed in consultation with state bank and credit union regulators.

<sup>2</sup> For the purposes of this statement, financial institutions are those supervised by the Board, FDIC, NCUA, or OCC.

<sup>3</sup> Consistent with the Board, FDIC, and OCC joint guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (December 2006), CRE loans include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. CRE loans also include land development and construction loans (including 1-4 family residential and commercial construction loans), other land loans, loans to real estate investment trusts (REITs), and unsecured loans to developers. For credit unions, “commercial real estate loans” refers to “commercial loans,” as defined in Section 723.2 of the NCUA Rules and Regulations, secured by real estate.



Such constructive efforts may involve loan accommodations<sup>4</sup> or more extensive loan workout arrangements.<sup>5</sup>

This statement provides a broad set of risk management principles relevant to CRE loan accommodations and workouts in all business cycles, particularly in challenging economic environments. A wide variety of factors can negatively affect CRE portfolios, including economic downturns, natural disasters, and local, national, and international events. This statement also describes the approach examiners will use to review CRE loan accommodation and workout arrangements and provides examples of CRE loan workout arrangements as well as useful references in the appendices.

The agencies have found that prudent CRE loan accommodations and workouts are often in the best interest of the financial institution and the borrower. The agencies expect their examiners to take a balanced approach in assessing the adequacy of a financial institution's risk management practices for loan accommodation and workout activities. Consistent with the *Interagency Guidelines Establishing Standards for Safety and Soundness*,<sup>6</sup> financial institutions that implement prudent CRE loan accommodation and workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse

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<sup>4</sup> For the purposes of this statement, an accommodation includes any agreement to defer one or more payments, make a partial payment, forbear any delinquent amounts, modify a loan or contract, or provide other assistance or relief to a borrower who is experiencing a financial challenge.

<sup>5</sup> Workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions.

<sup>6</sup> 12 CFR part 30, appendix A (OCC); 12 CFR part 208 Appendix D-1 (Board); and 12 CFR part 364 appendix A (FDIC). For the NCUA, refer to 12 CFR part 741.3(b)(2), 12 CFR part 741 appendix B, 12 CFR part 723, and letter to credit unions 10-CU-02 "Current Risks in Business Lending and Sound Risk Management Practices" issued January 2010. Credit unions should also refer to the Commercial and Member Business Loans section of the NCUA Examiner's Guide.

classification. In addition, modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the outstanding loan balance.

## **I. Purpose**

Consistent with the safety and soundness standards, this statement updates and supersedes previous supervisory guidance to assist financial institutions' efforts to modify CRE loans to borrowers who are, or may be, unable to meet a loan's current contractual payment obligations or fully repay the debt.<sup>7</sup> This statement is intended to promote supervisory consistency among examiners, enhance the transparency of CRE loan accommodation and workout arrangements, and support supervisory policies and actions that do not inadvertently curtail the availability of credit to sound borrowers.

This statement addresses prudent risk management practices regarding short-term loan accommodations, risk management for loan workout programs, long-term loan workout arrangements, classification of loans, and regulatory reporting and accounting requirements and considerations. The statement also includes selected references and materials related to regulatory reporting.<sup>8</sup> The statement does not, however, affect existing regulatory reporting requirements or supervisory guidance provided in relevant interagency statements issued by the agencies or accounting requirements under U.S. generally accepted accounting principles (GAAP). Certain principles in this statement

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<sup>7</sup> This statement replaces the interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (October 2009). See *FFIEC Press Release, October 30, 2009*, available at: <https://www.ffiec.gov/press/pr103009.htm>.

<sup>8</sup> For banks, the FFIEC Consolidated Reports of Condition and Income (FFIEC Call Report), and for credit unions, the NCUA 5300 Call Report (NCUA Call Report).

are also generally applicable to commercial loans that are secured by either real property or other business assets of a commercial borrower.

Five appendices are incorporated into this statement:

- Appendix 1 contains examples of CRE loan workout arrangements illustrating the application of this statement to classification of loans and determination of nonaccrual treatment.
- Appendix 2 lists selected relevant rules as well as supervisory and accounting guidance for real estate lending, appraisals, allowance methodologies,<sup>9</sup> restructured loans, fair value measurement, and regulatory reporting matters such as nonaccrual status. The agencies intend this statement to be used in conjunction with materials identified in Appendix 2 to reach appropriate conclusions regarding loan classification and regulatory reporting.
- Appendix 3 discusses valuation concepts for income-producing real property.<sup>10</sup>
- Appendix 4 provides the special mention and adverse classification definitions used by the Board, FDIC, and OCC.<sup>11</sup>
- Appendix 5 addresses the relevant accounting and supervisory guidance on estimating loan losses for financial institutions that use the current

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<sup>9</sup> The allowance methodology refers to the allowance for credit losses (ACL) under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses*.

<sup>10</sup> Valuation concepts applied to regulatory reporting processes also should be consistent with ASC Topic 820, *Fair Value Measurement*.

<sup>11</sup> Credit unions must apply a relative credit risk score (i.e., credit risk rating) to each commercial loan as required by 12 CFR part 723 Member Business Loans; Commercial Lending (see Section 723.4(g)(3)) or the equivalent state regulation as applicable.

expected credit losses (CECL) methodology.

## **II. Short-Term Loan Accommodations**

The agencies encourage financial institutions to work proactively and prudently with borrowers who are, or may be, unable to meet their contractual payment obligations during periods of financial stress. Such actions may entail loan accommodations that are generally short-term or temporary in nature and occur before a loan reaches a workout scenario. These actions can mitigate long-term adverse effects on borrowers by allowing them to address the issues affecting repayment ability and are often in the best interest of financial institutions and their borrowers.

When entering into an accommodation with a borrower, it is prudent for a financial institution to provide clear, accurate, and timely information about the arrangement to the borrower and any guarantor. Any such accommodation must be consistent with applicable laws and regulations. Further, a financial institution should employ prudent risk management practices and appropriate internal controls over such accommodations. Weak or imprudent risk management practices and internal controls can adversely affect borrowers and expose a financial institution to increases in credit, compliance, operational, or other risks. Imprudent practices that are widespread at a financial institution may also pose a risk to its capital adequacy.

Prudent risk management practices and internal controls will enable financial institutions to identify, measure, monitor, and manage the credit risk of accommodated loans. Prudent risk management practices include developing and maintaining appropriate policies and procedures, updating and assessing financial and collateral information, maintaining an appropriate risk rating (or grading) framework, and ensuring

proper tracking and accounting for loan accommodations. Prudent internal controls related to loan accommodations include comprehensive policies<sup>12</sup> and practices, proper management approvals, an ongoing credit risk review function, and timely and accurate reporting and communication.

### **III. Loan Workout Programs**

When short-term accommodation measures are not sufficient or have not been successful in addressing credit problems, financial institutions could proceed into longer-term or more complex loan arrangements with borrowers under a formal workout program. Loan workout arrangements can take many forms, including, but not limited to:

- Renewing or extending loan terms;
- Granting additional credit to improve prospects for overall repayment; or
- Restructuring<sup>13</sup> the loan with or without concessions.

A financial institution's risk management practices for implementing workout arrangements should be appropriate for the scope, complexity, and nature of the financial institution's lending activity. Further, these practices should be consistent with safe and sound lending policies and supervisory guidance, real estate lending standards and requirements,<sup>14</sup> and relevant regulatory reporting requirements. Examiners will evaluate the effectiveness of a financial institution's practices, which typically include:

- A prudent loan workout policy that establishes appropriate loan terms and

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<sup>12</sup> See 12 CFR 34.62(a) and 160.101(a) (OCC); 12 CFR 208.51(a) (Board); and 12 CFR 365.2(a) (FDIC) regarding real estate lending policies at financial institutions. For NCUA, refer to 12 CFR part 723 for commercial real estate lending and 12 CFR part 741, appendix B, which addresses loan workouts, nonaccrual policy, and regulatory reporting of workout loans.

<sup>13</sup> A restructuring involves a formal, legally enforceable modification in the loan's terms.

<sup>14</sup> 12 CFR part 34, subpart D, and Appendix to 160.101 (OCC); 12 CFR section 208.51 (Board); and 12 CFR part 365 (FDIC). For NCUA requirements, refer to 12 CFR part 723 for member business loan and commercial loan regulations, which addresses CRE lending, and 12 CFR part 741, Appendix B, which addresses loan workouts, nonaccrual policy, and regulatory reporting of workout loans.

amortization schedules and that permits the financial institution to reasonably adjust the loan workout plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize;<sup>15</sup>

- Management infrastructure to identify, measure, and monitor the volume and complexity of the loan workout activity;
- Documentation standards to verify a borrower’s creditworthiness, including financial condition, repayment ability, and collateral values;
- Management information systems and internal controls to identify and track loan performance and risk, including impact on concentration risk and the allowance;
- Processes designed to ensure that the financial institution’s regulatory reports are consistent with regulatory reporting requirements;
- Loan collection procedures;
- Adherence to statutory, regulatory, and internal lending limits;
- Collateral administration to ensure proper lien perfection of the financial institution’s collateral interests for both real and personal property; and
- An ongoing credit risk review function.<sup>16</sup>

#### **IV. Long-Term Loan Workout Arrangements**

An effective loan workout arrangement should improve the lender’s prospects for repayment of principal and interest, be consistent with sound banking and accounting

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<sup>15</sup> Federal credit unions are reminded that in making decisions related to loan workout arrangements, they must take into consideration any applicable maturity limits (12 CFR 701.21(c)(4)).

<sup>16</sup> See *Interagency Guidance on Credit Risk Review Systems*. OCC Bulletin 2020-50 (May 8, 2020); FDIC Financial Institution Letter FIL-55-2020 (May 8, 2020); Federal Reserve Supervision and Regulation (SR) letter 20-13 (May 8, 2020); and NCUA press release (May 8, 2020).

practices, and comply with applicable laws and regulations. Typically, financial institutions consider loan workout arrangements after analyzing a borrower's repayment ability, evaluating the support provided by guarantors, and assessing the value of any collateral pledged. Proactive engagement by the financial institution with the borrower often plays a key role in the success of the workout.

Consistent with safety and soundness standards, examiners will not criticize a financial institution for engaging in loan workout arrangements, even though such loans may be adversely classified, so long as management has:

- For each loan, developed a well-conceived and prudent workout plan that supports the ultimate collection of principal and interest and that is based on key elements such as:
  - Updated and comprehensive financial information on the borrower, real estate project, and all guarantors and sponsors;
  - Current valuations of the collateral supporting the loan and the workout plan;
  - Appropriate loan structure (e.g., term and amortization schedule), covenants, and requirements for curtailment or re-margining; and
  - Appropriate legal analyses and agreements, including those for changes to original or subsequent loan terms;
- Analyzed the borrower's global debt<sup>17</sup> service coverage, including realistic projections of the borrower's cash flow, as well as the availability, continuity,

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<sup>17</sup> Global debt service coverage is inclusive of the cash flows generated by both the borrower(s) and guarantor(s), as well as the combined financial obligations (including contingent obligations) of the borrower(s) and guarantor(s).

and accessibility of repayment sources;

- Analyzed the available cash flow of guarantors;
- Demonstrated the willingness and ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout arrangement;
- Maintained an internal risk rating or loan grading system that accurately and consistently reflects the risk in the workout arrangement; and
- Maintained an allowance methodology that calculates (or measures) an allowance, in accordance with GAAP, for loans that have undergone a workout arrangement and recognizes loan losses in a timely manner through provision expense and recording appropriate charge-offs.<sup>18</sup>

#### ***A. Supervisory Assessment of Repayment Ability of Commercial Borrowers***

The primary focus of an examiner's review of a CRE loan, including binding commitments, is an assessment of the borrower's ability to repay the loan. The major factors that influence this analysis are the borrower's willingness and ability to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business. When analyzing a commercial borrower's repayment ability, examiners should consider the following factors:

- The borrower's character, overall financial condition, resources, and payment history;
- The nature and degree of protection provided by the cash flow from business operations or the underlying collateral on a global basis that considers the

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<sup>18</sup> Additionally, if applicable, financial institutions should recognize in a separate liability account an allowance for expected credit losses on off-balance sheet credit exposures related to restructured loans (e.g., loan commitments) and should reverse interest accruals on loans that are deemed uncollectible.



borrower's and guarantor's total debt obligations;

- Relevant market conditions,<sup>19</sup> particularly those on a state and local level, that may influence repayment prospects and the cash flow potential of the business operations or the underlying collateral; and
- The prospects for repayment support from guarantors.

### ***B. Supervisory Assessment of Guarantees and Sponsorships***

Examiners should review the financial attributes of guarantees and sponsorships in considering the loan classification. The presence of a legally enforceable guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation and may be sufficient to preclude adverse loan classification or reduce the severity of the loan classification. A financially responsible guarantor possesses the financial ability, the demonstrated willingness, and the incentive to provide support for the loan through ongoing payments, curtailments, or re-margining.

Examiners also review the financial attributes and economic incentives of sponsors that support a loan. Even if not legally obligated, financially responsible sponsors are similar to guarantors in that they may also possess the financial ability, the demonstrated willingness, and may have an incentive to provide support for the loan through ongoing payments, curtailments, or re-margining.

Financial institutions that have sufficient information on the guarantor's global financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant

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<sup>19</sup> See 12 CFR 34.62(c) and 160.101(c)(OCC); 12 CFR 208.51(a) (Board); and 12 CFR 365.2(c) (FDIC) regarding the need for financial institutions to monitor conditions in the real estate market in its lending area to ensure that its real estate lending policies continue to be appropriate for current market conditions. For the NCUA, refer to 12 CFR 723.4(f)(6) requiring that a federally insured credit union's commercial loan policy have underwriting standards that include an analysis of the impact of current market conditions on the borrower and associated borrowers.

factors (including credit ratings, when available) are better able to determine the guarantor's financial ability to fulfill its obligation. An effective assessment includes consideration of whether the guarantor has the financial ability to fulfill the total number and amount of guarantees currently extended by the guarantor. A similar analysis should be made for any material sponsors that support the loan.

Examiners should consider whether a guarantor has demonstrated the willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. An important consideration is whether any previous performance under its guarantee(s) was voluntary or the result of legal or other actions by the lender to enforce the guarantee(s).

### ***C. Supervisory Assessment of Collateral Values***

As the primary sources of loan repayment decline, information on the underlying collateral's estimated value becomes more important in analyzing the source of repayment, assessing credit risk, and developing an appropriate loan workout plan. Examiners will analyze real estate collateral values based on the financial institution's original appraisal or evaluation, any subsequent updates, additional pertinent information (e.g., recent inspection results), and relevant market conditions. Examiners will assess the major facts, assumptions, and valuation approaches in the collateral valuation and their influence in the financial institution's credit and allowance analyses.

The agencies' appraisal regulations require financial institutions to review appraisals for compliance with the Uniform Standards of Professional Appraisal Practice.<sup>20</sup> As part of that process, and when reviewing collateral valuations, financial

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<sup>20</sup> See 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E, and 12 CFR part 225, subpart G (Board); 12 CFR part 323 (FDIC); and 12 CFR part 722 (NCUA).

institutions should ensure that assumptions and conclusions used are reasonable. Further, financial institutions typically have policies<sup>21</sup> and procedures that dictate when collateral valuations should be updated as part of financial institutions' ongoing credit risk reviews and monitoring processes, as relevant market conditions change, or as a borrower's financial condition deteriorates.<sup>22</sup>

For a CRE loan in a workout arrangement, a financial institution should consider the current project plans and market conditions in a new or updated appraisal or evaluation, as appropriate. In determining whether to obtain a new appraisal or evaluation, a prudent financial institution considers whether there has been material deterioration in the following factors:

- The performance of the project;
- Conditions for the geographic market and property type;
- Variances between actual conditions and original appraisal assumptions;
- Changes in project specifications (e.g., changing a planned condominium project to an apartment building);
- Loss of a significant lease or a take-out commitment; or
- Increases in pre-sale fallout.

A new appraisal may not be necessary when an evaluation prepared by the financial institution appropriately updates the original appraisal assumptions to reflect current market conditions and provides a reasonable estimate of the underlying

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<sup>21</sup> See Footnote 12.

<sup>22</sup> For further reference, see *Interagency Appraisal and Evaluation Guidelines*, 75 FR 77450 (December 10, 2010).

collateral's fair value.<sup>23</sup> If new money is being advanced, financial institutions should refer to the agencies' appraisal regulations to determine whether a new appraisal is required.<sup>24</sup>

The market value provided by an appraisal and the fair value for accounting purposes are based on similar valuation concepts.<sup>25</sup> The analysis of the underlying collateral's market value reflects the financial institution's understanding of the property's current "as is" condition (considering the property's highest and best use) and other relevant risk factors affecting the property's value. Valuations of commercial properties may contain more than one value conclusion and could include an "as is" market value, a prospective "as complete" market value, and a prospective "as stabilized" market value.

Financial institutions typically use the market value conclusion (and not the fair value) that corresponds to the workout plan objective and the loan commitment. For example, if the financial institution intends to work with the borrower so that a project will achieve stabilized occupancy, then the financial institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading after confirming that the appraisal's assumptions and conclusions are reasonable. Conversely,

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<sup>23</sup> According to the FASB ASC Master Glossary, "fair value" is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

<sup>24</sup> See footnote 20.

<sup>25</sup> The term "market value" as used in an appraisal is based on similar valuation concepts as "fair value" for accounting purposes under GAAP. For both terms, these valuation concepts about the real property and the real estate transaction contemplate that the property has been exposed to the market before the valuation date, the buyer and seller are well informed and acting in their own best interest (that is, the transaction is not a forced liquidation or distressed sale), and marketing activities are usual and customary (that is, the value of the property is unaffected by special financing or sales concessions). The market value in an appraisal may differ from the collateral's fair value if the values are determined as of different dates or the fair value estimate reflects different assumptions from those in the appraisal. This may occur as a result of changes in market conditions and property use since the "as of" date of the appraisal.

if the financial institution intends to foreclose, then it is required for financial reporting purposes that the financial institution use the fair value (less costs to sell)<sup>26</sup> of the property in its current “as is” condition in its collateral assessment.

If weaknesses exist in the financial institution’s supporting loan documentation or appraisal or evaluation review process, examiners should direct the financial institution to address the weaknesses, which may require the financial institution to obtain additional information or a new collateral valuation.<sup>27</sup> However, in the rare instance when a financial institution is unable or unwilling to address weaknesses in a timely manner, examiners will assess the property’s operating cash flow and the degree of protection provided by a sale of the underlying collateral as part of determining the loan’s classification. In performing their credit analysis, examiners will consider expected cash flow from the property, current or implied value, relevant market conditions, and the relevance of the facts and the reasonableness of assumptions used by the financial institution. For an income-producing property, examiners evaluate:

- Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs;
- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Effective rental rates or sale prices, considering sales and financing

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<sup>26</sup> Costs to sell may be used in determining any allowance for collateral-dependent loans. Under ASC Topic 326, a loan is collateral dependent when the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity’s assessment as of the reporting date. Costs to sell are used when the loan is dependent on the sale of the collateral. Costs to sell are not used when the collateral-dependent loan is dependent on the operation of the collateral.

<sup>27</sup> See 12 CFR 34.43(c) (OCC); 12 CFR 225.63(c) (Board); 12 CFR 323.3(c) (FDIC); and 12 CFR 722.3(e) (NCUA).

concessions;

- Time frame for achieving stabilized occupancy or sellout;
- Volume and trends in past due leases; and
- Discount rates and direct capitalization rates (refer to Appendix 3 for more information).

Assumptions, when recently made by qualified appraisers (and, as appropriate, by qualified, independent parties within the financial institution) and when consistent with the discussion above, should be given reasonable deference by examiners. Examiners should also use the appropriate market value conclusion in their collateral assessments. For example, when the financial institution plans to provide the resources to complete a project, examiners can consider the project's prospective market value and the committed loan amount in their analyses.

Examiners generally are not expected to challenge the underlying assumptions, including discount rates and capitalization rates, used in appraisals or evaluations when these assumptions differ only marginally from norms generally associated with the collateral under review. The examiner may adjust the estimated value of the collateral for credit analysis and classification purposes when the examiner can establish that underlying facts or assumptions presented by the financial institution are irrelevant or inappropriate or can support alternative assumptions based on available information.

CRE borrowers may have commercial loans secured by owner occupied real estate or other business assets, such as inventory and accounts receivable, or may have CRE loans also secured by furniture, fixtures, and equipment. For these loans, examiners should assess the adequacy of the financial institution's policies and practices for

quantifying the value of such collateral, determining the acceptability of the assets as collateral, and perfecting its security interests. Examiners should also determine whether the financial institution has appropriate procedures for ongoing monitoring of this type of collateral.

## **V. Classification of Loans**

Loans that are adequately protected by the current sound worth and debt service ability of the borrower, guarantor, or the underlying collateral generally are not adversely classified. Similarly, loans to sound borrowers that are modified in accordance with prudent underwriting standards should not be adversely classified by examiners unless well-defined weaknesses exist that jeopardize repayment. However, such loans could be flagged for management's attention or for inclusion in designated "watch lists" of loans that management is more closely monitoring.

Further, examiners should not adversely classify loans solely because the borrower is associated with a particular industry that is experiencing financial difficulties. When a financial institution's loan modifications are not supported by adequate analysis and documentation, examiners are expected to exercise reasonable judgment in reviewing and determining loan classifications until such time as the financial institution is able to provide information to support management's conclusions and internal loan grades.

Refer to Appendix 4 for the classification definitions.<sup>28</sup>

### ***A. Loan Performance Assessment for Classification Purposes***

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<sup>28</sup> The NCUA does not require credit unions to adopt a uniform regulatory classification schematic of loss, doubtful, or substandard. A credit union must apply a relative credit risk score (i.e., credit risk rating) to each commercial loan as required by 12 CFR part 723, Member Business Loans; Commercial Lending, or the equivalent state regulation as applicable (see Section 723.4(g)(3)). Adversely classified refers to loans more severely graded under the credit union's credit risk rating system. Adversely classified loans generally require enhanced monitoring and present a higher risk of loss. Refer to the NCUA's Examiner's Guide for further information on credit risk rating systems.

The loan's record of performance to date should be one of several considerations when determining whether a loan should be adversely classified. As a general principle, examiners should not adversely classify or require the recognition of a partial charge-off on a performing commercial loan solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it is appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment.

One perspective on loan performance is based upon an assessment as to whether the borrower is contractually current on principal or interest payments. For many loans, the assessment of payment status is sufficient to arrive at a loan's classification. In other cases, being contractually current on payments can be misleading as to the credit risk embedded in the loan. This may occur when the loan's underwriting structure or the liberal use of extensions and renewals masks credit weaknesses and obscures a borrower's inability to meet reasonable repayment terms.

For example, for many acquisition, development, and construction projects, the loan is structured with an "interest reserve" for the construction phase of the project. At the time the loan is originated, the lender establishes the interest reserve as a portion of the initial loan commitment. During the construction phase, the lender recognizes interest income from the interest reserve and capitalizes the interest into the loan balance. After completion of the construction, the lender recognizes the proceeds from the sale of lots, homes, or buildings for the repayment of principal, including any of the capitalized interest. For a commercial construction loan where the property has achieved stabilized occupancy, the lender uses the proceeds from permanent financing for repayment of the



construction loan or converts the construction loan to an amortizing loan.

However, if the development project stalls and management fails to evaluate the collectability of the loan, interest income could continue to be recognized from the interest reserve and capitalized into the loan balance, even though the project is not generating sufficient cash flows to repay the loan. In this case, the loan will be contractually current due to the interest payments being funded from the reserve, but the repayment of principal may be in jeopardy. This repayment uncertainty is especially true when leases or sales have not occurred as projected and property values have dropped below the market value reported in the original collateral valuation. In this situation, adverse classification of the loan may be appropriate.

A second perspective for assessing a loan's classification is to consider the borrower's expected performance and ability to meet its obligations in accordance with the modified terms over the remaining life of the loan. Therefore, the loan classification is meant to measure risk over the term of the loan rather than just reflecting the loan's payment history. As a borrower's expected performance is dependent upon future events, examiners' credit analyses should focus on:

- The borrower's financial strength as reflected by its historical and projected balance sheet and income statement outcomes; and
- The prospects for the CRE property considering events and market conditions that reasonably may occur during the term of the loan.

#### ***B. Classification of Renewals or Restructurings of Maturing Loans***

Loans to commercial borrowers can have short maturities, including short-term working capital loans to businesses, financing for CRE construction projects, or bridge

loans to finance recently completed CRE projects for a period to achieve stabilized occupancy before obtaining permanent financing or selling the property. When there has been deterioration in collateral values, a borrower with a maturing loan amid an economic downturn may have difficulty obtaining short-term financing or adequate sources of long-term credit, despite the borrower's demonstrated and continued ability to service the debt. In such cases, financial institutions may determine that the most appropriate course is to restructure or renew the loan. Such actions, when done prudently, are often in the best interest of both the financial institution and the borrower.

A restructured loan typically reflects an elevated level of credit risk, as the borrower may not be, or has not been, able to perform according to the original contractual terms. The assessment of each loan should be based upon the fundamental characteristics affecting the collectability of that loan. In general, renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not automatically be subject to adverse classification by examiners. However, consistent with safety and soundness standards, such loans should be identified in the financial institution's internal credit grading system and may warrant close monitoring. Adverse classification of a renewed or restructured loan would be appropriate if, despite the renewal or restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan pursuant to reasonable modified terms.

### ***C. Classification of Problem CRE Loans Dependent on the Sale of Collateral for Repayment***

As a general classification principle for a problem CRE loan that is dependent on the sale of the collateral for repayment, any portion of the loan balance that exceeds the

amount that is adequately secured by the fair value of the real estate collateral less the costs to sell should be classified “loss.” This principle applies to loans that are collateral dependent based on the sale of the collateral in accordance with GAAP and for which there are no other available reliable sources of repayment such as a financially capable guarantor.<sup>29</sup>

The portion of the loan balance that is adequately secured by the fair value of the real estate collateral less the costs to sell generally should be adversely classified no worse than “substandard.” The amount of the loan balance in excess of the fair value of the real estate collateral, or portions thereof, should be adversely 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, examiners should use a “doubtful” classification infrequently, as such a designation is temporary and subject to a financial institution’s timely reassessment of the loan once the outcomes of pending events have occurred or the amount of loss can be reasonably determined.

#### ***D. Classification and Accrual Treatment of Restructured Loans with a Partial Charge-off***

Based on consideration of all relevant factors, an assessment may indicate that a loan has well-defined weaknesses that jeopardize collection in full of all amounts contractually due and may result in a partial charge-off as part of a restructuring. When well-defined weaknesses exist and a partial charge-off has been taken, the remaining

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<sup>29</sup> See footnote 26.

recorded balance for the restructured loan generally should 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. Such situations may occur when significant remaining risk exposures are identified but are not quantified, such as bankruptcy or a loan collateralized by a property with potential environmental concerns.

A restructuring may involve a multiple note structure in which, for example, a loan is restructured into two notes (referred to as Note A and Note B). Lenders may separate a portion of the current outstanding debt into a new, legally enforceable note (Note A) that is reasonably assured of repayment and performance according to prudently modified terms. When restructuring a collateral-dependent loan using a multiple note structure, the amount of Note A should be determined using the fair value of the collateral. This note may be placed back in accrual status in certain situations. In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account. Additionally, a properly structured and performing Note A generally would not be adversely classified by examiners. The portion of the debt that is unlikely to be repaid or collected and therefore is deemed uncollectible (Note B) would be adversely classified “loss” and must be charged off.

In contrast, the loan should remain on, or be placed in, nonaccrual status if the financial institution does not split the loan into separate notes, but internally recognizes a partial charge-off. A partial charge-off would indicate that the financial institution does not expect full repayment of the amounts contractually due. If facts change after the

charge-off is taken such that the full amounts contractually due, including the amount charged off, are expected to be collected and the loan has been brought contractually current, the remaining balance of the loan may be returned to accrual status without having to first receive payment of the charged-off amount.<sup>30</sup> In these cases, examiners should assess whether the financial institution has well-documented support for its credit assessment of the borrower's financial condition and the prospects for full repayment.

## **VI. Regulatory Reporting and Accounting Considerations**

Financial institution management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements. Management also is responsible for establishing and maintaining an appropriate governance and internal control structure over the preparation of regulatory reports. The agencies have observed this governance and control structure commonly includes policies and procedures that provide clear guidance on accounting matters. Accurate regulatory reports are critical to the transparency of a financial institution's financial position and risk profile and are imperative for effective supervision. Decisions related to loan workout arrangements may affect regulatory reporting, particularly interest accruals and loan loss estimates. Therefore, it is important that loan workout staff appropriately communicate with the accounting and regulatory reporting staff concerning the financial institution's loan restructurings and that the consequences of restructurings are presented accurately in regulatory reports.

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<sup>30</sup> The charged-off amount should not be reversed or re-booked, under any condition, to increase the recorded investment in the loan or its amortized cost, as applicable, when the loan is returned to accrual status. However, expected recoveries, prior to collection, are a component of management's estimate of the net amount expected to be collected for a loan under ASC Topic 326. Refer to relevant regulatory reporting instructions for supervisory guidance on returning a loan to accrual status.

In addition to evaluating credit risk management processes and validating the accuracy of internal loan grades, examiners are responsible for reviewing management's processes related to accounting and regulatory reporting. While similar data are used for loan risk monitoring, accounting, and reporting systems, this information does not necessarily produce identical outcomes. For example, loss classifications may not be equivalent to the associated allowance measurements.

***A. Allowance for Credit Losses***

Examiners need to have a clear understanding of the differences between credit risk management and accounting and regulatory reporting concepts (such as accrual status and the allowance) when assessing the adequacy of the financial institution's reporting practices for on- and off-balance sheet credit exposures. Refer to Appendix 5 for a summary of the allowance standard under ASC Topic 326, *Financial Instruments – Credit Losses*. Examiners should also refer to regulatory reporting instructions in the FFIEC Call Report and the NCUA 5300 Call Report guidance as well as applicable accounting standards for further information.

***B. Implications for Interest Accrual***

A financial institution needs to consider whether a loan that was accruing interest prior to the loan restructuring should be placed in nonaccrual status at the time of modification to ensure that income is not materially overstated. Consistent with FFIEC and NCUA Call Report instructions, a loan that has been restructured so as to be reasonably assured of repayment and performance according to prudent modified terms need not be placed in nonaccrual status. Therefore, for a loan to remain in accrual status, the restructuring and any charge-off taken on the loan must be supported by a current,

well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must be placed in nonaccrual status.

A restructured loan placed in nonaccrual status should not be returned to accrual status until the borrower demonstrates sustained repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. It may also include historical periods prior to the date of the loan restructuring. While an appropriately designed restructuring should improve the collectability of the loan in accordance with a reasonable repayment schedule, it does not relieve the financial institution from the responsibility to promptly charge off all identified losses. For more detailed instructions about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, refer to the instructions for the FFIEC Call Report and the NCUA 5300 Call Report.

## Appendix 1

### Examples of CRE Loan Workout Arrangements

The examples in this appendix are provided for illustrative purposes only and are designed to demonstrate an examiner’s analytical thought process to derive an appropriate classification and evaluate implications for interest accrual.<sup>31</sup> Although not discussed in the examples below, examiners consider the adequacy of a financial institution’s supporting documentation, internal analysis, and business decision to enter into a loan workout arrangement. The examples also do not address the effect of the loan workout arrangement on the allowance and subsequent reporting requirements. Financial institutions should refer to the appropriate regulatory reporting instructions for supervisory guidance on the recognition, measurement, and regulatory reporting of loan modifications.

Examiners should use caution when applying these examples to “real-life” situations, consider all facts and circumstances of the loan being evaluated, and exercise judgment before reaching conclusions related to loan classification and nonaccrual treatment.<sup>32</sup>

#### ***A. Income Producing Property – Office Building***

**BASE CASE:** A lender originated a \$15 million loan for the purchase of an office building with monthly payments based on an amortization of 20 years and a balloon payment of \$13.6 million at the end of year five. At origination, the loan had a 75 percent loan-to-value (LTV) based on an appraisal reflecting a \$20 million market value

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<sup>31</sup> The agencies view that the accrual treatments in these examples as falling within the range of acceptable practices under regulatory reporting instructions.

<sup>32</sup> In addition, estimates of the fair value of collateral use assumptions based on judgment and should be consistent with measurement of fair value in ASC Topic 820, *Fair Value Measurement*; see Appendix 2.



on an “as stabilized” basis, a debt service coverage (DSC) ratio of 1.30x, and a market interest rate. The lender expected to renew the loan when the balloon payment became due at the end of year five. Due to technological advancements and a workplace culture change since the inception of the loan, many businesses switched to hybrid work-from-home arrangements to reduce longer-term costs and improve employee retention. As a result, the property’s cash flow declined as the borrower has had to grant rental concessions to either retain its existing tenants or attract new tenants, since the demand for office space has decreased.

**SCENARIO 1:** At maturity, the lender renewed the \$13.6 million loan for one year at a market interest rate that provides for the incremental risk and payments based on amortizing the principal over the remaining 15 years. The borrower had not been delinquent on prior payments and has sufficient cash flow to service the loan at the market interest rate terms with a DSC ratio of 1.12x, based on updated financial information.

A review of the leases reflects that most tenants are stable occupants, with long-term leases and sufficient cash flow to pay their rent. The major tenants have not adopted hybrid work-from-home arrangements for their employees given the nature of the businesses. A recent appraisal reported an “as stabilized” market value of \$13.3 million for the property for an LTV of 102 percent. This reflects current market conditions and the resulting decline in cash flow.

***Classification:*** The lender internally graded the loan pass and is monitoring the credit. The examiner agreed, because the borrower has the ability to continue making loan payments based on reasonable terms, despite a decline in cash flow and in the

market value of the collateral.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status. The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, cash flow appears sufficient to make these payments, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

**SCENARIO 2:** At maturity, the lender renewed the \$13.6 million loan at a market interest rate that provides for the incremental risk and payments based on amortizing the principal over the remaining 15 years. The borrower had not been delinquent on prior payments. Current projections indicate the DSC ratio will not drop below 1.12x based on leases in place and letters of intent for vacant space. However, some leases are coming up for renewal, and additional rental concessions may be necessary to either retain those existing tenants or attract new tenants. The lender estimates the property's current "as stabilized" market value is \$14.5 million, which results in a 94 percent LTV, but a current valuation has not been ordered. In addition, the lender has not asked the borrower or guarantors to provide current financial statements to assess their ability to support any cash flow shortfall.

***Classification:*** The lender internally graded the loan pass and is monitoring the credit. The examiner disagreed with the internal grade and listed the credit as special mention. While the borrower has the ability to continue to make payments based on leases currently in place and letters of intent for vacant space, there has been a declining trend in the property's revenue stream, and there is most likely a reduced collateral margin. In addition, there is potential for further deterioration in the cash

flow as more leases will expire in the upcoming months, while absorption for office space in this market has slowed. Lastly, the examiner noted that the lender failed to request current financial information and to obtain an updated collateral valuation,<sup>33</sup> representing administrative weaknesses.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status. The borrower has demonstrated the ability to make regularly scheduled payments and, even with the decline in the borrower's creditworthiness, cash flow is sufficient at this time to make payments, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

**SCENARIO 3:** At maturity, the lender restructured the \$13.6 million loan on a 12-month interest-only basis at a below market interest rate. The borrower has been sporadically delinquent on prior principal and interest payments. The borrower projects a DSC ratio of 1.10x based on the restructured interest-only terms. A review of the rent roll, which was available to the lender at the time of the restructuring, reflects the majority of tenants have short-term leases, with three leases expected to expire within the next three months. According to the lender, leasing has not improved since the restructuring as market conditions remain soft. Further, the borrower does not have an update as to whether the three expiring leases will renew at maturity; two of the tenants have moved to hybrid work-from-home arrangements. A recent appraisal provided a \$14.5 million "as stabilized" market value for the property, resulting in a 94 percent LTV.

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<sup>33</sup> In relation to comments on valuations within these examples, refer to the appraisal regulations applicable to the financial institution to determine whether there is a regulatory requirement for either an evaluation or appraisal. See footnote 20.

***Classification:*** The lender internally graded the loan pass and is monitoring the credit. The examiner disagreed with the internal grade and classified the loan substandard due to the borrower's limited ability to service a below market interest rate loan on an interest-only basis, sporadic delinquencies, and an increase in the LTV based on an updated appraisal. In addition, there is lease rollover risk because three of the leases are expiring soon, which could further limit cash flow.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status due to the positive cash flow and collateral margin. The examiner did not concur with this treatment as the loan was not restructured with reasonable repayment terms, and the borrower has not demonstrated the ability to amortize the loan and has limited ability to service a below market interest rate on an interest-only basis. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

### ***B. Income Producing Property – Retail Properties***

**BASE CASE:** A lender originated a 36-month, \$10 million loan for the construction of a shopping mall. The construction period was 24 months with a 12-month lease-up period to allow the borrower time to achieve stabilized occupancy before obtaining permanent financing. The loan had an interest reserve to cover interest payments over the three-year term. At the end of the third year, there is \$10 million outstanding on the loan, as the shopping mall has been built and the interest reserve, which has been covering interest payments, has been fully drawn.

At the time of origination, the appraisal reported an “as stabilized” market value of \$13.5 million for the property. In addition, the borrower had a take-out commitment that would provide permanent financing at maturity. A condition of the take-out lender was that the shopping mall had to achieve a 75 percent occupancy level.

Due to weak economic conditions and a shift in consumer behavior to a greater reliance on e-commerce, the property only reached a 55 percent occupancy level at the end of the 12-month lease up period. As a result, the original takeout commitment became void. In addition, there has been a considerable tightening of credit for these types of loans, and the borrower has been unable to obtain permanent financing elsewhere since the loan matured. To date, the few interested lenders are demanding significant equity contributions and much higher pricing.

**SCENARIO 1:** The lender renewed the loan for an additional 12 months to provide the borrower time for higher lease-up and to obtain permanent financing. The extension was made at a market interest rate that provides for the incremental risk and is on an interest-only basis. While the property’s historical cash flow was insufficient at a 0.92x debt service ratio, recent improvements in the occupancy level now provide adequate coverage based on the interest-only payments. Recent events include the signing of several new leases with additional leases under negotiation; however, takeout financing continues to be tight in the market.

In addition, current financial statements reflect that the builder, who personally guarantees the debt, has cash on deposit at the lender plus other unencumbered liquid assets. These assets provide sufficient cash flow to service the borrower’s global debt service requirements on a principal and interest basis, if necessary, for the next 12

months. The guarantor covered the initial cash flow shortfalls from the project and provided a good faith principal curtailment of \$200,000 at renewal, reducing the loan balance to \$9.8 million. A recent appraisal on the shopping mall reports an “as is” market value of \$10 million and an “as stabilized” market value of \$11 million, resulting in LTVs of 98 percent and 89 percent, respectively.

**Classification:** The lender internally graded the loan as a pass and is monitoring the credit. The examiner disagreed with the lender’s internal loan grade and listed it as special mention. While the project continues to lease up, cash flows cover only the interest payments. The guarantor has the ability, and has demonstrated the willingness, to cover cash flow shortfalls; however, there remains considerable uncertainty surrounding the takeout financing for this loan.

**Nonaccrual Treatment:** The lender maintained the loan in accrual status as the guarantor has sufficient funds to cover the borrower’s global debt service requirements over the one-year period of the renewed loan. Full repayment of principal and interest is reasonably assured from the project’s and guarantor’s cash resources, despite a decline in the collateral margin. The examiner concurred with the lender’s accrual treatment.

**SCENARIO 2:** The lender restructured the loan on an interest-only basis at a below market interest rate for one year to provide additional time to increase the occupancy level and, thereby, enable the borrower to arrange permanent financing. The level of lease-up remains relatively unchanged at 55 percent, and the shopping mall projects a DSC ratio of 1.02x based on the preferential loan terms. At the time of the restructuring, the lender used outdated financial information, which resulted in a positive cash flow

projection. However, other file documentation available at the time of the restructuring reflected that the borrower anticipates the shopping mall's revenue stream will further decline due to rent concessions, the loss of a tenant, and limited prospects for finding new tenants.

Current financial statements indicate the builder, who personally guarantees the debt, cannot cover any cash flow shortfall. The builder is highly leveraged, has limited cash or unencumbered liquid assets, and has other projects with delinquent payments. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in an LTV ratio of 111 percent.

***Classification:*** The lender internally classified the loan as substandard. The examiner disagreed with the internal grade and classified the amount not protected by the collateral value, \$1 million, as loss and required the lender to charge-off this amount. The examiner did not factor costs to sell into the loss classification analysis, as the current source of repayment is not reliant on the sale of the collateral. The examiner classified the remaining loan balance, based on the property's "as is" market value of \$9 million, as substandard given the borrower's uncertain repayment ability and weak financial support.

***Nonaccrual Treatment:*** The lender determined the loan did not warrant being placed in nonaccrual status. The examiner did not concur with this treatment because the partial charge-off is indicative that full collection of principal is not anticipated, and the lender has continued exposure to additional loss due to the project's insufficient cash flow and reduced collateral margin and the guarantor's inability to provide further support. After a discussion with the examiner on regulatory reporting

requirements, the lender placed the loan on nonaccrual.

**SCENARIO 3:** The loan has become delinquent. Recent financial statements indicate the borrower and the guarantor have minimal other resources available to support this loan. The lender chose not to restructure the \$10 million loan into a new single amortizing note of \$10 million at a market interest rate because the project's projected cash flow would only provide a 0.88x DSC ratio as the borrower has been unable to lease space. A recent appraisal which reasonably estimates the fair value on the shopping mall reported an "as is" market value of \$7 million, resulting in an LTV of 143 percent. At the original loan's maturity, the lender restructured the \$10 million debt, which is a collateral-dependent loan, into two notes. The lender placed the first note of \$7 million (Note A) on monthly payments that amortize the debt over 20 years at a market interest rate that provides for the incremental risk. The project's DSC ratio equals 1.20x for the \$7 million loan based on the shopping mall's projected net operating income. For the second note (Note B), the lender placed the remaining \$3 million, which represents the excess of the \$10 million debt over the \$7 million market value of the shopping mall, into a 2 percent interest-only loan that resets in five years into an amortizing payment. The lender then charged-off the \$3 million note due to the project's lack of repayment ability and to provide reasonable collateral protection for the remaining on-book loan of \$7 million. The lender also reversed accrued but unpaid interest. Since the restructuring, the borrower has made payments on both loans for more than six consecutive months and an updated financial analysis shows continued ability to repay under the new terms.

**Classification:** The lender internally graded the on-book loan of \$7 million as a pass loan due to the borrower's demonstrated ability to perform under the modified terms.



The examiner agreed with the lender's grade as the lender restructured the original obligation into Notes A and B, the lender charged off Note B, and the borrower has demonstrated the ability to repay Note A. Using this multiple note structure with charge-off of the Note B enables the lender to recognize interest income.

***Nonaccrual Treatment:*** The lender placed the on-book loan (Note A) of \$7 million loan in nonaccrual status at the time of the restructure. The lender later restored the \$7 million to accrual status as the borrower has the ability to repay the loan, has a record of performing at the revised terms for more than six months, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment. Interest payments received on the off-book loan have been recorded as recoveries because full recovery of principal and interest on this loan (Note B) was not reasonably assured.

**SCENARIO 4:** Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this loan. The lender restructured the \$10 million loan into a new single note of \$10 million at a market interest rate that provides for the incremental risk and is on an amortizing basis. The project's projected cash flow reflects a 0.88x DSC ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in an LTV of 111 percent. Based on the property's current market value of \$9 million, the lender charged-off \$1 million immediately after the renewal.

***Classification:*** The lender internally graded the remaining \$9 million on-book portion of the loan as a pass loan because the lender's analysis of the project's cash flow indicated a 1.05x DSC ratio when just considering the on-book balance. The

examiner disagreed with the internal grade and classified the \$9 million on-book balance as substandard due to the borrower's marginal financial condition, lack of guarantor support, and uncertainty over the source of repayment. The DSC ratio remains at 0.88x due to the single note restructure, and other resources are scant.

***Nonaccrual Treatment:*** The lender maintained the remaining \$9 million on-book portion of the loan on accrual, as the borrower has the ability to repay the principal and interest on this balance. The examiner did not concur with this treatment.

Because the lender restructured the debt into a single note and had charged-off a portion of the restructured loan, the repayment of the principal and interest contractually due on the entire debt is not reasonably assured given the DSC ratio of 0.88x and nominal other resources. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

The loan can be returned to accrual status<sup>34</sup> if the lender can document that subsequent improvement in the borrower's financial condition has enabled the loan to be brought fully current with respect to principal and interest and the lender expects the contractual balance of the loan (including the partial charge-off) will be fully collected. In addition, interest income may be recognized on a cash basis for the partially charged-off portion of the loan when the remaining recorded balance is considered fully collectible. However, the partial charge-off would not be reversed.

### ***C. Income Producing Property – Hotel***

**BASE CASE:** A lender originated a \$7.9 million loan to provide permanent financing

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<sup>34</sup> Refer to the supervisory guidance on “nonaccrual status” in the FFIEC Call Report and NCUA 5300 Call Report instructions.

for the acquisition of a stabilized 3-star hotel property. The borrower is a limited liability company with underlying ownership by two families who guarantee the loan. The loan term is five years, with payments based on a 25-year amortization and with a market interest rate. The LTV was 79 percent based on the hotel's appraised value of \$10 million.

At the end of the five-year term, the borrower's annualized DSC ratio was 0.95x. Due to competition from a well-known 4-star hotel that recently opened within one mile of the property, occupancy rates have declined. The borrower progressively reduced room rates to maintain occupancy rates, but continued to lose daily bookings. Both occupancy and Revenue per Available Room (RevPAR)<sup>35</sup> declined significantly over the past year. The borrower then began working on an initiative to make improvements to the property (i.e., automated key cards, carpeting, bedding, and lobby renovations) to increase competitiveness, and a marketing campaign is planned to announce the improvements and new price structure.

The borrower had paid principal and interest as agreed throughout the first five years, and the principal balance had reduced to \$7 million at the end of the five-year term.

**SCENARIO 1:** At maturity, the lender renewed the loan for 12 months on an interest-only basis at a market interest rate that provides for the incremental risk. The extension was granted to enable the borrower to complete the planned renovations, launch the marketing campaign, and achieve the borrower's updated projections for sufficient cash flow to service the debt once the improvements are completed. (If the initiative is successful, the loan officer expects the loan to either be renewed on an amortizing basis

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<sup>35</sup> Total guest room revenue divided by room count and number of days in the period.

or refinanced through another lending entity.) The borrower has a verified, pledged reserve account to cover the improvement expenses. Additionally, the guarantors' updated financial statements indicate that they have sufficient unencumbered liquid assets. Further, the guarantors expressed the willingness to cover any estimated cash flow shortfall through maturity. Based on this information, the lender's analysis indicates that, after deductions for personal obligations and realistic living expenses and verification that there are no contingent liabilities, the guarantors should be able to make interest payments. To date, interest payments have been timely. The lender estimates the property's current "as stabilized" market value at \$9 million, which results in a 78 percent LTV.

***Classification:*** The lender internally graded the loan as a pass and is monitoring the credit. The examiner agreed with the lender's internal loan grade. The examiner concluded that the borrower and guarantors have sufficient resources to support the interest payments; additionally, the borrower's reserve account is sufficient to complete the renovations as planned.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status as full repayment of principal and interest is reasonably assured from the hotel's and guarantors' cash flows, despite a decline in the borrower's cash flow due to competition. The examiner concurred with the lender's accrual treatment.

**SCENARIO 2:** At maturity of the original loan, the lender restructured the loan on an interest-only basis at a below market interest rate for 12 months to provide the borrower time to complete its renovation and marketing efforts and increase occupancy levels. At the end of the 12-month period, the hotel's renovation and marketing efforts were

completed but unsuccessful. The hotel continued to experience a decline in occupancy levels, resulting in a DSC ratio of 0.60x. The borrower does not have ability to offer additional incentives to lure customers from the competition. RevPAR has also declined. Current financial information indicates the borrower has limited ability to continue to make interest payments, and updated projections indicate that the borrower will be below break-even performance for the next 12 months. The borrower has been sporadically delinquent on prior interest payments. The guarantors are unable to support the loan as they have limited unencumbered liquid assets and are highly leveraged. The lender is in the process of renewing the loan again.

The most recent hotel appraisal, dated as of the time of the first restructuring, reports an “as stabilized” appraised value of \$7.2 million (\$6.7 million for the real estate and \$500,000 for the tangible personal property of furniture, fixtures, and equipment), resulting in an LTV of 97 percent. The appraisal does not account for the diminished occupancy, and its assumptions significantly differ from current projections. A new valuation is needed to ascertain the current value of the property.

***Classification:*** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender’s treatment due to the borrower’s diminished ongoing ability to make payments, the guarantors’ limited ability to support the loan, and the reduced collateral position. The lender is obtaining a new valuation and will adjust the internal classification, if necessary, based on the updated value.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments. The examiner did

not concur with this treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash resources to service the below market interest rate on an interest-only basis, and the collateral margin has narrowed and may be narrowed further with a new valuation, which collectively indicates that full repayment of principal and interest is in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

**SCENARIO 3:** At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market interest rate to give the borrower additional time to complete renovations and increase marketing efforts. While the combined borrower/guarantors' liquidity indicated they could cover any cash flow shortfall until maturity of the restructured note, the borrower only had 50 percent of the funds to complete its renovations in reserve. Subsequently, the borrower attracted a sponsor to obtain the remaining funds necessary to complete the renovation plan and marketing campaign.

Eight months later, the hotel experienced an increase in its occupancy and achieved a DSC ratio of 1.20x on an amortizing basis. Updated projections indicated the borrower would be at or above the 1.20x DSC ratio for the next 12 months, based on market terms and rate. The borrower and the lender then agreed to restructure the loan again with monthly payments that amortize the debt over 20 years, consistent with the current market terms and rates. Since the date of the second restructuring, the borrower has made all principal and interest payments as agreed for six consecutive months.

**Classification:** The lender internally classified the most recent restructured loan

substandard. The examiner agreed with the lender's initial substandard grade at the time of the subject restructuring, but now considers the loan as a pass as the borrower was no longer having financial difficulty and has demonstrated the ability to make payments according to the modified principal and interest terms for more than six consecutive months.

***Nonaccrual Treatment:*** The original restructured loan was placed in nonaccrual status. The lender initially maintained the most recent restructured loan in nonaccrual status as well, but returned it to an accruing status after the borrower made six consecutive monthly principal and interest payments. The lender expects full repayment of principal and interest. The examiner concurred with the lender's accrual treatment.

**SCENARIO 4:** The lender extended the original amortizing loan for 12 months at a market interest rate. The borrower is now experiencing a six-month delay in completing the renovations due to a conflict with the contractor hired to complete the renovation work, and the current DSC ratio is 0.85x. A current valuation has not been ordered. The lender estimates the property's current "as stabilized" market value is \$7.8 million, which results in an estimated 90 percent LTV. The lender did receive updated projections, but the borrower is now unlikely to achieve break-even cash flow within the 12-month extension timeframe due to the renovation delays. At the time of the extension, the borrower and guarantors had sufficient liquidity to cover the debt service during the twelve-month period. The guarantors also demonstrated a willingness to support the loan by making payments when necessary, and the loan has not gone delinquent. With the guarantors' support, there is sufficient liquidity to make payments to maturity, though

such resources are declining rapidly.

**Classification:** The lender internally graded the loan as pass and is monitoring the credit. The examiner disagreed with the lender's grading and listed the loan as special mention. While the borrower and guarantor can cover the debt service shortfall in the near-term, the duration of their support may not extend long enough to replace lost cash flow from operations due to delays in the renovation work. The primary source of repayment does not fully cover the loan as evidenced by a DSC ratio of 0.85x. It appears that competition from the new hotel will continue to adversely affect the borrower's cash flow until the renovations are complete, and if cash flow deteriorates further, the borrower and guarantors may be required to use more liquidity to support loan payments and ongoing business operations. The examiner also recommended the lender obtain a new valuation.

**Nonaccrual Treatment:** The lender maintained the loan in accrual status. The borrower and guarantors have demonstrated the ability and willingness to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, global cash resources appear sufficient to make these payments, and the ultimate full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

#### ***D. Acquisition, Development and Construction – Residential***

**BASE CASE:** The lender originated a \$4.8 million acquisition and development (A&D) loan and a \$2.4 million construction revolving line of credit (revolver) for the development and construction of a 48-lot single-family project. The maturity for both



loans is three years, and both are priced at a market interest rate; both loans also have an interest reserve. The LTV on the A&D loan is 75 percent based on an “as complete” value of \$6.4 million. Up to 12 units at a time will be funded under the construction revolver at the lesser of 80 percent LTV or 100 percent of costs. The builder is allowed two speculative (“spec”) units (including one model). The remaining units must be pre-sold with an acceptable deposit and a pre-qualified mortgage. As units are settled, the construction revolver will be repaid at 100 percent (or par); the A&D loan will be repaid at 120 percent, or \$120,000 (\$4.8 million/48 units x 120 percent). The average sales price is projected to be \$500,000, and total construction cost to build each unit is estimated to be \$200,000. Assuming total cost is lower than value, the average release price will be \$320,000 (\$120,000 A&D release price plus \$200,000 construction costs). Estimated time for development is 12 months; the appraiser estimated absorption of two lots per month for total sell-out to occur within three years (thus, the loan would be repaid upon settlement of the 40th unit, or the 32nd month of the loan term). The borrower is required to curtail the A&D loan by six lots, or \$720,000, at the 24th month, and another six lots, or \$720,000, by the 30th month.

**SCENARIO 1:** Due to issues with the permitting and approval process by the county, the borrower’s development was delayed by 18 months. Further delays occurred because the borrower was unable to pave the necessary roadways due to excessive snow and freezing temperatures. The lender waived both \$720,000 curtailment requirements due to the delays. Demand for the housing remains unchanged.

At maturity, the lender renewed the \$4.8 million outstanding A&D loan balance and the \$2.4 million construction revolver for 24 months at a market interest rate that provides

for the incremental risk. The interest reserve for the A&D loan has been depleted as the lender had continued to advance funds to pay the interest charges despite the delays in development. Since depletion of the interest reserve, the borrower has made the last several payments out-of-pocket.

Development is now complete, and construction has commenced on eight units (two “spec” units and six pre-sold units). Combined borrower and guarantor liquidity show they can cover any debt service shortfall until the units begin to settle and the project is cash flowing. The lender estimates that the property’s current “as complete” value is \$6 million, resulting in an 80 percent LTV. The curtailment schedule was re-set to eight lots, or \$960,000, by month 12, and another eight lots, or \$960,000, by month 18. A new appraisal has not been ordered; however, the lender noted in the file that, if the borrower does not meet the absorption projections of six lots/quarter within six months of booking the renewed loan, the lender will obtain a new appraisal.

**Classification:** The lender internally graded the restructured loans as pass and is monitoring the credits. The examiner agreed, as the borrower and guarantor can continue making payments on reasonable terms and the project is moving forward supported by housing demand and is consistent with the builder’s development plans. However, the examiner noted weaknesses in the lender’s loan administrative practices as the financial institution did not (1) suspend the interest reserve during the development delay and (2) obtain an updated collateral valuation.

**Nonaccrual Treatment:** The lender maintained the loans in accrual status. The project is moving forward, the borrower has demonstrated the ability to make the regularly scheduled payments after depletion of the interest reserve, global cash

resources from the borrower and guarantor appears sufficient to make these payments, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

**SCENARIO 2:** Due to weather and contractor issues, development was not completed until month 24, a year behind the original schedule. The borrower began pre-marketing, but sales have been slow due to deteriorating market conditions in the region. The borrower has achieved only eight pre-sales during the past six months. The borrower recently commenced construction on the pre-sold units.

At maturity, the lender renewed the \$4.8 million A&D loan balance and \$2.4 million construction revolver on a 12-month interest-only basis at a market interest rate, with another 12-month option predicated upon \$1 million in curtailments having occurred during the first renewal term (the lender had waived the initial term curtailment requirements). The lender also renewed the construction revolver for a one-year term and reduced the number of "spec" units to just one, which also will serve as the model. A recent appraisal estimates that absorption has dropped to four lots per quarter for the first two years and assigns an "as complete" value of \$5.3 million, for an LTV of 91 percent. The interest reserve is depleted, and the borrower has been paying interest out-of-pocket for the past few months. Updated borrower and guarantor financial statements indicate the continued ability to cover interest-only payments for the next 12 to 18 months.

**Classification:** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the deterioration and uncertainty surrounding the market (as evidenced by slower than anticipated sales on the project), the lack of principal reduction, and the reduced

collateral margin.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the development is complete, the borrower has pre-sales and construction has commenced, and the borrower and guarantor have sufficient means to make interest payments at a market interest rate until the earlier of maturity or the project begins to cash flow. The examiner concurred with the lender's accrual treatment.

**SCENARIO 3:** Lot development was completed on schedule, and the borrower quickly sold and settled the first 10 units. At maturity, the lender renewed the \$3.6 million A&D loan balance (\$4.8 million reduced by the sale and settlement of the 10 units (\$120,000 release price x 10) to arrive at \$3.6 million) and \$2.4 million construction revolver on a 12-month interest-only basis at a below market interest rate.

The borrower then sold an additional 10 units to an investor; the loan officer (new to the financial institution) mistakenly marked these units as pre-sold and allowed construction to commence on all 10 units. Market conditions then deteriorated quickly, and the investor defaulted under the terms of the bulk contract. The units were completed, but the builder has been unable to re-sell any of the units, recently dropping the sales price by 10 percent and engaging a new marketing firm, which is working with several potential buyers.

A recent appraisal estimates that absorption has dropped to three lots per quarter and assigns an "as complete" value of \$2.3 million for the remaining 28 lots, resulting in an LTV of 156 percent. A bulk appraisal of the 10 units assigns an "as-is" value of the units of \$4.0 million (\$400,000/unit). The loans are cross-defaulted and cross-collateralized; the LTV on a combined basis is 95 percent (\$6 million outstanding debt (A&D plus

revolver) divided by \$6.3 million in combined collateral value). Updated borrower and guarantor financial statements indicate a continued ability to cover interest-only payments for the next 12 months at the reduced rate; however, this may be limited in the future given other troubled projects in the borrower's portfolio that have been affected by market conditions.

The lender modified the release price for each unit to net proceeds; any additional proceeds as units are sold will go towards repayment of the A&D loan. Assuming the units sell at a 10 percent reduction, the lender calculates the average sales price would be \$450,000. The financial institution's prior release price was \$320,000 (\$120,000 for the A&D loan and \$200,000 for the construction revolver). As such (by requiring net proceeds), the financial institution will be receiving an additional \$130,000 per lot, or \$1.3 million for the completed units, to repay the A&D loan (\$450,000 average sales price less \$320,000 bank's release price equals \$130,000). Assuming the borrower will have to pay \$30,000 in related sales/settlement costs leaves approximately \$100,000 remaining per unit to apply towards the A&D loan, or \$1 million total for the remaining 10 units (\$100,000 times 10).

***Classification:*** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the borrower and guarantor's diminished ability to make interest payments (even at the reduced rate), the stalled status of the project, and the reduced collateral protection.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower had previously demonstrated an ability to make interest payments. The examiner disagreed as the loan was not restructured on reasonable repayment terms.

While the borrower and guarantor may be able to service the debt at a below market interest rate in the near term using other unencumbered liquid assets, other projects in their portfolio are also affected by poor market conditions and may require significant liquidity contributions, which could affect their ability to support the loan. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

***E. Construction Loan – Single Family Residence***

**BASE CASE:** The lender originated a \$1.2 million construction loan on a single-family “spec” residence with a 15-month maturity to allow for completion and sale of the property. The loan required monthly interest-only payments at a market interest rate and was based on an “as completed” LTV of 70 percent at origination. During the original loan construction phase, the borrower was able to make all interest payments from personal funds. At maturity, the home had been completed, but not sold, and the borrower was unable to find another lender willing to finance this property under similar terms.

**SCENARIO 1:** At maturity, the lender restructured the loan for one year on an interest-only basis at a below market interest rate to give the borrower more time to sell the “spec” home. Current financial information indicates the borrower has limited ability to continue to make interest-only payments from personal funds. If the residence does not sell by the revised maturity date, the borrower plans to rent the home. In this event, the lender will consider modifying the debt into an amortizing loan with a 20-year maturity, which would be consistent with this type of income-producing investment property. Any

shortfall between the net rental income and loan payments would be paid by the borrower. Due to declining home values, the LTV at the renewal date was 90 percent.

**Classification:** The lender internally classified the loan substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the borrower's diminished ongoing ability to make payments and the reduced collateral position.

**Nonaccrual Treatment:** The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments during the construction phase. The examiner did not concur with this treatment because the loan was not restructured on reasonable repayment terms. The borrower had limited ability to continue to service the debt, even on an interest-only basis at a below market interest rate, and the deteriorating collateral margin indicated that full repayment of principal and interest was not reasonably assured. The examiner instructed the lender to place the loan in nonaccrual status.

**SCENARIO 2:** At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market interest rate to give the borrower more time to sell the "spec" home. Eight months later, the borrower rented the property. At that time, the borrower and the lender agreed to restructure the loan again with monthly payments that amortize the debt over 20 years at a market interest rate for a residential investment property. Since the date of the second restructuring, the borrower had made all payments for over six consecutive months.

**Classification:** The lender internally classified the restructured loan substandard. The examiner agreed with the lender's initial substandard grade at the time of the

restructuring, but now considered the loan as a pass due to the borrower's demonstrated ability to make payments according to the reasonably modified terms for more than six consecutive months.

***Nonaccrual Treatment:*** The lender initially placed the restructured loan in nonaccrual status but returned it to accrual after the borrower made six consecutive monthly payments. The lender expects full repayment of principal and interest from the rental income. The examiner concurred with the lender's accrual treatment.

**SCENARIO 3:** The lender restructured the loan for one year on an interest-only basis at a below market interest rate to give the borrower more time to sell the "spec" home. The restructured loan has become more than 90 days past due, and the borrower has not been able to rent the property. Based on current financial information, the borrower does not have the ability to service the debt. The lender considers repayment to be contingent upon the sale of the property. Current market data reflects few sales, and similar new homes in this property's neighborhood are selling within a range of \$750,000 to \$900,000 with selling costs equaling 10 percent, resulting in anticipated net sales proceeds between \$675,000 and \$810,000.

***Classification:*** The lender graded \$390,000 loss (\$1.2 million loan balance less the maximum estimated net sales proceeds of \$810,000), \$135,000 doubtful based on the range in the anticipated net sales proceeds, and the remaining balance of \$675,000 substandard. The examiner agreed, as this classification treatment results in the recognition of the credit risk in the collateral-dependent loan based on the property's value less costs to sell. The examiner instructed management to obtain information on the current valuation on the property.



***Nonaccrual Treatment:*** The lender placed the loan in nonaccrual status when it became 60 days past due (reversing all accrued but unpaid interest) because the lender determined that full repayment of principal and interest was not reasonably assured. The examiner concurred with the lender's nonaccrual treatment.

**SCENARIO 4:** The lender committed an additional \$48,000 for an interest reserve and extended the \$1.2 million loan for 12 months at a below market interest rate with monthly interest-only payments. At the time of the examination, \$18,000 of the interest reserve had been added to the loan balance. Current financial information obtained during the examination reflects the borrower has no other repayment sources and has not been able to sell or rent the property. An updated appraisal supports an "as is" value of \$952,950. Selling costs are estimated at 15 percent, resulting in anticipated net sales proceeds of \$810,000.

***Classification:*** The lender internally graded the loan as pass and is monitoring the credit. The examiner disagreed with the internal grade. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower has limited ability to service the debt, and the reduced collateral margin indicated that full repayment of principal and interest was not assured. After discussing regulatory reporting requirements with the examiner, the lender reversed the \$18,000 interest capitalized out of the loan balance and interest income. Further, the examiner classified \$390,000 loss based on the adjusted \$1.2 million loan balance less estimated net sales proceeds of \$810,000, which was classified substandard. This classification treatment recognizes the credit risk in the collateral-dependent loan based on the property's market value less costs to sell. The examiner also provided

supervisory feedback to management for the inappropriate use of interest reserves and lack of current financial information in making that decision. The remaining interest reserve of \$30,000 is not subject to adverse classification because the loan should be placed in nonaccrual status.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status. The examiner did not concur with this treatment. The loan was not restructured on reasonable repayment terms, the borrower has limited ability to service a below market interest rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is not assured. The lender's decision to provide a \$48,000 interest reserve was not supported, given the borrower's inability to repay it. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual, and reversed the capitalized interest to be consistent with regulatory reporting instructions. The lender also agreed to not recognize any further interest income from the interest reserve.

***F. Construction Loan – Land Acquisition, Condominium Construction and Conversion***

**BASE CASE:** The lender originally extended a \$50 million loan for the purchase of vacant land and the construction of a luxury condominium project. The loan was interest-only and included an interest reserve to cover the monthly payments until construction was complete. The developer bought the land and began construction after obtaining purchase commitments for 1/3 of the 120 planned units, or 40 units. Many of these pending sales were speculative with buyers committing to buy multiple units with

minimal down payments. The demand for luxury condominiums in general has declined since the borrower launched the project, and sales have slowed significantly over the past year. The lack of demand is attributed to a slowdown in the economy. As a result, most of the speculative buyers failed to perform on their purchase contracts and only a limited number of the other planned units have been pre-sold.

The developer experienced cost overruns on the project and subsequently determined it was in the best interest to halt construction with the property 80 percent completed. The outstanding loan balance is \$44 million with funds used to pay construction costs, including cost overruns and interest. The borrower estimates an additional \$10 million is needed to complete construction. Current financial information reflects that the developer does not have sufficient cash flow to pay interest (the interest reserve has been depleted); and, while the developer does have equity in other assets, there is doubt about the borrower's ability to complete the project.

**SCENARIO 1:** The borrower agreed to grant the lender a second lien on an apartment project in its portfolio, which provides \$5 million in additional collateral support. In return, the lender advanced the borrower \$10 million to finish construction. The condominium project was completed shortly thereafter. The lender also agreed to extend the \$54 million loan (\$44 million outstanding balance plus \$10 million in new money) for 12 months at a market interest rate that provides for the incremental risk, to give the borrower additional time to market the property. The borrower agreed to pay interest whenever a unit was sold, with any outstanding balance due at maturity.

The lender obtained a recent appraisal on the condominium building that reported a prospective "as complete" market value of \$65 million, reflecting a 24-month sell-out

period and projected selling costs of 15 percent of the sales price. Comparing the \$54 million loan amount against the \$65 million “as complete” market value plus the \$5 million pledged in additional collateral (totaling \$70 million) results in an LTV of 77 percent. The lender used the prospective “as complete” market value in its analysis and decision to fund the completion and sale of the units and to maximize its recovery on the loan.

***Classification:*** The lender internally classified the \$54 million loan as substandard due to the units not selling as planned and the project’s limited ability to service the debt despite the 1.3x gross collateral margin. The examiner agreed with the lender’s internal grade.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status due to the protection afforded by the collateral margin. The examiner did not concur with this treatment due to the uncertainty about the borrower’s ability to sell the units and service the debt, raising doubts as to the full repayment of principal and interest.

After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

**SCENARIO 2:** A recent appraisal of the property reflects that the highest and best use would be conversion to an apartment building. The appraisal reports a prospective “as complete” market value of \$60 million upon conversion to an apartment building and a \$67 million prospective “as stabilized” market value upon the property reaching stabilized occupancy. The borrower agreed to grant the lender a second lien on an apartment building in its portfolio, which provides \$5 million in additional collateral support. In return, the lender advanced the borrower \$10 million, which is needed to

finish construction and convert the project to an apartment complex. The lender also agreed to extend the \$54 million loan for 12 months at a market interest rate that provides for the incremental risk, to give the borrower time to lease the apartments. Interest payments are deferred. The \$60 million “as complete” market value plus the \$5 million in other collateral results in an LTV of 83 percent. The prospective “as complete” market value is primarily relied on as the loan is funding the conversion of the condominium to apartment building.

***Classification:*** The lender internally classified the \$54 million loan as substandard due to the units not selling as planned and the project’s limited ability to service the debt. The collateral coverage provides adequate support to the loan with a 1.2x gross collateral margin. The examiner agreed with the lender’s internal grade.

***Nonaccrual Treatment:*** The lender determined the loan should be placed in nonaccrual status due to an oversupply of units in the project’s submarket, and the borrower’s untested ability to lease the units and service the debt, raising concerns as to the full repayment of principal and interest. The examiner concurred with the lender’s nonaccrual treatment.

***G. Commercial Operating Line of Credit in Connection with Owner Occupied Real Estate***

**BASE CASE:** Two years ago, the lender originated a CRE loan at a market interest rate to a borrower whose business occupies the property. The loan was based on a 20-year amortization period with a balloon payment due in three years. The LTV equaled 70 percent at origination. A year ago, the lender financed a \$5 million operating line of

credit for seasonal business operations at market terms. The operating line of credit had a one-year maturity with monthly interest payments and was secured with a blanket lien on all business assets. Borrowings under the operating line of credit are based on accounts receivable that are reported monthly in borrowing base reports, with a 75 percent advance rate against eligible accounts receivable that are aged less than 90 days old. Collections of accounts receivable are used to pay down the operating line of credit. At maturity of the operating line of credit, the borrower's accounts receivable aging report reflected a growing trend of delinquency, causing the borrower temporary cash flow difficulties. The borrower has recently initiated more aggressive collection efforts.

**SCENARIO 1:** The lender renewed the \$5 million operating line of credit for another year, requiring monthly interest payments at a market interest rate, and principal to be paid down by accounts receivable collections. The borrower's liquidity position has tightened but remains satisfactory, cash flow available to service all debt is 1.20x, and both loans have been paid according to the contractual terms. The primary repayment source for the operating line of credit is conversion of accounts receivable to cash. Although payments have slowed for some customers, most customers are paying within 90 days of invoice. The primary repayment source for the real estate loan is from business operations, which remain satisfactory, and an updated appraisal is not considered necessary.

**Classification:** The lender internally graded both loans as pass and is monitoring the credits. The examiner agreed with the lender's analysis and the internal grades. The lender is monitoring the trend in the accounts receivable aging report and the borrower's ongoing collection efforts.

***Nonaccrual Treatment:*** The lender determined that both the real estate loan and the renewed operating line of credit may remain in accrual status as the borrower has demonstrated an ongoing ability to perform, has the financial ability to pay a market interest rate, and full repayment of principal and interest is reasonably assured. The examiner concurred with the lender's accrual treatment.

**SCENARIO 2:** The lender restructured the operating line of credit by reducing the line amount to \$4 million, at a below market interest rate. This action is expected to alleviate the borrower's cash flow problem. The borrower is still considered to be a viable business even though its financial performance has continued to deteriorate, with sales and profitability declining. The trend in accounts receivable delinquencies is worsening, resulting in reduced liquidity for the borrower. Cash flow problems have resulted in sporadic over advances on the \$4 million operating line of credit, where the loan balance exceeds eligible collateral in the borrowing base. The borrower's net operating income has declined but reflects the ability to generate a 1.08x DSC ratio for both loans, based on the reduced rate of interest for the operating line of credit. The terms on the real estate loan remained unchanged. The lender estimated the LTV on the real estate loan to be 90 percent. The operating line of credit currently has sufficient eligible collateral to cover the outstanding line balance, but customer delinquencies have been increasing.

***Classification:*** The lender internally classified both loans substandard due to deterioration in the borrower's business operations and insufficient cash flow to repay the debt at market terms. The examiner agreed with the lender's analysis and the internal grades. The lender will monitor the trend in the business operations, accounts receivable, profitability, and cash flow. The lender may need to order a new

appraisal if the DSC ratio continues to fall and the overall collateral margin further declines.

***Nonaccrual Treatment:*** The lender reported both the restructured operating line of credit and the real estate loan on a nonaccrual basis. The operating line of credit was not renewed on market interest rate repayment terms, the borrower has an increasingly limited ability to service the below market interest rate debt, and there is insufficient support to demonstrate an ability to meet the new payment requirements. The borrower's ability to continue to perform on the operating line of credit and real estate loan is not assured due to deteriorating business performance caused by lower sales and profitability and higher customer delinquencies. In addition, the collateral margin indicates that full repayment of all of the borrower's indebtedness is questionable, particularly if the borrower fails to continue as a going concern. The examiner concurred with the lender's nonaccrual treatment.

#### ***H. Land Loan***

**BASE CASE:** Three years ago, the lender originated a \$3.25 million loan to a borrower for the purchase of raw land that the borrower was seeking to have zoned for residential use. The loan terms were three years interest-only at a market interest rate; the borrower had sufficient funds to pay interest from cash flow. The appraisal at origination assigned an "as is" market value of \$5 million, which resulted in a 65 percent LTV. The zoning process took longer than anticipated, and the borrower did not obtain full approvals until close to the maturity date. Now that the borrower successfully obtained the residential zoning, the borrower has been seeking construction financing to repay the land loan. At



maturity, the borrower requested a 12-month extension to provide additional time to secure construction financing which would include repayment of the subject loan.

**SCENARIO 1:** The borrower provided the lender with current financial information, demonstrating the continued ability to make monthly interest payments and principal curtailments of \$150,000 per quarter. Further, the borrower made a principal payment of \$250,000 in exchange for a 12-month extension of the loan. The borrower also owned an office building with an “as stabilized” market value of \$1 million and pledged the property as additional unencumbered collateral, granting the lender a first lien. The borrower’s personal financial information also demonstrates that cash flow from personal assets and the rental income generated by the newly pledged office building are sufficient to fully amortize the land loan over a reasonable period. A decline in market value since origination was due to a change in density; the project was originally intended as 60 lots but was subsequently zoned as 25 single-family lots because of a change in the county’s approval process. A recent appraisal of the raw land reflects an “as is” market value of \$3 million, which results in a 75 percent LTV when combined with the additional collateral and after the principal reduction. The lender restructured the loan into a \$3 million loan with quarterly curtailments for another year at a market interest rate that provides for the incremental risk.

***Classification:*** The lender internally graded the loan as pass due to adequate cash flow from the borrower’s personal assets and rental income generated by the office building to make principal and interest payments. Also, the borrower provided a principal curtailment and additional collateral to maintain a reasonable LTV. The examiner agreed with the lender’s internal grade.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status, as the borrower has sufficient funds to cover the debt service requirements for the next year. Full repayment of principal and interest is reasonably assured from the collateral and the borrower's financial resources. The examiner concurred with the lender's accrual treatment.

**SCENARIO 2:** The borrower provided the lender with current financial information that indicated the borrower is unable to continue to make interest-only payments. The borrower has been sporadically delinquent up to 60 days on payments. The borrower is still seeking a loan to finance construction of the project and has not been able to obtain a takeout commitment; it is unlikely the borrower will be able to obtain financing, since the borrower does not have the equity contribution most lenders require as a condition of closing a construction loan. A decline in value since origination was due to a change in local zoning density; the project was originally intended as 60 lots but was subsequently zoned as 25 single-family lots. A recent appraisal of the property reflects an "as is" market value of \$3 million, which results in a 108 percent LTV. The lender extended the \$3.25 million loan at a market interest rate for one year with principal and interest due at maturity.

***Classification:*** The lender internally graded the loan as pass because the loan is currently not past due and is at a market interest rate. Also, the borrower is trying to obtain takeout construction financing. The examiner disagreed with the internal grade and adversely classified the loan. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower does not have the ability to service the debt and full repayment of principal and interest is not

assured. The examiner classified \$550,000 loss (\$3.25 million loan balance less \$2.7 million, based on the current appraisal of \$3 million less estimated cost to sell of 10 percent or \$300,000). The examiner classified the remaining \$2.7 million balance substandard. This classification treatment recognizes the credit risk in this collateral-dependent loan based on the property's market value less costs to sell.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status. The examiner did not concur with this treatment and instructed the lender to place the loan in nonaccrual status because the borrower does not have the ability to service the debt, value of the collateral is permanently impaired, and full repayment of principal and interest is not assured.

### ***I. Multi-Family Property***

**BASE CASE:** The lender originated a \$6.4 million loan for the purchase of a 25-unit apartment building. The loan maturity is five years, and principal and interest payments are based on a 30-year amortization at a market interest rate. The LTV was 75 percent (based on an \$8.5 million value), and the DSC ratio was 1.50x at origination (based on a 30-year principal and interest amortization).

Leases are typically 12-month terms with an additional 12-month renewal option. The property is 88 percent leased (22 of 25 units rented). Due to poor economic conditions, delinquencies have risen from two units to eight units, as tenants have struggled to make ends meet. Six of the eight units are 90 days past due, and these tenants are facing eviction.

**SCENARIO 1:** At maturity, the lender renewed the \$5.9 million loan balance on

principal and interest payments for 12 months at a market interest rate that provides for the incremental risk. The borrower had not been delinquent on prior payments. Current financial information indicates that the DSC ratio dropped to 0.80x because of the rent payment delinquencies. Combining borrower and guarantor liquidity shows they can cover cash flow shortfall until maturity (including reasonable capital expenditures since the building was recently renovated). Borrower projections show a return to break-even within six months since the borrower plans to decrease rents to be more competitive and attract new tenants. The lender estimates that the property's current "as stabilized" market value is \$7 million, resulting in an 84 percent LTV. A new appraisal has not been ordered; however, the lender noted in the file that, if the borrower does not meet current projections within six months of booking the renewed loan, the lender will obtain a new appraisal.

***Classification:*** The lender internally graded the renewed loan as pass and is monitoring the credit. The examiner disagreed with the lender's analysis and classified the loan as substandard. While the borrower and guarantor can cover the debt service shortfall in the near-term using additional guarantor liquidity, the duration of the support may be less than the lender anticipates if the leasing fails to materialize as projected. Economic conditions are poor, and the rent reduction may not be enough to improve the property's performance. Lastly, the lender failed to obtain an updated collateral valuation, which represents an administrative weakness.

***Nonaccrual Treatment:*** The lender maintained the loan in accrual status. The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower's creditworthiness, the borrower and guarantor

appear to have sufficient cash resources to make these payments if projections are met, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment.

**SCENARIO 2:** At maturity, the lender renewed the \$5.9 million loan balance on a 12-month interest-only basis at a below market interest rate. In response to an event that caused severe economic conditions, the federal and state governments enacted moratoriums on all evictions. The borrower has been paying as agreed; however, cash flow has been severely impacted by the rent moratoriums. While the moratoriums do not forgive the rent (or unpaid fees), they do prevent evictions for unpaid rent and have been in effect for the past six months. As a result, the borrower's cash flow is severely stressed, and the borrower has asked for temporary relief of the interest payments. In addition, a review of the current rent roll indicates that five of the 25 units are now vacant. A recent appraisal values the property at \$6 million (98 percent LTV). Updated borrower and guarantor financial statements indicate the continued ability to cover interest-only payments for the next 12 to 18 months at the reduced rate of interest. Updated projections that indicate below break-even performance over the next 12 months remain uncertain given that the end of the moratorium (previously extended) is a "soft" date and that tenant behaviors may not follow historical norms.

**Classification:** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's treatment due to the borrower's diminished ability to make interest payments (even at the reduced rate) and lack of principal reduction, the uncertainty surrounding the rent moratoriums, and the reduced and tight collateral position.

***Nonaccrual Treatment:*** The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make principal and interest payments and has some ability to make payments on the interest-only terms at a below market interest rate. The examiner did not concur with this treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash flow to amortize the debt, and the slim collateral margin indicates that full repayment of principal and interest may be in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

**SCENARIO 3:** At maturity, the lender renewed the \$5.9 million loan balance on a 12-month interest-only basis at a below market interest rate. The borrower has been sporadically delinquent on prior principal and interest payments. A review of the current rent roll indicates that 10 of the 25 units are vacant after tenant evictions. The vacated units were previously in an advanced state of disrepair, and the borrower and guarantors have exhausted their liquidity after repairing the units. The repaired units are expected to be rented at a lower rental rate. A post-renovation appraisal values the property at \$5.5 million (107 percent LTV). Updated projections indicate the borrower will be below break-even performance for the next 12 months.

***Classification:*** The lender internally classified the loan as substandard and is monitoring the credit. The examiner agreed with the lender's concerns due to the borrower's diminished ability to make principal or interest payments, the guarantor's limited ability to support the loan, and insufficient collateral protection. However, the examiner classified \$900,000 loss (\$5.9 million loan balance less \$5 million (based on the current appraisal of \$5.5 million less estimated cost to sell of 10

percent, or \$500,000)). The examiner classified the remaining \$5 million balance substandard. This classification treatment recognizes the collateral dependency.

***Nonaccrual Treatment:*** The lender maintained the loan on accrual basis because the borrower demonstrated a previous ability to make principal and interest payments.

The examiner did not concur with the lender's treatment as the loan was not restructured on reasonable repayment terms, the borrower has insufficient cash flow to service the debt at a below market interest rate on an interest-only basis, and the impairment of value indicates that full repayment of principal and interest is in doubt. After a discussion with the examiner on regulatory reporting requirements, the lender placed the loan on nonaccrual.

## Appendix 2

### Selected Rules, Supervisory Guidance, and Authoritative Accounting

#### Guidance

##### Rules

- Federal regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: 12 CFR part 34, subpart D, and appendix A to subpart D (OCC), 160.100, 160.101, and Appendix to 160.101 (OCC); 12 CFR part 208, subpart E and appendix C (Board); and 12 CFR part 365 and appendix A (FDIC). For NCUA, refer to 12 CFR part 723 for member business loan and commercial loan regulation which addresses commercial real estate lending and 12 CFR part 741, appendix B, which addresses loan workouts, nonaccrual policy, and regulatory reporting of workout loans.
- Federal regulations on the *Interagency Guidelines Establishing Standards for Safety and Soundness*: 12 CFR part 30, appendix A (OCC); 12 CFR part 208 Appendix D-1 (Board); and 12 CFR part 364 appendix A (FDIC). For NCUA safety and soundness regulations and supervisory guidance, see 12 CFR 741.3(b)(2); 12 CFR part 741, appendix B; 12 CFR part 723; and NCUA letters to credit unions 10-CU-02 “Current Risks in Business Lending and Sound Risk Management Practices” issued January 2010 (NCUA). Credit unions should also refer to the Commercial and Member Business Loans section of the NCUA Examiner’s Guide.
- Federal appraisal regulations: 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E and 12 CFR part 225, subpart G (Board); 12 CFR part 323 (FDIC);



and 12 CFR part 722 (NCUA).

### **Supervisory Guidance**

- *FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031, FFIEC 041, and FFIEC 051 Instructions) and *NCUA 5300 Call Report Instructions*.
- *Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)*, issued April 2023.
- *Interagency Guidance on Credit Risk Review Systems*, issued May 2020.
- *Interagency Supervisory Examiner Guidance for Institutions Affected by a Major Disaster*, issued December 2017.
- Board, FDIC, and OCC joint guidance entitled *Statement on Prudent Risk Management for Commercial Real Estate Lending*, issued December 2015.
- *Interagency Appraisal and Evaluation Guidelines*, issued October 2010.
- Board, FDIC, and OCC joint guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 2006.
- *Interagency FAQs on Residential Tract Development Lending*, issued September 2005.

### **Authoritative Accounting Standards**

- *ASC Topic 310, Receivables*
- *ASC Topic 326, Financial Instruments – Credit losses*
- *ASC Topic 820, Fair Value Measurement*
- *ASC Subtopic 825-10, Financial Instruments – Overall*

## Appendix 3

### Valuation Concepts for Income Producing Real Estate

Several conceptual issues arise during the process of reviewing a real estate loan and in using the present value calculation to determine the value of collateral. The following discussion sets forth the meaning and use of those key concepts.

**The Discount Rate and the Present Value:** The discount rate used to calculate the present value is the rate of return that market participants require for the specific 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. The present value is the value of a future payment or series of payments discounted to the date of the valuation. If the income producing real estate is a property that requires cash outlays, a net present value calculation may be used in the valuation of collateral. Net present value considers the present value of capital outlays and subtracts that from the present value of payments received for the income producing property.

**Direct Capitalization (“Cap” Rate) Technique:** Many market participants and analysts use the “cap” rate technique 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 an estimate of its “stabilized” annual income by a factor called a “cap” rate. Stabilized annual 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. The "cap" rate, usually defined for each property type in a market area, is viewed by some analysts as the required rate of return stated in terms of current income. The "cap" rate can be 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 an appropriate valuation technique 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 annual 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, the net present value approach and the direct capitalization technique will yield the same results.

The direct capitalization technique is not an appropriate valuation technique 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 accomplished through periodic income, the reversion, or a combination of both. 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 periodic income streams over a number of years in the future (discount rate) compared to a static one-year analysis (“cap” rate).

Other factors affecting the “cap” rate (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, has to be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller the depreciation in any one year, hence, the smaller the annual income required by the investor, and the lower the “cap” rate. Differences in terms and the extent of debt financing and the related costs are also taken into account.

**Selecting Discount and Cap Rates:** The choice of the appropriate values for discount and “cap” rates is a key aspect of income analysis. In markets marked by both a lack of transactions and 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 an income analysis generally should fall within a fairly narrow range for comparable properties.

**Holding Period versus Marketing Period:** When the net present value approach is applied to troubled properties, the chosen time frame should reflect the period over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That period is sometimes referred to as the “holding period.” The longer the period is before stabilization, the smaller the reversion value will be within the total value estimate. The marketing period is the time that may be required to sell the property in an open market.

## Appendix 4

### Special Mention and Adverse Classification Definitions<sup>36</sup>

The Board, FDIC, and OCC use the following definitions for assets adversely classified for supervisory purposes as well as those assets listed as special mention:

#### Special Mention

Special Mention Assets: 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.

#### Adverse Classifications

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

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<sup>36</sup> Federal banking agencies loan classification definitions of Substandard, Doubtful, and Loss may be found in the Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions Attachment 1—Classification Definitions (OCC: OCC Bulletin 2013-28; Board: SR Letter 13-18; and FDIC: FIL-51-2013). The Federal banking agencies definition of Special Mention may be found in the Interagency Statement on the Supervisory Definition of Special Mention Assets (June 10, 1993). The NCUA does not require credit unions to adopt the definition of special mention or a uniform regulatory classification schematic of loss, doubtful, substandard. A credit union must apply a relative credit risk score (i.e., credit risk rating) to each commercial loan as required by 12 CFR part 723 Member Business Loans; Commercial Lending (see Section 723.4(g)(3)) or the equivalent state regulation as applicable. Adversely classified refers to loans more severely graded under the credit union's credit risk rating system. Adversely classified loans generally require enhanced monitoring and present a higher risk of loss.

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.

Loss Assets: Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

## Appendix 5

### Accounting – Current Expected Credit Losses Methodology (CECL)

This appendix addresses the relevant accounting and supervisory guidance for financial institutions in accordance with Accounting Standards Update (ASU) 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and its subsequent amendments (collectively, ASC Topic 326) in determining the allowance for credit losses (ACL). Additional supervisory guidance for the financial institution’s estimate of the ACL and for examiners’ responsibilities to evaluate these estimates is presented in the *Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)*. Additional information related to identifying and disclosing modifications for regulatory reporting under ASC Topic 326 is located in the FFIEC Call Report and NCUA 5300 Call Report instructions.

In accordance with ASC Topic 326, expected credit losses on restructured or modified loans are estimated under the same CECL methodology as all other loans in the portfolio. Loans, including loans modified in a restructuring, should be evaluated on a collective basis unless they do not share similar risk characteristics with other loans. Changes in credit risk, borrower circumstances, recognition of charge-offs, or cash collections that have been fully applied to principal, often require reevaluation to determine if the modified loan should be included in a different pool of assets with similar risks for measuring expected credit losses.

Although ASC Topic 326 allows a financial institution to use any appropriate loss estimation method to estimate the ACL, there are some circumstances when specific



measurement methods are required. If a financial asset is collateral dependent,<sup>37</sup> the ACL is estimated using the fair value of the collateral. For a collateral-dependent loan, regulatory reporting requires that if the amortized cost of the loan exceeds the fair value<sup>38</sup> of the collateral (less costs to sell if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, as applicable), this excess is included in the amount of expected credit losses when estimating the ACL. However, some or all of this difference may represent a loss for classification purposes that should be charged off against the ACL in a timely manner.

Financial institutions also should consider the need to recognize an allowance for expected credit losses on off-balance sheet credit exposures, such as loan commitments, in other liabilities consistent with ASC Topic 326.

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<sup>37</sup> The repayment of a collateral-dependent loan is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date. Refer to the glossary entry in the FFIEC Call Report instructions for "Allowance for Credit Losses – Collateral-Dependent Financial Assets."

<sup>38</sup> The fair value of collateral should be measured in accordance with FASB ASC Topic 820, *Fair Value Measurement*. For allowance measurement purposes, the fair value of collateral should reflect the current condition of the property, not the potential value of the collateral at some future date.

**Michael J. Hsu,**  
*Acting Comptroller of the Currency.*

By order of the Board of Governors of the Federal Reserve System.

**Ann E. Misback,**  
*Secretary of the Board.*

Federal Deposit Insurance Corporation.  
By order of the Board of Directors.  
Dated at Washington, DC, on May 31, 2023.

**James P. Sheesley,**  
*Assistant Executive Secretary.*

By order of the Board of the National Credit Union Administration.  
Dated at Alexandria, VA, this 26th of June 2023.

**Melane Conyers-Ausbrooks,**  
*Secretary of the Board, National Credit Union Administration.*