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Comptroller of the Currency
Administrator of National Banks

Commercial Real Estate and Construction Lending

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Assets

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Real Estate and Construction Lending — Introduction

Background

The authority for national banks to engage in real estate lending is set forth at 12 USC 371 and the Comptroller of the Currency's regulations at 12 CFR 34. Real estate loans include loans secured by single- and multi-family residential property and commercial and industrial buildings of all types. Permanent loans to finance the purchase of 1- to 4-family residential property will be addressed in a separate Handbook booklet on Residential Real Estate and Home Equity Loans. Commercial real estate loans include loans secured by liens on condominiums, leaseholds, cooperatives, forest tracts, land sales contracts, construction project loans, and in the few states where they are considered real property, oil and other types of mineral rights. National banks may make, arrange, purchase, or sell loans or extensions of credit secured by liens on interests in real estate.

Loans secured by real estate can be divided into two categories based on the source of repayment: credit-based loans and project financing. Credit-based loans are loans secured by real estate that will be repaid from the borrower's business operations or personal assets. Although the primary collateral for the loan is real estate, the real estate is not the source of repayment. In many instances, these loans are used to finance the acquisition of an owner-occupied business premises that has an economic life similar to the term of the loan. In other cases, they are term loans used for other business purposes, such as working capital. In both cases, however, repayment is expected from the cash flow of the business rather than from the underlying real estate. Examiners should evaluate credit-based real estate loans in essentially the same manner as commercial loans.

The primary focus of this booklet on Real Estate and Construction Lending is the analysis of project financing. Although project financing also relies on cash flow, it is cash flow originating in the underlying real estate collateral. Project financing is repayable primarily from income currently being produced (or anticipated) from existing or future improvements to real estate. The credit capacity of the borrower and any guarantees are secondary sources of repayment.

The borrower in project financing may take any one of several legal forms to hold title to the real estate. Corporations, joint ventures, real estate investment trusts, or partnerships where the general partner is a Subchapter S corporation are the most popular forms. They allow investors to maximize tax benefits and limit personal liability.

Project financing transactions progress in phases based on the value added by the development of a parcel of real estate. Property must first be acquired; then it must be cleared and improved with sewers, utilities, and streets. Only then can a building be constructed. As each of these phases of the development process is accomplished, the overall value of the property is increased. When the project is completed and ready to produce income or be sold, it will be refinanced by a permanent lender.

A bank may finance any one or all of the phases of a real estate project. Most permanent financing, however, is provided by institutional lenders and investors with longer investment horizons than banks, such as insurance companies, pension funds, and real estate investment trusts.

Although banks usually prefer to finance the land development and construction phases of a real estate project, they also provide short-term financing for completed projects. These so-called "mini-perm" loans are used when the developer intends to sell the project soon after normal occupancy levels are achieved. The mini-perm loan allows the developer to avoid the cost and work associated with obtaining a permanent loan commitment prior to completing the project. Mini-perm loans, however, have also been common in distressed periods for commercial real estate, such as the early 1990s, when they reflected developers' inability to obtain permanent financing. The "involuntary" mini-perm loans of that period were often part of a bank's work-out strategy for its troubled commercial real estate construction and development loans.

Real Estate Markets

Real estate is a cyclical industry that is affected by both local and national economic conditions, including: growth in population and employment, consumer spending, interest rates, and inflation. While macroeconomic conditions are important factors affecting the overall state of the real estate industry, local supply and demand conditions are by far the more important factors affecting real estate markets.

A bank's commercial real estate and construction lending may be targeted to one or more of the five primary real estate sectors, including: office, retail, industrial, hospitality, and residential (multifamily and 1- to 4-family). Each of these market sectors has its own characteristics. In the office sector, the demand for office spaced is highly dependent on white collar employment. Office space expansion generally lags economic recoveries. In the retail sector, the demand for retail space and the level of retail rents are affected by the levels of employment and consumer confidence and spending. The industrial sector is most susceptible to the level of consumer spending, inventory levels, defense spending, and the volume of exports. The hospitality sector is affected by the strength of the U.S. dollar, consumer spending, the price of air travel, and business conditions. A weak dollar induces foreign visitors to travel to the United States, while prompting American vacationers to remain in the states. Finally, in the multifamily residential sector, the demand for apartments is heavily influenced by the affordability of ownership housing, local employment conditions, and the vacancy of existing inventory.

Population growth is a key factor for all sectors of the real estate industry because it influences consumer spending and the demand for goods and services. It also influences federal appropriations and state funding for local infrastructure projects and other services directly affecting real estate markets. Changing demographics, such as increases in the level of immigrants or retirees, are also important factors affecting real estate markets.

Risks Associated With Real Estate Lending

The OCC assesses banking risk relative to its impact on capital and earnings. From a supervisory perspective, risk is the potential that events, expected or unanticipated, may have an adverse impact on the bank's capital or earnings. The OCC has defined nine categories of risk for bank supervision purposes. These risks are: Credit, Interest Rate, Liquidity, Price, Foreign Exchange, Transaction, Compliance, Strategic, and Reputation. These categories are not mutually exclusive, any product or service may expose the bank to multiple risks. For analysis and discussion purposes, however, the OCC identifies and assesses the risks separately.

The applicable risks associated with real estate and construction lending are: credit risk, interest rate risk, liquidity risk, transaction risk, and compliance risk. These are discussed more fully in the following paragraphs.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet.

Given the nature of most commercial real estate markets, the financing of commercial real estate projects is subject to an exceptionally high degree of credit risk. The limited supply of land at a given commercially attractive location, the exceptionally long economic life of the assets, the very long delivery time frames required for the development and construction of major projects, and high interest rate sensitivity have given commercial real estate markets a long history of extreme cyclical fluctuations and volatility.

In the context of commercial real estate lending, the bank's credit risk can be affected by one or more of the following risks that imperil the borrower:

- A real estate project can expose the borrower to risk from competitive market factors, such as when a property does not achieve lease-up according to plan. These competitive market factors may have their origins in overly optimistic initial projections of demand, or they may be increased by a slowing of demand during or shortly after the completion of a project. Competitive market factors can be compounded by a high volume of distressed property sales that can depress the value of other properties in that market. Investors who buy distressed property can charge lower rents, luring tenants away from competing properties and bidding rents down.

- Interest rate sensitivity of real estate investments is an important consideration when lending to the real estate industry. From the borrower's perspective, interest rates affect the cost and availability of financing, the cost of construction, and the financial viability of a real estate project. Given the floating rate of most debt and the fixed rates on many leases, increasing interest rates are detrimental to the future repayment capacity of most real estate projects. Higher interest rates also reduce the market liquidity of real estate by making alternative investments more attractive to investors. Some banks are requiring their larger commercial real estate borrowers to hedge the interest rate risk in their projects by entering into interest rate swaps or collars.

- Rollover of leases is another risk to the borrower that is present in most commercial real estate projects. Real estate markets that feature five- and ten-year leases are particularly vulnerable to declining values. In extremely depressed real estate markets, leases have commonly been broken mid-contract, as tenants went out of business or simply threatened to move out unless their leases were renegotiated. Similarly, competing owners with large inventories of empty space have been known to buy-out existing leases in order to attract tenants to their properties. The value of even fully leased buildings can decline when leases must be rolled over or extended at lower, current market rates. As expiring leases cause project cash flows to decline, the developer may become unable to meet scheduled mortgage payments.

- Commercial real estate developers must consider and plan for the risks associated with changes in their regulatory environment. Changes in zoning regulations, tax laws, and environmental regulations are examples of local and federal regulations that have had a significant effect on property values and the economic feasibility of existing and proposed real estate projects.

- A developer faces construction risk that a project will not be completed on time (or at all), or that building costs will exceed the budget and result in a project that is not economically feasible. Construction risk is discussed in more detail later is this introduction.

Interest Rate Risk

Interest rate risk is the risk to earnings or capital arising from movements in interest rates. The economic perspective focuses on the value of the bank in today's interest rate environment and the sensitivity of that value to changes in interest rates. Interest rate risk arises from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-related options embedded in bank products (options risk). The evaluation of interest rate risk must consider the impact of complex, illiquid hedging strategies or products, and also the potential impact on fee income which is sensitive to changes in interest rates. In those situations where trading is separately managed this refers to structural positions and not trading portfolios.

Most commercial real estate project financing done by banks is on a floating rate basis, so the interest rate sensitivity for the lending bank is relatively low.

Liquidity Risk

Liquidity risk is the risk to earnings or capital arising from a bank's inability to meet its obligations when they come due without incurring unacceptable losses. Liquidity risk includes the inability to manage unplanned decreases or changes in funding sources. Liquidity risk also arises from the bank's failure to recognize or address changes in market conditions that affect the ability to liquidate assets quickly and with minimal loss in value.

In the context of commercial real estate project financing, liquidity risk is a function of the bank's ability to convert the book value of its loan asset to cash. This conversion can be achieved by discounting the loan, refinancing it with another lender, or selling the project to an investor. The market liquidity risk associated with most commercial real estate project loans is high because the appraised value that the bank is lending against is usually not achieved until the project is completed and reaches a stabilized level of occupancy.

Transaction Risk

The risk to earnings or capital arising from problems with service or product delivery. This risk is a function of internal controls, information systems, employee integrity, and operating processes. Transaction risk exists in all products and services.

Banks engaged in construction lending need effective systems for monitoring the progress of construction and controlling the disbursement of loan proceeds. Ineffective systems can introduce significant operational risks. Methods of controlling the operational risks associated with these activities are discussed later in this introduction.

Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain bank products or activities of the bank’s clients may be ambiguous or untested. This risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.

Banks engaged in commercial real estate lending also expose themselves to what is commonly referred to as environmental risk. This is the risk that, under the provisions of the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), the bank may be held financially responsible for the cleanup of hazardous waste on property that it has taken as collateral.

Policies or procedures should be in place to protect the bank from liability for any environmental hazards associated with real estate that it holds as collateral. Asbestos in commercial buildings, contaminated soil and underground water supplies, or use of the property to produce or store toxic materials are only a few examples of environmental risk that may subject a bank to potential liability.

Ideally, a bank should attempt to identify environmental risks before funding a loan or offering any type of commitment to lend. If the bank discovers that it has already accepted contaminated property as collateral, however, it should monitor the situation for any adverse effects on credit risk. It should also take steps to minimize any potential liability to the bank.

A bank should seek the advice of environmental risk experts if it believes the environmental problems are serious. Expert advice can be critical when deciding whether to foreclose on a contaminated property. Expert advice also can help a bank preserve its "innocent landowner" defenses under the CERCLA.

Real Estate Loan Policy

Subpart D of 12 CFR 34 contains uniform standards for real estate lending activities. The regulation requires national banks to adopt written real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the bank and the nature and scope of its operations. The bank's board of directors must review and approve the real estate lending policy at least annually.

The regulation requires each national bank to:

- Establish loan portfolio diversification standards.
- Establish prudent underwriting standards, including loan-to-value limits, that are clear and measurable.
- Establish loan administration procedures for the real estate portfolio.

- Establish documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policy.
- Monitor conditions in the real estate market in the bank's lending area to ensure that its real estate lending policy continues to be appropriate for current market conditions.

In addition, the regulation specifies that a bank's real estate lending policy should reflect a consideration of the "Interagency Guidelines for Real Estate Lending Policies." The interagency guidelines set forth key elements of a real estate lending policy. Among them are: loan portfolio management considerations, underwriting standards, and loan administration. Because some banks engage in only limited real estate lending, it may not be necessary for all banks to address each and every item in the guidelines. Examiners should exercise their own judgment when determining whether a particular bank's real estate lending policies satisfy the requirements of the regulation. (See Appendix B.)

Loan Portfolio Management Considerations

A bank's real estate lending policy should contain a general outline of the scope and distribution of its credit facilities that is consistent with the bank's strategic plan. The policy should describe the way in which real estate loans are to be made, serviced, and collected. When formulating its loan policy, a bank should consider both internal and external factors such as:

- The size and financial condition of the bank.
- The expertise and size of the lending staff.
- The need to avoid undue concentrations of risk.
- Compliance with all applicable laws and regulations, including the Community Reinvestment Act and anti-discrimination laws.
- Market conditions.

A bank should also monitor conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to its lending decisions. Pertinent market supply and demand factors include:

- Demographic indicators, including population and employment trends.
- Zoning requirements.
- Current and projected vacancy and absorption rates.
- The volume of available space, including completed, under

construction, and new projects approved by local building authorities but not yet under construction.

- Current and projected lease terms, rental rates, and sales prices, including concessions and amenities.
- Current and projected operating expenses for different types of projects.
- Economic indicators, including trends and diversification of the market.
- Valuation trends, including discount and direct capitalization rates.

Underwriting Standards

A bank's lending policy should reflect the level of risk that is acceptable to its board of directors. Clear and measurable underwriting standards should be included in the policy to guide the lending staff when evaluating all of the credit factors associated with a loan, including:

- The capacity of the borrower, or income from the underlying property, to adequately service principal and interest on the debt. Typically, banks will establish minimum "debt service coverage" ratios) the number of times net operating income will cover annual debt service. While minimum ratio requirements will vary between banks and by type of project, they usually fall within the range of 1.05 to 1.5.
- The value of the mortgaged property.
- The overall creditworthiness of the borrower, including the demands of supporting other projects.
- The "hard equity," in the form of cash or unencumbered equity in the property, that is required to be invested by the borrower.
- Whether, and to what extent, the bank will give any credit for appreciation in the value of previously purchased land for purposes of its minimum equity requirements.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (such as guarantees, mortgage insurance, or take-out commitments).

Loan-to-Value Limits

Each bank should establish, as one component of its underwriting standards, internal loan-to-value (LTV) limits for real estate loans. These internal limits, however, should not exceed the following supervisory limits established by the "Interagency Guidelines for Real Estate Lending Policies." (See Appendix B).

Supervisory Loan-to-Value Limits

Loan Category	Loan-to-Value Limit[1]
Raw Land	65%
Land Development	75%
Construction:	
Commercial, Multifamily[2], and other Nonresidential	80%
1- to 4-Family Residential	85%[3]
Improved Property	85%
Owner-occupied 1- to 4-family and home equity	--[4]

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[1] The supervisory loan-to-value limits should be applied to the underlying property that collateralizes the loan. For loans that fund multiple phases of the same real estate project (e.g., a loan for the acquisition and development of land and the construction of an office building), the appropriate loan-to-value limit is the 80 percent limit applicable to the final phase of the project funded by the loan. However, this should not be interpreted to mean that the bank can finance 100 percent of the acquisition cost of the land. The bank should fund the loan in accordance with prudent disbursement procedures that set appropriate levels for the hard equity contributions of the borrower throughout the disbursement period and term of the loan. As a general guideline, the funding of the initial acquisition of the raw land should not exceed the 65 percent supervisory LTV; likewise, disbursements to fund the land development phase of the project should generally not exceed the 75 percent supervisory LTV.

In situations where a loan is fully cross-collateralized by two or more properties or is secured by a collateral pool of two or more properties, the appropriate maximum loan amount under supervisory loan-to-value limits is the sum of the results of each property's collateral value multiplied by the appropriate loan-to-value limit for that type of property, minus any existing senior liens associated with that property. To ensure that collateral margins remain within the supervisory limits, banks should redetermine conformity whenever collateral substitutions are made to the collateral pool.

[2] Multifamily construction includes condominiums and cooperatives.

[3] For a multiple phase 1- to 4-family residential loan where the bank is funding both the construction of the house and the permanent mortgage for a borrower who will be the owner-occupant, there is no supervisory limit. However, if the LTV equals or exceeds 90 percent, the bank should require an appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

[4] A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, the bank should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

When establishing internal loan-to-value limits, the bank should carefully consider the bank-specific and market factors discussed in the Loan Portfolio Management Considerations portion of this introduction, and other relevant factors, such as the particular subcategory or type of loan. The bank should consider establishing a lower loan-to-value limit for any subcategory of loans that exhibits greater credit risk than the overall category.

The loan-to-value ratio is only one of several pertinent credit factors to be considered when underwriting a real estate loan. Establishing these supervisory limits does not mean that loans at these levels are necessarily sound.

Loans in Excess of the Supervisory Loan-to-Value Limits

The interagency guidelines recognize that appropriate loan-to-value limits vary not only among categories of real estate loans but also among individual loans. Therefore, it may be appropriate in individual cases for a bank to originate or purchase loans with loan-to-value ratios in excess of the supervisory loan-to-value limits, based on the support provided by other credit factors. Such loans should be identified in the bank's records, and their aggregate amount reported at least quarterly to the board of directors. (Additional reporting requirements are described under the Exceptions to the General Lending Policy section of this introduction.)

The aggregate amount of all loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total capital, as defined in 12 CFR 3.2(e). Moreover, within that aggregate limit, total loans for all commercial, agricultural, multifamily, or other non-1-to-4-family residential properties should not exceed 30 percent of total capital.

When determining the aggregate amount of such loans, the bank should:

- Include all loans secured by the same property if any one of those loans exceeds the supervisory loan-to-value limits; and
- Include the recourse obligation of any such loan sold with recourse.

Conversely, a loan should no longer be reported to the directors as part of aggregate totals when a reduction in principal or senior liens, or additional contribution of collateral or equity (e.g., improvements to the real property securing the loan), bring the loan-to-value ratio into compliance with supervisory limits.

Excluded Transactions

The interagency guidelines also recognize that there are a number of lending situations in which other factors significantly outweigh the need to apply the supervisory loan-to-value limits. The following nine types of transactions are excluded:

1. Loans guaranteed or insured by the U.S. government or its agencies, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit.

2. Loans backed by the full faith and credit of a state government, provided that the amount of the assurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit.

3. Loans guaranteed or insured by a state, municipal, or local government, or an agency thereof, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit, and provided that the lender has determined that the guarantor or insurer has the financial capacity and willingness to perform under the terms of the guaranty or insurance agreement.

4. Loans that are to be sold promptly after origination, without recourse, to a financially responsible third party.

5. Loans that are renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs), or loans that are renewed, refinanced, or restructured in connection with a workout situation, either with or without the advancement of new funds, where consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery on the loan.

6. Loans that facilitate the sale of real estate acquired by the lender in the ordinary course of collecting a debt previously contracted in good faith.

7. Loans for which a lien on or interest in real property is taken as additional collateral through an abundance of caution by the lender (e.g., the bank takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral).

8. Loans, such as working capital loans, where the lender does not rely principally on real estate as security and the extension of credit is not used to acquire, develop, or construct permanent improvements on real property.

9. Loans for the purpose of financing permanent improvements to real property, but not secured by the property, if such security interest is not required by prudent underwriting practice.

Exceptions to the General Lending Policy

The lending policy should include mechanisms for considering loan requests from creditworthy borrowers whose needs fall outside the limits of the general lending policy. Requests for such exception loans should be reviewed and approved at an appropriate level within the bank. The underwriting decision should be supported by a written justification that clearly sets forth all of the relevant credit factors considered. Exception loans of a significant size should be individually reported to the board of directors.

Supervisory Review of Real Estate Lending Policies and Practices

Examiners should determine whether a bank's real estate lending policies and practices are consistent with safe and sound banking practice, satisfy the requirements of Subpart D of 12 CFR 34, and reflect an appropriate consideration of the interagency guidelines. When evaluating the adequacy of real estate lending policies and practices, examiners should consider:

- The nature and scope of the bank's real estate lending activities.
- The size and financial condition of the bank.
- The quality of management and internal controls.
- The expertise and size of the lending and loan administration staff.
- Market conditions.

Examiners should determine whether the bank is monitoring overall compliance with its real estate lending policy. Examiners also should review lending policy exception reports to determine whether exceptions to loan policy are adequately documented and appropriate in light of all of the relevant credit considerations. An excessive number of exceptions to the real estate lending policy may indicate that the bank is unduly relaxing its underwriting practices or it may suggest that the bank needs to revise its loan policy.

Appraisal and Evaluation Programs

As is true of all lending activities, a bank's primary concern should be that its real estate loans are made with a reasonable probability that the borrower will have sufficient cash flow to meet the repayment terms. However, the value of the collateral is a significant factor affecting the risk in real estate lending, so it also is essential for the bank to have adequate appraisal and evaluation programs.

Appraisals are professional judgments of the market value of real property. Professional appraisers use three approaches to estimate the market value of property) the cost approach, the market data or direct sales approach, and the income approach. (See Attachment 2 of Appendix A for a more detailed discussion of these three approaches.)

Failure to have an appraisal and evaluation program that provides an independent and objective valuation of real estate collateral is a serious weakness in a bank's credit administration system. The program should include a real estate collateral evaluation policy that:

- Incorporates prudent standards and procedures for obtaining initial and subsequent appraisals or evaluations.
- Is tailored to the bank's size and location and to the nature of its real estate-related activities.
- Establishes a means of monitoring the value of real estate collateral securing the bank's real estate loans.
- Establishes the manner in which the bank selects, evaluates, and monitors individuals who perform or review real estate appraisals and evaluations.

A bank's appraisal and evaluation program also must comply with Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989

(FIRREA). For federally related transactions, FIRREA requires the use of state licensed or certified appraisers, who are subject to effective state supervision. Appraisals must be in writing and conform with the "Uniform Standards of Professional Appraisal Practice" issued by the Appraisal Foundation. Twelve CFR 34, Subpart C) Appraisals, and the "Interagency Appraisal and Evaluation Guidelines," October 27, 1994, implement FIRREA's appraisal standards for national banks. (See Appendix E for a more detailed discussion of the appraisal guidelines).

Construction Lending

Construction lending provides a developer with funds to build improvements and time to lease or sell the space built. When properly controlled, commercial or residential construction lending can return significant profits to a bank over a relatively short period of time. Because the higher rate of return on a construction loan is indicative of the higher risks assumed, however, a bank must monitor closely its construction lending activities.

Construction loans are vulnerable to a wide variety of risks. A bank must properly assess the developer's ability to complete the construction project within specified cost and time limits. When evaluating the likelihood that a proposed construction project will be successful, a bank should be aware of the following risks:

- Failure to complete the project by the agreed take-out date voids a permanent funding commitment.
- Cost overruns occur. Cost exceeds take-out commitment or sale price. For example, inclement weather, material or labor shortages, or substandard work that must be redone to pass inspection can delay completion, increase interest expense, and cause the total cost of the project to exceed the original budget.
- Completed project is an economic failure.
- Progress payments diverted by developer. Suppliers and subcontractors' file mechanics' liens for non-payment of debts.
- General contractor files for bankruptcy before completing the project.
- Labor disputes or the failure of a major supplier or subcontractor to deliver goods and services.
- Uninsured destruction of completed work or work in process.

The four basic types of construction lending are: unsecured front-money loans, land development loans, residential construction loans, and commercial construction loans.

Unsecured Front-Money Loans

Unsecured front-money loans are working capital advances to a borrower who may be engaged in a new and unproven venture. The borrower may use the funds to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and/or meet minimum working capital requirements established by other construction lenders. Repayment of an unsecured front-money loan often comes from the first draw against a construction loan. A bank extending a front-money loan should require the construction loan agreement to permit repayment of the front-money loan on the first advance.

Since front-money lending is inherently risky, a bank should assure that it has the necessary expertise to evaluate and manage the risk prior to engaging in this type of lending. Banks should avoid unsecured front-money loans used as a developer's equity investment in a project or for initial cost overruns, since they are symptomatic of an undercapitalized or possibly inexperienced or inept builder.

Land Development Loans

Land development loans are usually a secured form of borrowing for the purpose of preparing land for future construction. They are typically used to finance the grading of a property and the installation of streets and utilities. In some cases, the loan may also finance the purchase of the land. Land development loans may be repaid from the sale of improved lots to other builders, or they may simply be rolled into a construction loan to the same borrower.

To effectively administer a land development loan, a bank should require the borrower to submit a feasibility plan that describes each step of the development. The feasibility or development plan should include all projected costs of the development, including costs for obtaining building and zoning permits, environmental impact statements, and other associated costs, such as any off-site improvements required by the local building authority.

A bank should structure the repayment program to follow the project's development or sales program. A land development loan should have sufficient spread between the amount of the loan and the estimated market value of the project to provide a margin for unforeseen expenses. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised and any collateral should be released in a manner that maintains a reasonable margin.

Banks commonly finance land development work for larger, residential tract projects in several sections or phases. This allows the bank to control the risk and ensure that an oversupply of developed lots does not occur. Release prices for the lots in the early sections of the project are set at a level that is sufficient to ensure a comfortable margin on the payout of the land development loan for the entire project. Banks commonly set lot release prices that are sufficient (typically in the range of 125 percent of the lot's loan value) to ensure that the break-even or repayment point for the entire loan is reached with the sale of about two-thirds of the total available lots in the project, or when the project has achieved no more than 80 percent of the expected net sales proceeds (usually referred to as the repayment rate).

When a land development loan to investors or speculators is unsecured, it is critical for a bank to analyze the borrower's financial statements to determine the source of repayment. Moreover, a bank should be wary of overly optimistic sales projections and avoid making loans to highly leveraged borrowers or borrowers with nonliquid net worths.

Residential Construction Loans

Residential construction loans are made on either a speculative ("spec") basis, where homes are built to be sold later in the general market, or on a pre-sold basis for a specific buyer. Banks engaged in residential construction lending should review the homebuilders/borrower's financial condition, experience, and reputation to assess the likelihood that the proposed homes will be completed.

A bank lending to residential tract builders should tailor its control procedures to the individual project. To avoid overextending the builder's capacity, the loan agreement should include a predetermined limit on the number of unsold units to be financed at any one time. On pre-sold homes, the construction

lender should review the sales contract and the buyer's permanent financing commitment.

In larger, residential tract developments that are financed and built in sections or phases, banks often require that some fixed percentage of units in the next section be under a firm sales contract before they will begin releasing funds for its development. When analyzing loans to residential tract builders, examiners should also be aware that rapid sales absorption following the opening of a new section in a development does not necessarily signal strong market acceptance. Often, the first sales in a section are the most attractive lots in the section. If the bank allows the developer to build too much inventory on the basis of these early sales, it could be left with collateral consisting mainly of less desirable, slower selling units.

Commercial Construction Loans

A bank's commercial construction lending activities can encompass a wide variety of projects ranging from apartment, condominium, and office buildings, to shopping centers and hotels. Each type of project requires a developer with special skills and expertise to successfully construct, manage, and market the project.

Commercial construction loan agreements sometimes require the borrower to have a pre-committed, permanent loan to take-out the construction lender. Such commitments, however, are usually written in a way that the permanent lender can rescind its commitment to fund the permanent loan if there are any problems with the project. A number of banks have been forced to convert their construction loans to mini-perm financing because a development project became troubled and either lost, or was unable to attract, a permanent lender.

A bank may enter into an "open-end" construction loan in which there is no pre-committed source of repayment. Open-ended construction loans entail additional risk because a bank making such a loan may be forced to provide permanent financing to the borrower, oftentimes in distressed circumstances. When evaluating the risk posed by an open-end construction loan, a bank should consider whether the completed project will be able to attract extended-term financing that can be supported by the projected net operating income from the project. Some construction lenders use a "mortgagability" analysis in assessing the risk of an open-end construction

loan. Under such an analysis, the lender uses the net operating income expected to be generated from the property when completed in determining how large an amortizing, permanent loan the property could support.

A bank should review the feasibility study for proposed construction projects, including any sensitivity and risk analyses. Such studies usually include a marketing plan for the project and information about the project's anticipated absorption rate based on estimates of future supply and demand conditions. A feasibility study is especially important when a bank is considering an open-end construction loan because repayment of the loan may depend upon the project's sales or leasing program.

One way for a bank to minimize commercial construction lending risk is to fund the construction loan after or at the same time that the developer's equity contributions have been provided. Such "stage-funding" agreements allow a bank to disburse loan funds to coincide with equity contributions at agreed-upon-intervals during the construction, marketing, and management phases of the project.

Stage funding agreements are common in syndicated commercial real estate projects. Syndicated arrangements often permit the developer to receive equity contributions from investors throughout the life of the project. If the project relies upon a syndication of investors, the bank should assess the likelihood that the syndication will be able to raise the necessary equity.

Evaluating the Borrower in a Construction Loan

Since the actual value of the real estate is questionable until the project is completed, a bank should assess the borrower's overall financial strength and development expertise, i.e., whether or not the borrower can complete the project within budget and according to the construction plans. A bank must assess the borrower's development expertise because the availability of permanent financing may be predicated upon the project being completed by a set date. Such extended-term loans, known as take-out financing agreements, are usually voidable if construction is not completed by the final funding date or the total cost exceeds the amount of the take-out, if the project does not receive occupancy permits, or if the pre-leasing or occupancy rate does not meet an agreed-upon level.

Before a construction loan agreement is entered into, a bank should investigate the character, expertise, and financial standing of all the parties

involved. A bank's documentation files should include background information concerning reputation, work and credit experience, and financial statements (preferably audited) for at least the three most recent fiscal years. Such documentation should indicate that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The bank should also contact other lenders and trade creditors to determine the financial histories of the builder and permanent lender.

If the loan has a guarantor, a bank should obtain information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors to evaluate the guarantor's financial capacity to fulfill the obligation if the borrower defaults on the loan. The bank also should investigate the number and amount of the guarantees currently extended by a guarantor to determine whether the guarantor has the financial capacity to satisfy all existing contingent claims. The bank should determine whether the guarantor previously has voluntarily honored a guarantee, as well as the marketability of any assets supporting the guarantee. Finally, since some guarantees are limited (e.g., cover interest only, or step-down in amount over the development, construction, and lease-up phases of the project), the bank should closely monitor the project for satisfactory completion and stable operations before issuing a release to the guarantor.

(The "Treatment of Guarantees in the Classification Process" is discussed in more detail in attachment 1 to Appendix A.)

Evaluating the Collateral for Construction Loans

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. Since appraised collateral values are not usually achieved until funds are fully advanced and improvements made, a bank should assure itself that the completed project will provide adequate collateral coverage of the loan.

When obtaining an appraisal or evaluation of the project, a bank should, at a minimum, obtain an "as is" market value of the property. Banks also normally request that the appraiser report the "as completed" value of the property, and its value when a stabilized level of occupancy is achieved. Appraisal projections should be accompanied by a feasibility study that

explains the effect of the planned improvements on the market value of the land. Although the feasibility study need not be incorporated into the appraisal report, the appraiser's evaluation of the study should be fully explained in the appraisal.

Documentation for Construction Loans

A bank's documentation files for construction loans should provide information on the essential details of the loan transaction, the security interest in the real estate collateral, and the take-out loan commitment, if any. These documents indicate that the bank's lending officer is obtaining the information needed to process and service the loan and to protect the bank in the event of default.

Documentation files generally include:

- Financial and background information on the borrower to substantiate the expertise and financial strength of the borrower to complete the project.

- The construction loan agreement that sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or mortgage. The loan agreement should specify the performance of each party during the entire course of construction. Any changes to the borrower's plans should be approved both by the construction lender and the take-out lender because changes can increase the cost of construction without necessarily increasing the sale price of the completed project. Alternatively, lower construction costs may not indicate a true saving, but might instead indicate that lesser quality materials or workmanship are being used.

- A recorded mortgage or deed of trust that can be used to foreclose and to obtain title to the collateral.

- A title insurance binder or policy, usually issued by a recognized title insurance company or, in some states, an attorney's opinion. The policy should be updated with each advance of funds, if such additional protection is available.

- Insurance policies and proof of premium payment as evidence that the builder has adequate and enforceable coverage, including: liability, fire, builder's special risks and, where appropriate, flood insurance.

- An appropriate appraisal or evaluation showing the market value of the property on an "as is" and "as completed" basis, and when a stabilized level of occupancy is achieved.

- Project plans, feasibility study, and construction budget showing the development plans, project costs, marketing plans, and equity contributions. The documentation should include a detailed cost breakdown for the land and "hard" construction costs, as well as the indirect or "soft" costs for the project, such as administrative costs, and architectural, engineering, and legal fees. If internal expertise is not available, the bank may need to retain an independent construction expert to review these documents to assess the reasonableness and appropriateness of the construction plans and costs.

- Property surveys, easements, and soil reports.

- The architect's certification of the plan's compliance with all applicable building codes, zoning, environmental protection and other government regulations, as well as an engineer's report on compliance with building codes and standards.

- The take-out commitment, if any, from a permanent lender and the terms of the loan. The documentation files should indicate that the bank verified the financial ability of the permanent lender to fund the take-out commitment and reviewed the take-out agreement to determine the circumstances in which it could be voided. Although documentation for take-out commitments vary, it often includes:

) The amount of the commitment.
) Details of the project being financed.
) Expiration date of the commitment.
) Standby fee requirement.
) Floor and ceiling rental rates and minimum occupancy requirements.
) An assignment of rents.
) A requirement that the construction loan is to be fully disbursed and not in any way in default at the time settlement occurs.

- The commitment agreement, sometimes referred to as the buy/sell contract or the tri-party agreement, signed by the borrower, the construction lender, and the permanent lender. The agreement prevents the permanent lender from withdrawing the take-out commitment because of unacceptable documentation. It also protects the construction lender against unforeseen events, such as the death of a principal, before the permanent loan documents are signed. The agreement provides the permanent lender with an assurance that the loan will be available at the stipulated time and usually eliminates the need for a standby fee. On occasion, the agreement may include an assignment of rents giving the permanent lender the right to receive lease payments and/or rents directly from the lessees.

- A completion or performance bond written by an insurance company.

- An owner's affidavit or a borrowing resolution, which empowers a representative of the borrower to enter into the loan agreement.

- Evidence that property taxes have been paid to date.

- Any environmental surveys deemed necessary given the location and type of project.

Documentation for Residential Construction) Tract Developments

Documentation files for construction loans on residential subdivisions (tracts) include many of the documents described above. Because future sales may be slow if financing costs to potential home buyers rise, however, some construction lenders also document that the developer has arranged for permanent financing for each house to be constructed in the subdivision. This type of take-out agreement usually takes place between the developer and a mortgage banking firm, but construction lenders may also agree to take the permanent mortgages.

A developer also might seek confirmation from the Department of Housing and Urban Development's Federal Housing Administration (FHA) and the Veterans Administration (VA) that the subdivision meets the FHA and VA building standards. This allows the developer to market the homes to individuals who wish to obtain mortgages through the FHA or VA mortgage insurance programs.

Documentation files for residential tract loans frequently contain a master note for the gross amount of the loan for the entire project and a master deed of trust covering all of the land involved in the project. The files should also include a master appraisal and economic analysis for the entire development, and an appraisal or evaluation for each type of house to be built. The economic analysis compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. The analysis should indicate that the developer's homes will be in sufficient demand given the project's location, type of home, and unit sales price.

Disbursement of Construction Loans

Banks generally disburse construction loan funds by way of a standard payment plan or a progress payment plan. Both plans should be structured so that the amount of each construction draw is commensurate with improvements made to date. The bank should not advance funds unless they are to be used solely for the project being financed and as stipulated in the draw request. Moreover, a construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project. Some states require an updated lien search and title insurance whenever construction funds are disbursed.

Standard Payment Plan

A standard payment plan is normally used for residential and smaller commercial construction loans. Because residential housing projects usually consist of houses in various stages of construction, this plan uses a pre-established schedule for fixed payments at the end of each specified stage of construction.

A standard payment plan most commonly consists of five equal installments. The first four disbursements are made when construction has reached agreed-upon-stages, verified by actual inspection of the property. The final payment is made only after the legally stipulated period for mechanics' liens has expired.

Most banks require five-payment disbursement plans for each house constructed within a tract development. As each house is completed and sold, the bank modifies its master deed of trust by releasing liability for that

particular house. Except in some workout situations, excess net sales proceeds are remitted to the borrower.

Progress Payment Plan

The progress payment plan is normally used for commercial projects. Under a progress payment plan, the bank releases funds as the borrower completes certain phases of construction. The bank normally retains, or holds back, 10 percent to 20 percent of each payment to cover project cost overruns or outstanding bills from suppliers or subcontractors.

Under a progress payment plan, the borrower requests payment from the bank in the form of a "construction draw" request or "certification of payment," which sets forth the funding request by construction phase and cost category. The borrower also certifies that the conditions of the loan agreement have been met, e.g., that all requested funds are being used for the project, and that suppliers and subcontractors are being paid. The construction draw request should include waivers from the project's subcontractors and suppliers indicating that payment has been received for the work completed. After reviewing the draw request and independently confirming the progress of work, the bank then disburses funds for construction costs incurred, less the holdback.

Final Disbursement

The final draw on a commercial construction loan usually includes payment of the holdback as stipulated in the loan agreement. The draw is used by the borrower to pay all remaining bills. Before releasing the final draw and disbursing the holdback, a bank should confirm that the borrower has obtained all waivers of liens or releases from the project's contractors, subcontractors, and suppliers. The bank also should obtain and review the final inspection report to confirm that the project is completed and meets the building specifications. The bank also should confirm that the builder has obtained a certificate of occupancy from the governing building authority.

In addition, final disbursement should not occur until the bank is assured that the construction loan can be converted to a permanent loan. For loans without a take-out commitment, the bank should satisfy itself that all conditions typically imposed by permanent lenders for that type of project have been met. If the project has a pre-committed take-out lender, the

construction lender should be sure that the construction loan documents are in order so that the permanent lender can assume the security interest in the project.

A take-out or permanent lender sometimes pays off only a portion of the construction loan because the conditional requirement for the borrower to obtain full funding has not been met. One example of a conditional requirement would be that the project attain a certain level of occupancy. Before the required level of occupancy is attained, the construction lender is subordinated to the take-out lender for the remaining balance of the construction loan. After occupancy levels are attained, the construction lender is repaid in full and the lien on the property is released.

Proper loan documentation is also essential when the project is to be purchased for cash. In this instance, the construction lender issues a release and cancels the note. For condominium projects, the construction lender may also provide the funding for marketing the individual units. The lender releases the loan on a unit-by-unit basis, similar to what occurs with a residential development construction loan.

If the commercial project is comprised of leased units, the lender must ensure that its position is protected if the builder is unable to obtain extended-term funding. A bank may require tenants to enter into subordination, attornment, and non-disturbance agreements, which protect the bank's interests in the leases by acknowledging the right of the bank to assume the landlord's position if the borrower declares bankruptcy. To ensure that the bank has full knowledge of all provisions of the lease agreements, the bank also should require tenants to sign an estoppel certificate, which is a statement of material facts or conditions that cannot be denied at a later date.

Monitoring the Progress of Construction Projects

As noted earlier, a bank must monitor the progress of the projects it is financing to ensure that the borrower's request for funds is appropriate for the particular stage of development and in accordance with the predetermined disbursement schedule. The bank must obtain accurate and timely inspection reports reflecting the status of the project and alerting it to situations where the project is not proceeding as planned.

To detect signs of financial problems in a project or with the developer, a bank periodically should review the developer's financial statements and accounts receivable and payable. The bank should review the statements to assess the liquidity, debt capacity, and cash flow of the developer. The review can help detect problems not only with the bank's own loan, but also potential funding problems arising from one of the developer's other projects. The bank also should review the borrower's major sources of cash, and ascertain whether the source is dependent upon the sale of real estate, expected infusion of outside capital, or income generated from completed projects.

Other ways to detect problems include obtaining an updated credit report on the developer to determine if there are any unpaid bills, if trade payables are being paid late, or if suits or judgments have been entered against the borrower. In many localities, banks may also access weekly legal reports and trade reports to investigate the borrower's standing. A bank should also verify tax payments to ensure that the borrower is making timely payment.

Most construction budgets include an amount that is allocated for contingencies. These amounts are intended to cover reasonable but unexpected increases in construction costs. They are typically used to cover such things as price increases in materials, or the need to pay overtime because of delays in the shipment of materials or adverse weather. Cost overruns on a project, however, may also be the result of poor job estimating. In that case, the increased cost should ordinarily be covered by the borrower rather than by a draw-down on the loan amount budgeted for contingencies.

The construction lender should also be wary of funds being misused to pay for extra costs not stipulated in the loan agreement. Examples of extra costs include rebuilding to meet specification changes not previously disclosed, starting a new project, or paying subcontractors for work performed elsewhere. The practice of "front loading," whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon. If the bank does not detect this problem in the early stages of construction, there will almost certainly be insufficient loan funds to complete construction if there is a default.

Monitoring Residential Construction Projects

In addition to periodically inspecting each house during the course of its construction, a bank should ensure that it obtains periodic reports reflecting progress on the entire project as compared to budgeted projections. These progress reports are usually provided on a monthly basis and should summarize inventory lists maintained for each section or phase of the project. The inventory lists should identify each lot number, the style of house, the release price, the sales price, and the loan balance. The inventory list should be posted daily and should indicate advances and the balance outstanding for each house, the date on which construction on each house was completed, the date each house was sold, and the date paid.

The progress report also should reflect the overall status of the project and whether advances are being made in compliance with the loan agreement. This report should indicate the number of homes under construction, their stage of construction, the number completed, the number sold during the month, and the total number under contract. Because most tract financing loan agreements restrict additional advances if the builder begins to accumulate a number of completed but unsold houses, the progress report also should age the builder's inventory.

Slow sales or excessive inventories relative to sales, excessive costs, and unprofitable operations are indications that the borrower may have difficulty repaying the loan. Other problems, such as delays in completing construction because of adverse weather conditions, usually increase project costs and could weaken the borrower's ability to repay the loan.

On an ongoing basis, a bank must also monitor the borrower's need for working capital. The analysis must cover all projects that the developer is engaged in, whether financed by the bank or not. Other unsuccessful projects could seriously weaken the developer despite a successful sales program in the development being reviewed. The bank also should monitor general economic factors that could affect the marketing and selling of residential properties in the bank's lending areas.

Monitoring Commercial Construction Projects

An established loan administration process that continually monitors each project's progress, costs, and loan advances is essential if a bank is to

effectively control its commercial construction loan program. A bank must periodically schedule physical inspections of the project and evaluate the work performed against project design and budgeted cost. Banks will often retain an independent construction consulting firm if they do not have the necessary in-house engineering, architectural, and construction expertise to perform this function.

As is the case in residential construction projects, a bank should obtain monthly reports of work completed, cost-to-date, cost-to-complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be reviewed by the construction consulting firm and approved and documented by the bank and take-out lender. A significant number of change orders could indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget.

A bank must also monitor general economic factors that could affect the success of the project upon completion. Since the development, construction, and lease-up of a commercial project can span several years, the bank must continually assess the marketability of the project and whether demand will continue to exist for the project when it is completed.

Interest Reserves

Construction loan budgets often include an interest reserve to carry the project from its origination to completion, including the projected lease-up period. When establishing the amount of interest reserves to be provided, a bank should evaluate the reasonableness of the assumptions used in the project's feasibility study, including the interest rate sensitivity analysis and the time allotted for the completion and lease-up of the project.

During the lease-up period, any income from the project should ordinarily revert to the bank and be applied to debt service before there is a draw on the interest reserve. The bank should monitor closely the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted by the borrower for other projects or for other purposes.

In some cases, the budgeted interest reserve is exhausted before the project is completed and lease-up achieved. Ideally, in this situation the borrower/guarantor should be held responsible for providing additional cash

to cover the interest payments. Where this has not been possible, rather than place the loan in nonaccrual status, some lenders have chosen to revise the budget's assumptions about stabilization of the project and "repack" the loan budget with additional interest. To avoid criticism, a decision to revise the loan budget and repack the interest reserve should be clearly supported by reasonable economic projections for the project.

Warning Signs for Problem Real Estate Loans

When evaluating the collectibility of a bank's commercial real estate portfolio, examiners should look for indicators of weakness in the real estate markets served by the bank. The examiner also should look for indications of actual or potential problems in individual real estate projects or transactions financed by the bank.

A number of indicators can help examiners evaluate the condition of real estate markets. Declining rents and/or sales prices may signal a weakness in real estate markets. In addition, permits for) and the value of) new construction, absorption rates, employment trends, and vacancy rates are useful. If these indicators show weaknesses, the real estate market could be experiencing difficulties that could result in cash flow problems for individual real estate projects, in declining real estate values and, ultimately, in troubled real estate loans.

A number of early warning signs, such as delinquency in the payment of interest, could indicate potential problems with individual real estate construction loans. Other warning signs could include:

- An excess of similar projects under construction or completed and not leased/sold.
- A pattern of increasing marketing periods or increasing concessions and declining effective rents for similar projects.
- Construction delays or other events that could lead to cost overruns that may require renegotiation of loan terms.
- A feasibility study or analysis that fails to reflect current and reasonably anticipated market conditions.
- Changes in the initial concept or plan of construction (e.g., the conversion of a condominium project to an apartment project because of unfavorable market conditions).

Other indications of potential or actual difficulties in a bank's commercial real estate portfolio may include:

- Rent concessions or sales discounts that cause the borrower to have less cash flow than projected in the original feasibility study or appraisal.
- Unusually generous concessions on finishing tenant space, moving expenses, and lease buyouts.
- Slow leasing, the lack of sustained sales activity, or sales cancellations that could reduce a project's income potential, thereby leading to protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning or road improvements.
- Tax arrearage.

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

- Loans with no or minimal borrower equity.
- Loans on speculative, undeveloped property where the borrower's only source of repayment is the sale of the property.
- Loans for commercial development projects without significant preleasing commitments and/or without commitments for permanent take-out financing.
- Loans based on land values that have been inflated by rapid turnover of ownership without any corresponding improvements to the property or supportable income projections to justify an increase in value (commonly referred to as "land flips").
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans, or development plans that are outdated or no longer viable.
- Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.

Workouts and Foreclosures

Since the full collateral value supporting a construction loan does not exist when the loan is granted, a bank must be in a position to either complete

the project or to salvage its construction advances if default occurs. Instituting litigation against a borrower to collect on a construction loan or liquidating collateral are usually last resort measures in a workout situation. Legal action is usually undesirable because legal costs can mount quickly, thereby increasing the potential loss, and bankruptcy or the lack of attachable assets may even make such action futile.

A bank should take every precaution to minimize outside attacks against collateral if default occurs. Mechanics' and materialmen's liens, tax liens, and other judgments may prevent the construction lender from being in the preferred position indicated by documents in the file. In addition, some state laws favor subcontractors (materialmen's liens, etc.) over lenders. Other states protect the construction lender to the point of first default, provided certain legal requirements have been met, such as recording a lien before the builder begins any work or arranges for the delivery of materials and supplies.

Sound workout programs begin with a complete understanding of all relevant information, as well as a realistic evaluation of the abilities of both the borrower and bank management. In some cases, a bank may determine that the most desirable and prudent course is to rollover or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who may not be in a position, at the present time, to obtain long-term financing for the loan principal. (See Appendix F for a more detailed discussion of troubled loan workouts.)

Review of Individual Loans and the Analysis of Collateral Value

The underlying reason for reviewing a commercial real estate loan is to determine the ability of the loan to be repaid. The income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms, from the borrower's other resources if necessary, are the primary factors to be considered.

When evaluating the overall risk associated with a commercial real estate loan, examiners should consider the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral. If other sources of repayment for a troubled commercial real

estate loan become inadequate, the analysis necessarily focuses on the value of the collateral.

Bank management must review the reasonableness of the assumptions and conclusions underlying each appraisal and should adjust any assumptions that appear to be too optimistic or pessimistic. For example, appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.

Examiners must evaluate collateral values by analyzing the facts, assumptions, and approaches used in the most recent appraisal (including any comments made by bank management on the value rendered by the appraiser). Examiners may make adjustments to the assessment of value under the circumstances described below. This review should only be used to help the examiner classify a credit. Examiners should not make actual adjustments to an appraisal. (The "The Valuation of Income-Producing Real Estate" is discussed in more detail in attachment 2 to Appendix A.)

A discounted cash flow analysis is appropriate for estimating the value of income-producing real estate collateral, but the analysis should not be based solely on the current performance of the collateral or similar properties. Instead, the analysis should take into account, on a discounted basis, the ability of the subject property to generate income over time based upon reasonable and supportable assumptions.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners should consider:

- Current and projected vacancy and absorption rates.
- Lease renewal trends and anticipated rents.
- Volume and trends in past due leases.
- Effective rental rates or sales prices (taking into account all concessions).
- Outstanding leases, with a summary of their terms, for the subject property.
- Net operating income of the property as compared with budget projections.
- Discount rates and direct capitalization rates.

Examiners should evaluate the capacity of a property to generate cash flow to service a loan by evaluating rents (or sales), expenses, and rates of

occupancy that are estimated to be achieved over time. A determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. If markets are depressed or reflect speculative pressures, but can be expected to return to normal (stabilized) conditions over a reasonable period of time, examiners should not simply project current levels of net operating income to determine collateral values.

Examiners should not use worst case scenarios that are unlikely to occur when adjusting appraisal assumptions for credit analysis purposes. For example, examiners should not necessarily assume that a building will become vacant simply because a tenant currently renting at above the current market rate will vacate the property when the current lease expires. It may be appropriate, however, for the examiner to adjust the collateral value if the valuation assumes renewal at the above market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and capitalization rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions. Examiners should not use exaggerated, imprudent, or unsustainably high or low discount rates, capitalization rates, and income projections.

Examiners should give a reasonable amount of deference to assumptions recently made by qualified appraisers (and, as appropriate, by bank management). Examiners should not challenge the underlying assumptions, including discount and capitalization rates, used in appraisals that differ only in a limited way from the norms that would generally be associated with the property under review. Examiners, however, can adjust the estimated value of the underlying collateral for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Cross-collateralization

It is not uncommon for a bank's loan on one property to be cross-collateralized by junior liens on one or more other properties controlled by the same borrower. Although such arrangements increase the total amount

of collateral securing the bank's loan, they can present the bank with a difficult choice. Should the borrower get into difficulty and default on the senior mortgage on any of the cross-collateralizing properties, the bank would be faced with having to increase its exposure to the borrower in order to protect its collateral interest in the property.

Classification Guidelines for Troubled Commercial Real Estate Loans

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

When evaluating commercial real estate credits for possible classification, examiners should apply the uniform classification definitions found in the Handbook section on Classification of Credits. To determine the appropriate classification, examiners should consider all information relevant to evaluating the prospects that the loan will be repaid. This includes information on the borrower's creditworthiness; the value of, and cash flow provided by all collateral supporting the loan; and any support provided by financially responsible guarantors.

The borrower's record of performance to date must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support from reliable sources for repayment.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with certain commercial real estate

markets should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled markets.

Classification of Troubled, Project-dependent Commercial Real Estate Loans

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

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss." The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcome 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, examiners may use a "doubtful" classification on the entire loan balance. This, however, should occur infrequently.

Guidelines for Classifying Partially Charged-off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When the bank has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate, however, when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance generally would be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded

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

Guidelines for Classifying Formally Restructured Loans

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

In-substance Foreclosures

Losses on real estate loans that meet the criteria for in-substance foreclosure must be recognized based on the fair value of the collateral. Such loans, however, need not be reported as "Other Real Estate Owned" unless the bank has taken possession of the underlying collateral. (See Appendix D for a more detailed discussion of in-substance foreclosures.)

Examination Objectives

1. To determine if policies, practices, procedures, and internal controls regarding loans secured by real estate are adequate.

2. To determine if bank officers are operating in conformance with the established guidelines.

3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.

4. To determine the scope and adequacy of the audit function.

5. To determine compliance with applicable laws, rulings, and regulations.

6. To assess the types and levels of risk associated with the bank's real estate lending activities and the quality of controls over those risks.

7. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws, rulings, or regulations have been noted.

1. Review previous real estate examination findings. Review bank management's response to those findings.

2. Review work performed by internal/external auditors and credit examiners including any report(s) issued.

3. Review Supervisory Strategy and Scope Memorandum issued by bank examiner-in-charge (EIC).

4. Review internal bank reports on the real estate department(s). Determine any material changes in types of products, underwriting criteria, volumes, and changes in market focus.

5. Review real estate lending policies, paying particular attention to any changes since the previous examination.

6. Based on performance of the previous steps, combined with discussions with the bank EIC and other appropriate supervisors, determine the scope of this examination. Set Examination Objectives. **Select from among the following examination procedures the necessary steps to meet those objectives. Seldom will it be necessary to perform all of the steps in an examination.**

7. Develop list of material to be requested from the bank. Give list to bank EIC for distribution to bank. Information to be requested includes:

   Essential Information

   - ☐ Loan trial balance(s).
   - ☐ Past due loans.
   - ☐ Loans in non-accrual status.
   - ☐ Loans whose terms have been modified by reducing the interest rate or principal payment, by deferring interest or principal, or by other restructuring of repayment terms.

- List of loans on which interest has been capitalized subsequent to the initial underwriting.
- List of internally adversely graded loans.
- Loans with negative amortization.
- List of rebooked charged-off loans.
- Lending policies.
- Organization chart(s) applicable to the real estate department(s).
- Resumes of management and senior staff in the real estate lending, appraisal and OREO entities.
- Copy of most recent Problem Loan Status Report on each adversely graded loan over a given amount.
- Loan commitments and other contingent accounts.

Other Information) Request only if needed

- Loans sold in full since the previous examination.
- Loans to principal shareholders, employees, officers, directors and their interests.
- Loans to officers and directors of other banks, and principal shareholders of correspondent banks.
- Miscellaneous loan debit and credit suspense accounts.
- Loans on which property taxes are delinquent or those being kept current by the bank.
- Participations purchased and sold since the previous examination.
- Each officer's lending authority.
- Current interest rate structure.
- List of loans being serviced.
- Internal management reports on loans with collateral and/or credit exceptions.
- Copies of any internal management reports used to monitor the progress and effectiveness of the appraisal process.

8. Obtain from either the examiner performing the evaluation of loan portfolio management or the bank EIC:

    - Any useful information obtained from the review of minutes of the loan and discount committee or any similar committee.
    - Reports related to real estate lending which have been furnished to the loan and discount committee or any similar committee, or the board of directors.
    - Copy of Uniform Review of Shared National Credits.

- ☐ Copy of previous examination report pages applicable to real estate lending.
- ☐ Copies of previously classified and Special Mention loan write-ups.
- ☐ List of directors, executive officers, principal shareholders, and their interests.

9. When requested information is received, verify its completeness versus the request list.

10. Obtain the loan trial balance, list of undisbursed loan proceeds and other appropriate information. Using an appropriate sampling technique, select loans to be examined in detail.

11. As examination procedures are performed, test for compliance with established policies and procedures and the existence of appropriate internal control measures (refer to the Internal Control Questionnaire as necessary). Identify any area with inadequate supervision and/or undue risk, and discuss with bank EIC the need to perform verification procedures.

12. Analyze individual commitments if the combined amount of the loan balance, if any, and the unfunded commitment exceeds the cut off or other sampling criteria.

13. Determine the disposition of loans classified or listed Special Mention at the previous examination by transcribing:

    a. Current balance(s) and payment status, or

    b. Date loan was repaid and the payment source.

14. Compare real estate credits included in the Shared National Credit (SNC) review to the sample selections to determine which are portions of SNC. For each loan identified above, transcribe appropriate information from the schedule to line sheets. Grade loan the same as was done at the SNC review. Do not do additional file work on SNC loans.

15. Determine if any previously charged-off loans have been rebooked. If so, determine that the rebooked loan(s):

a. Meets the bank policy criteria and terms for granting new loans.

b. Complies with OCC policy on these loans.

c. Is not subject to classification.

16. Transcribe information from the above schedules to the real estate line sheets, including indication of any past due or nonaccrual status.

17. Prepare real estate line sheets for any loans not in the sample that require in-depth review based on information derived from the above schedules.

18. Obtain liability and other information on common borrowers from examiners assigned cash items, overdrafts, lease financing, and other loan areas. Determine who will review the borrowing relationship.

19. Obtain all real estate line sheets from previous examinations. File previous linesheets with current linesheets on continued loan relationships.

20. Obtain bank collateral records and/or customer files and complete or update the documentation information required on the real estate line sheets.

21. Transcribe to the real estate line sheets any significant related loan and other asset balance applicable to each borrower selected in the preceding steps.

22. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Where appropriate, cross-reference line sheets to other borrowers.

23. Obtain credit files on borrowers selected in the preceding steps. Analyze those credits in detail, considering the following procedures:

    a. Analyze balance sheet, profit and loss statement, and other operating information in current and preceding financial statements. Determine the existence of any favorable or adverse trends.

- For owner-occupied buildings, concentrate analysis on the ability of the owner's overall cash flow to service all debts.
- For income-producing buildings, concentrate analysis of that building's cash flow ability to service this particular debt. Determine the debt service coverage ratio.

b. Relate items or groups of items in the current financial statement to other items or groups of items in the statement and determine the existence of any favorable or adverse ratios.

c. Review recent rent roll and leasing reports.

- Review the payment amount and status of all significant leases.
- Note any significant volume of leases that are expiring and will be renegotiated at current market rates. Analyze potential impact on future debt service coverage.
- Assess the quality and mix of tenants.

d. Review supporting information for major balance sheet items and for consolidation methods.

e. Compare the collateral's appraised value to the loan balance. Note any material change in current appraised value versus previous appraised value.

f. Determine the collateral location to ensure it is within the bank's trade area.

g. Review ownership records of the property and determine if recent sales prices and activities indicate the possibility of a land flip (multiple sales transactions between related parties within a short time to inflate the property value).

h. Determine the primary sources of repayment and evaluate their adequacy. For real estate construction loans:

- Determine that a thorough feasibility study justified the project before the bank issued a loan commitment.
- Determine if the amounts of construction loans and their estimated completion dates correspond to the amounts and

expiration dates of take-out commitments and completion bonds, if any.

- Determine the financial responsibility of the permanent lender, if any has been identified.
- Determine if properties securing construction loans that are made without benefit of take-out commitments will be readily saleable.
- Determine the repayment capacity of the borrower from other sources.
- Review the adequacy of bank management reports that are used to monitor construction progress, advances, sales, etc.
- Ascertain if inspection reports support disbursements to date.
- Determine if the undisbursed loan fund balance is sufficient to complete the project.
- Determine whether lien searches have been done to document the bank has a first lien.
- Determine if adequate hazard, builder's risk, and workman's compensation insurance is maintained.

i. Analyze support of guarantors and endorsers, if any.

j. Review compliance with loan agreement provisions.

k. Compare the interest rate charged to the bank's interest rate schedule and determine if the rates are within established parameters.

l. Compare the original amount of the loan with the lending officer's authority. Ensure the proper level of approval and reporting has been obtained.

m. Ascertain compliance with the bank's real estate loan policy.

24. For loans selected in sample(s), review appraisal reports and determine whether:

a. An appraisal was obtained at the time of origination.

b. The appraiser is qualified to value the type of property held as collateral.

c. The valuation method used is appropriate for the type of real estate held as collateral.

d. Assumptions used in determining the collateral value are well-documented and reasonable.

e. Officers have reviewed the appraisal report(s). When adjustments have been made, review those adjustments for reasonableness.

f. A new collateral appraisal or evaluation has been obtained when conditions warrant.

g. Appraisals conform to the appraisal regulation and bank policy.

h. Actual net operating income (NOI) and its components generally conform to the estimated NOI and its components from the appraisal. Investigate any significant differences.

25. For loans that do not require an appraisal:

    a. Determine that bank management has obtained a collateral evaluation.

    b. Determine the adequacy of that evaluation.

26. Review the information received and perform the following steps for:

    a. Participations purchased and sold:

        - Test participation certificates to determine the parties share in the risks and contractual payments on a pro rata basis.
        - Determine whether the books and records properly reflect the bank's asset and/or liability.
        - Determine whether the bank exercises similar controls over "loans serviced for others" as for its own loans.
        - Investigate any loans sales immediately prior to the examination to determine whether they were sold to avoid criticism during this examination.
        - Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications

and participations sold as it exercises for loans in its own portfolio.
- Determine that the bank, as a participant in a credit agented by another party, exercises similar controls over those participations purchased as it exercises for loans it has generated directly.

b. Extensions of credit to officers and directors of other banks, or principal shareholders of correspondent banks. Investigate any circumstances that may indicate preferential treatment.

c. Miscellaneous loan debit and credit suspense accounts:

- Review items for any charges or costs paid on any loan accounts.
- Discuss any large or old items with bank management.
- Perform additional procedures as required.

27. Determine the disposition of all documentation exceptions noted in the previous examination report.

28. Review paid-out construction loans that were reviewed during the previous examination. Determine the source of payment, paying particular attention to any circumstances in which the bank provided a term loan if it did not originally plan to.

29. Prepare a current list of documentation exceptions. Furnish a copy to bank management and request that management attempt to correct the deficiencies during the examination.

30. Review loans that have been identified (by either the bank or the examiners) as exceptions to any lending policy to determine if they are adequately documented and appropriate in light of all relevant credit considerations. Identify any trends in policy exceptions and assess the degree of risk in that practice.

31. Review loan grading differences with bank management and assign OCC grades to credits worked.

32. Determine compliance with applicable laws, rulings, and regulations, including:

a. 12 CFR 34, Subpart C) Appraisals

b. 12 CFR 34, Subpart D) Real Estate Lending Standards

c. 12 USC 84 and 12 CFR 32) Lending Limits:

- Obtain the basic 15 percent lending limit from the examiner assigned "Capital Accounts and Dividends."
- Determine advances or combinations of advances with aggregate balances above the limit (review 12 CFR 32.5).
- Determine applicability of the exceptions to the basic limit for each situation (review 12 CFR 32.6).

d. 12 USC 371(c)) Loans to Affiliates:

- Obtain a listing of loans to affiliates from the examiner assigned "Related Organizations."
- Compare the listing to the bank's customer liability records to determine its accuracy and completeness.

e. 18 USC 215) Commission or Gift for Procuring a Loan:

- Determine the possibility that a bank officer, director, employee, agent, or attorney may have received anything of value for procuring any extension of credit.
- Investigate any such suspected situation.

f. 2 USC 431(8)(B) and 441b) Political Contributions and Loans:

- Determine the existence of any loans in connection with any election to any political office.
- Review each such credit to determine whether it was made in accordance with applicable banking laws and regulations and in the ordinary course of business.
- Determine that each loan:

) Is made on a basis that assures repayment, evidenced by a written instrument, and subject to a due date or amortization schedule.

) Bears the usual and customary interest rate of the lending institution.

g. 12 USC 1972) Tie-in Provisions:

- Determine whether any extension of credit is conditioned upon:

) Obtaining or providing additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service.
) The customer not obtaining other credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to assure the soundness of the credit.

- Determine that loans to insiders of correspondent banks are not made on preferential terms.

h. 12 USC 375a, 12 CFR 215 and 12 USC 375b) Loans to Executive Officers, Directors, Principal Shareholders and Their Interests:

While reviewing information received from the examiner assigned "Loan Portfolio Management," including participations and loans sold:

- Test the accuracy and completeness of information about real estate loans by comparing it to the trial balance or to sampled loans.
- Review credit files to determine that required information is available.
- Determine that loans to executive officers, directors, principal shareholders or their related interests do not contain terms more favorable than those afforded other borrowers.
- Determine that loans to executive officers and principal shareholders, each combined with their respective related interests, do not exceed the limits imposed by 12 USC 84.

33. Perform appropriate procedures in the "Concentrations of Credit" program.

34. Prepare a report for the district office on all criticized participation loans that are not covered by the shared national credit program. Include the names and addresses of all participating national banks and copies of the loan write-ups.

35. Prepare a memorandum to the district office detailing those loans eligible for the shared national credit program that were not previously reviewed. Include names and addresses of all participants and the amounts of their credit. (This examination step applies only to credits where the bank under examination is the lead/agent bank).

36. Discuss with appropriate bank manager(s) and prepare summaries in report format on:

    a. Delinquent loans, including a breakout of "A" paper (bad debts as defined in 12 USC 56).

    b. Loans not supported by current and complete financial information.

    c. Loans on which documentation is deficient.

    d. Classified and Special Mention loans.

    e. Violations of laws, rulings, and regulations.

    f. If loans are listed as "loss," discuss with bank EIC the need to prepare a charge off letter.

    g. Other matters regarding the condition of the bank.

37. Prepare a memorandum to either the examiner assigned "Loan Portfolio Management" or the bank EIC stating your findings regarding:

    a. The quality of department management.

    b. The quality of loan underwriting practices.

    c. The quality of the internal loan grading.

    d. The adequacy of written policies relating to real estate lending.

e. The manner in which bank officers are operating in conformance with established policy.

f. Adverse trends within the real estate department.

g. Accuracy and completeness of the various management information systems.

h. The types and levels of risk associated with the bank's real estate lending activities and the quality of controls over those risks.

i. Commitments received from bank management to address any concerns identified.

j. Other matters of significance.

38. Upon completion of the memorandum referenced in procedure number 37, ensure that you have fully met your original examination objectives. If not, determine what needs to be done and discuss with the bank EIC the need to proceed further.

39. Provide either the examiner assigned "Loan Portfolio Management" or the bank EIC with a memorandum specifically stating what the OCC needs to do in the future to effectively supervise real estate lending in this bank. Also include estimates of the time frame, staffing, and workdays required.

The following questionnaire is provided as a tool to assist examiners in assessing the bank's internal controls, policies, practices, and procedures for making and servicing real estate loans. However, because the nature and scope of real estate lending activities differs among banks, not all of the questions will be relevant in every bank. Similarly, a negative answer to a particular question does not necessarily indicate a weakness in the bank's policies or procedures if other equally effective controls are in place or there are other circumstances that mitigate the risk.

Examiners should use their own judgment in deciding which internal control questions are relevant for a particular bank and whether a negative answer to any particular question should be a matter of supervisory concern.

Yes No

Real Estate Loan Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written real estate loan policies that are consistent with safe and sound banking practice and appropriate to the size of the bank and to the nature and scope of its operations? In particular, do the bank's policies:

   a. Identify the geographic areas in which the bank will consider lending?

   b. Establish a loan portfolio diversification policy and set limits for real estate loans by type and geographic market (e.g., limits on construction and other types of higher risk loans)?

   c. Identify appropriate terms and conditions by type of real estate loan?

d. Establish loan origination and approval procedures, both generally and by size and type of loan?

e. Establish prudent underwriting standards that are clear and measurable, including:

- The maximum loan amount by type of property?
- Maximum loan maturities by type of property?
- Amortization schedules?
- Pricing structure for different types of real estate loans?
- Loan-to-value limits that are no greater than specified in the Interagency Guidelines for Real Estate Lending Policies?

f. For development and construction projects, and completed commercial properties, do the bank's underwriting standards also establish:

- Requirements for feasibility studies and sensitivity and risk analyses (e.g., sensitivity of income projections to changes in economic variables such as interest rates, vacancy rates, or operating expenses)?
- Minimum requirements for initial investment and maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property)?
- Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property?
- Standards for the acceptability of and limits on non-amortizing loans?
- Standards for the acceptability of and limits on the financing of the borrower's soft costs on a project?
- Standards for the acceptability of and limits on the use of interest reserves?

Yes No

- Pre-leasing and pre-sale requirements for income-producing property?
- Pre-sale and minimum unit release requirements for non-income-producing property loans?
- Limits on partial recourse or nonrecourse loans and requirements for guarantor support?
- Requirements for building and loan agreements for construction loans?
- Requirements for take-out commitments?
- Minimum covenants for loan agreements?

g. Has the bank also established loan administration policies for its real estate portfolio that address:

- Documentation, including:

) Type and frequency of financial statements, including requirements for verification of information provided by the borrower?
) Type and frequency of collateral evaluations (appraisals and other estimates of value)?

- Loan closing and disbursement procedures, including the supervised disbursement of proceeds on construction loans?
- Payment processing?
- Escrow administration?
- Collateral administration, including inspection procedures for construction loans?
- Loan payoffs?
- Collections and foreclosure, including:

) Delinquency and follow-up procedures?
) Foreclosure timing?
) Extensions and other forms of forbearance?

Yes No

) Acceptance of deeds in lieu of foreclosure?

- Claims processing (e.g., seeking recovery on a defaulted loan covered by a government guaranty or insurance program)?
- Servicing and participation agreements?

2. Are procedures in effect to monitor compliance with the bank's real estate lending policies?

   a. Are exception loans of a significant size reported individually to the board of directors?

   b. Are the numbers and types of exceptions monitored so that the loan policy and lending practices can be periodically evaluated?

   c. Are loans that are in excess of the supervisory loan-to-value limits identified in the bank's records and their aggregate amount reported at least quarterly to the board of directors?

3. Does the bank monitor conditions in the real estate market in its lending area to ensure that its real estate lending policies continue to be appropriate to market conditions?

4. Are the bank's real estate lending policies reviewed and approved by the board of directors at least annually?

Appraisals and Evaluations

5. Has the bank's policy or procedures for appraisals and evaluations been approved by the board of directors?

6. Does the bank's policy or procedures provide for the monitoring of real estate collateral values for:

Yes No

a. Other real estate owned?

b. Troubled real estate loans?

c. Portfolio loans?

7. Does the bank's policy or procedures address the real estate lending engaged in by the bank and provide guidance for each category, including, for example, residential, income-producing, and construction projects?

8. Does the bank provide written instructions to the appraiser?

9. Are appraisals and evaluations required to be in writing, dated, and signed?

10. Does the bank have an internal review procedure to determine whether appraisal policies/procedures are being followed consistently and that appraisal documentation supports the appraiser's conclusions?

11. If staff appraisers are used, is their independence ensured by precluding them from the lending and collection functions?

12. If staff appraisers are used, does the bank occasionally have appraisals prepared by such staff reviewed by fee appraisers?

13. If fee appraisers are used, does the bank maintain a list of approved appraisers?

    a. Does the bank investigate the qualifications and reputations of fee appraisers before placing them on the list of approved appraisers?

Yes No

b. Does the bank periodically test appraisals to ensure that unsatisfactory fee appraisers are not being used and are removed from the list?

14. Are appraisal fees:

    a. Paid directly by the bank?

    b. The same amount regardless of whether or not the loan is granted?

15. Does the bank have procedures in place to ensure that appraisers do not have a financial or other interest in the property being appraised?

16. Are procedures in place to determine if there is a relationship between the appraiser and the borrower, or between the appraiser and an insider of the bank?

17. Is the appraiser not informed of the amount of the loan being requested?

18. Are the appraiser's underlying assumptions, including capitalization rates, future net income streams, recent sales activities, and omission of certain valuation methods required to be documented?

19. For comparable sales involving closely held entities, is the appraiser's determination that the sale was an arms-length transaction required to be documented?

20. Are procedures in place to review appraisals for reasonableness before funds are advanced?

21. For construction loans, if there is to be a take-out commitment, are appraisals also approved in writing by the permanent lender?

Yes No

(Questions 22 through 65 focus on real estate construction lending. Additional questions concerning other, generally applicable internal controls for real estate lending resume with question 66.)

Construction Loan Applications

22. Does the bank require:

    a. Detailed resumes of the contractor's and major subcontractors' construction experience, as well as other projects currently under construction?

    b. Current and historical financial statements?

    c. Trade reputation checks?

    d. Credit checks?

    e. Bonding company checks?

23. Do project cost estimates include:

    a. Land and construction costs?

    b. Off-site improvement expenses?

    c. The cost of legal services?

    d. Loan interest, supervisory fees, and insurance expenses?

24. Does the bank require an estimated cost breakdown for each construction stage?

25. Does the bank require that cost estimates of more complicated projects be reviewed by qualified personnel,

Yes No

i.e., an architect, construction engineer, or independent estimator?

26. Do cost budgets include the amount and source of the builder's and/or owner's equity contribution?

27. Are commitment fees required on approved construction loans, and if so, are computations based on interest rate structure and/or risk considerations?

28. Does bank policy require personal guarantees of construction loans by the borrowers?

Building and Loan Agreements

29. Is a building and loan agreement signed before a formal commitment or actual loan disbursement is made?

30. Is the building and loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to:

    a. Building codes?

    b. Subdivision regulations?

    c. Zoning and ordinances?

    d. Title and/or ground lease restrictions?

    e. Health regulations?

    f. Known or projected environmental protection considerations?

    g. Specifications required under the National Flood Insurance Program?

Yes No

h. Provisions in tenant leases?

i. Specifications approved by the permanent financier?

j. Specifications required by the completion bonding company and/or guarantors?

31. Does the bank require all change orders to be approved in writing by:

    a. The bank?

    b. Counsel?

    c. Permanent financier?

    d. Architect or supervising engineer?

    e. Prime tenants bound by firm leases or letters of intent to lease?

    f. Completion bonding company?

32. Does the building and loan agreement set a date for project completion?

33. Does the building and loan agreement require that:

    a. The contractor not start work until authorized to do so by the bank?

    b. On-site inspections be permitted?

    c. Disbursement of funds be made as work progresses?

Yes No

d. The bank be allowed to withhold disbursements if work is not performed in accordance with approved specifications?

e. A portion of the loan proceeds be retained pending satisfactory completion of the construction?

f. The lender be allowed to assume prompt and complete control of the project in the event of default?

g. The contractor carry builder's risk and workmen's compensation insurance?

h. Builder's risk insurance be on a non-reporting form or a reporting form that requires periodic increases in the project's value to be reported to the insurance company?

i. The bank authorize individual tract housing starts?

j. Periodic sales reports be submitted from tract developers?

k. Periodic reports on tract houses occupied under rental or lease, purchase option agreements be submitted?

l. Periodic reports on the status of any other projects in which the developer may be involved in.

Collateral

34. Does the bank place primary collateral reliance on first liens on real estate?

35. Does the bank temper the collateral reliance placed on:

Yes No

a. Ground leases?

b. Conditional sales contracts?

36. Are chattel mortgages taken on non-real estate construction improvements?

37. Does the bank require that construction loans:

a. Made without the benefit of prearranged permanent financing be limited to a percent of the completed cost or market value of the project?

b. Subject to the bank's own take-out commitment be limited to a percent of the appraised value of the completed project?

c. With a take-out commitment that is predicated upon achievement of rents or lease occupancy, be limited to the floor of such a commitment?

d. To finance land acquisition and development without prearranged permanent financing be limited to a percent of the appraised value for unimproved real estate loans?

38. Do construction loan policies preclude the issuance of standby commitments to "gap finance" projects with take-out restrictions regarding rentals or occupancy?

39. Are unsecured credit lines to contractors or developers who are also being financed by secured construction loans supervised by:

a. The construction loan department?

b. The officer supervising the construction loan?

Yes No

Inspections

40. Are inspection authorities noted in:

    a. The construction loan commitment?

    b. The building and loan agreement?

    c. Tri-party buy and sell agreement?

    d. Take-out commitment?

41. Are inspections conducted on an irregular schedule?

42. Are inspection reports sufficiently detailed to support disbursements?

43. Are inspectors rotated?

44. Are spot checks made of the inspectors' work?

45. Do inspectors determine compliance with plans and specifications as well as progress of work?

Disbursements

46. Are disbursements:

    a. Advanced on a prearranged disbursement plan?

    b. Made only after reviewing written inspection reports?

    c. Subject to advance, written authorization by the:

        - Contractor?
        - Borrower?
        - Inspector?
        - Lending officer?

Yes No

d. Reviewed by a bank employee who had no part in granting the loan?

e. Compared to original cost estimates?

f. Checked against previous disbursements?

g. Made directly to subcontractors?

h. Supported by receipted bills describing the work performed and the materials furnished?

47. Does the bank obtain waivers of subcontractors' and materialmen's liens as work is completed and disbursements made?

48. Are periodic reviews made of undisbursed loan proceeds to determine their adequacy to complete the projects?

49. Does the bank confirm that a certificate of occupancy has been obtained before final disbursement?

50. Does the bank obtain sworn and notarized releases of mechanics' liens at the time construction is completed and before final disbursement?

51. Are independent proofs made at least monthly of undisbursed loan proceeds and contingency or escrow accounts? Are statements on such accounts regularly mailed to customers?

Take-out Commitments

52. Are take-out agreements reviewed for acceptability by counsel?

Yes No

53. Are financial statements obtained and reviewed to determine the financial responsibility of permanent lenders?

54. Is a tri-party buy and sell agreement signed before the construction loan is closed?

55. Does the bank require take-out agreements to include an act of God clause, which provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

56. Does the bank accept stand-by commitments for "gap financing" of limited take-out commitments?

Completion Bonding Requirements

57. Does the bank require a completion insurance bond for all construction loans?

58. Does counsel review completion insurance bonds for acceptability?

59. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are the standards observed in all cases?

Documentation

60. Does the bank require and maintain documentary evidence of:

    a. The contractor's payment of:

        - Employee withholding taxes?
        - Builder's risk insurance?

Yes No

- Workmen's compensation insurance?
- Public liability insurance?

b. The property owner's payment of:

- Real estate taxes?
- Hazard insurance premiums?

61. Does the bank require that documentation files include:

a. Loan applications?

b. Financial statements for the:

- Borrower?
- Builder?
- Proposed prime tenant?
- Take-out lender?
- Guarantors?

c. Credit and trade checks on the:

- Borrower?
- Builder?
- Major sub-contractor?
- Proposed tenants?

d. A copy of plans and specifications?

e. A copy of the building permit?

f. A survey of the property?

g. Building and loan agreement?

h. Appraisal?

i. Up-to-date preliminary title search?

Yes No

j Mortgage?

k. Ground leases?

l. Assigned tenant leases or letters of intent to lease?

- Copies of any other legally binding agreements between the borrower and tenants?
- Reports of past due leases, including delinquent expense reimbursements?

m. Copy of take-out commitment?

n. Copy of the borrower's application to the take-out lender?

o. Tri-party buy and sell agreement?

p. Inspection reports?

q. Disbursement authorizations?

r. Undisbursed loan proceeds and contingency or escrow account reconcilements?

s. Insurance policies?

62. Does the bank employ standardized checklists to control documentation for individual files?

63. Do documentation files note all of the borrower's other loan and deposit account relationships?

64. Does the bank use tickler files that:

a. Control stage advance inspections and disbursements?

Yes No

b. Assure prompt administrative follow-up on items sent for:

- Recording?
- Attorney's opinion?
- Expert review?

65. Does the bank maintain tickler files that will give at least 30 days advance notice before expiration of:

a. Take-out commitment?

b. Hazard insurance?

c. Workmen's compensation insurance?

d. Public liability insurance?

Real Estate Loan Records

66. Is the preparation and posting of subsidiary real estate loan records performed or adequately supervised by persons who do not also:

a. Issue official checks and drafts singly?

b. Handle cash?

67. Are the subsidiary real estate loan records reconciled daily with the appropriate general ledger accounts and are reconciling items investigated by persons who do not also handle cash?

68. Are loan statements, delinquent account collection requests, and past-due notices checked to the trial balances used in reconciling real estate loan subsidiary records to general ledger amounts **and** are they handled only by persons who do not also handle cash?

Yes No

69. Are inquiries about loan balances received and investigated by persons who do not also handle cash?

70. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?

71. Is a daily record maintained summarizing note transaction details, that is, loans made, payments received, and interest collected to support applicable general ledger account entries?

72. Are frequent note and liability ledger trial balances prepared and reconciled to controlling accounts by employees who do not process or record loan transactions?

73. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?

74. Are properties under foreclosure proceedings segregated?

75. Is an overdue accounts report generated frequently? (If so, how often _____?)

Loan Interest and Commitment Fees

76. Is the preparation, addition, and posting of interest and fees records performed or adequately reviewed by, **and** any review performed by, persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

Yes No

77. Are any independent interest and fee computations made and compared, or adequately tested to initial interest records by persons who do not also:

    a. Issue official checks or drafts singly?

    b. Handle cash?

78. Are fees and other charges collected in connection with real estate loans accounted for in accordance with FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases?"

Other Areas of Interest

79. Does the bank take steps to determine whether there are any environmental hazards associated with the real estate proposed to be mortgaged?

80. When there is reason to believe that there may be serious environmental problems associated with property that it holds as collateral, does the bank:

    a. Take steps to monitor the situation so as to minimize any potential liability on the part of the bank?

    b. Seek the advice of experts, particularly in situations where the bank may be considering foreclosure on the contaminated property?

81. Are all real estate loan commitments issued in written form?

82. Are loan officers prohibited from processing loan payments?

Yes No

83. Is the receipt of loan payments by mail recorded upon receipt independently before being sent to and processed by a note teller?

84. Regarding mortgage documents:

    a. Has the responsibility for the document files been established?

    b. Does the bank utilize a check sheet to assure that required documents are received and on file?

    c. Are safeguards in effect to protect notes and other documents?

    d. Does the bank obtain a signed application form for all real estate mortgage loan requests?

    e. Are separate credit files maintained?

    f. Is there a program of systematic follow-up to determine that all required documents are received?

    g. Does a designated employee conduct a review after loan closing to determine if all documents are properly drawn, executed, and in the bank's files?

    h. Are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, cancelled and marked paid, where appropriate?

85. Regarding insurance coverage:

    a. Does the bank have a mortgage errors and omissions policy?

    b. Is there a procedure for determining that insurance premiums are current on properties securing loans?

Yes No

c. Does the bank require that the policies include a loss payable clause to the bank?

d. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?

e. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?

f. If advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

86. Are properties to which the bank has obtained title immediately transferred to the "other real estate owned" account?

87. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?

88. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?

89. Are procedures in effect to ensure compliance with the requirements of government agencies insuring or guaranteeing loans?

90. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

Conclusion

91. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant

Yes No

additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses indicated above (explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures)?

92. Based on a composite evaluation, as evidenced by the answers to the foregoing questions, internal control is considered _________ (good, medium, or bad).

1. Test the additions of the trial balances and the reconciliation of the trial balances to the general ledger, include loan commitments and other contingent liabilities.

2. Using an appropriate sampling technique, select loans from the trial balance and:

   a. Prepare and mail confirmation forms to borrowers. (Loans serviced by other institutions, either whole loans or participations, should be confirmed only with the servicing institution. Loans serviced for other institutions, either whole loans or participations, should be confirmed with the other institution and the borrower. Confirmation forms should include the borrower's name, loan number, original amount, interest rate, current loan balance, contingency and escrow account balance, and a brief description of the collateral.)

   b. After a reasonable time period, mail second requests.

   c. Follow up on any no-replies or exceptions and resolve differences.

   d. Examine notes for completeness and agree date, amount, and terms to trial balance.

   e. In the event any notes are not held at the bank, request confirmation with the holder.

   f. See that required initials of approving officer are on the note.

   g. See that the note is signed, appears to be genuine, and is negotiable.

   h. Compare collateral held in files with the description on the collateral register.

   i. List and investigate all collateral discrepancies.

j. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.

k. Request confirmation for any collateral held outside the bank.

l. Determine that each file contains documentation supporting guarantees and subordination agreements, where appropriate.

m. Determine that any required insurance coverage is adequate and that the bank is named as loss payee.

n. Review participation agreements making excerpts, when deemed necessary, for such items as rate of service fee, interest rate, retention of late charges and remittance requirements and determine whether the customer has complied.

o. Review loan agreement provisions for hold back or retention, and determine if undisbursed loan funds and/or contingency or escrow accounts are equal to retention or hold back requirements.

p. If separate reserves are maintained, determine if debit entries to those accounts are authorized in accordance with the terms of the loan agreement and if they are supported by inspection reports, certificates of completion, individual bills, or other evidence.

q. Review disbursement ledgers and authorizations, and determine if authorizations are signed in accordance with the terms of the loan agreement.

r. Agree debits in the undisbursed loan proceeds accounts to inspection reports, individual bills, or other evidence supporting disbursements.

3. Review the accrued interest accounts and:

   a. Review procedures for accounting for accrued interest and handling of adjustments.

   b. Scan accrued interest and income accounts for any unusual entries and follow up on any unusual items by tracing to initial and supporting records.

4. Obtain or prepare a schedule showing the amount of monthly interest income and the real estate loan balances at the end of each month since the last examination and:

   a. Calculate or check yield.

   b. Investigate significant fluctuations or trends.

5. Using a list of non-accruing loans, check loan accrual records to determine that interest income is not being taken.

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans[1]

March 20, 1992

Introduction

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

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

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

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

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

Examiner Review of Commercial Real Estate Loans

Loan Policy and Administration Review

As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

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

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness

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

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

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.

- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

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

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

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.[4]

Examiner Review of Individual Loans, Including the Analysis of Collateral Value

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on

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

this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower, the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral. However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.[5] However, as other sources of repayment for a troubled commercial real estate loan become trouble over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

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

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

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

[6] Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 255 (Regulation H and Y; Docket No. R-0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AB05); Department of the Treasury, Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90-1495).

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

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.[8] This approach is discussed in more detail in Attachment 2. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

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

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

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

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

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

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

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

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

Classification Guidelines

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

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3).[10] In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that

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

jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.[11]

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans[12]

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

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

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

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

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

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

Guidelines for classifying partially charged-off loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

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

Guidelines for classifying formally restructured loans

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

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

The adequacy of a depository institution's ALLL, including amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well

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

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

documented, and consistently applied analysis of the institution's loan and lease portfolio.[16]

The determination of the adequacy of the ALLL should be based upon management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient without further analysis and cannot produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should also consider other factors, including changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

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

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

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

As discussed in the previous section on classification guidelines, the value of the collateral is considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

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

Attachment 1

Treatment of Guarantees in the Classification Process

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

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

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and[2]
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

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

Considerations relating to a guarantor's willingness to repay. Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

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

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

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

Examiners also consider the economic incentives for performance from guarantors:

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

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

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

Attachment 2

The Valuation of Income-Producing Real Estate

Approaches to the Valuation of Real Estate

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

Cost Approach

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

Market Data or Direct Sales Comparison Approach

This approach examines the price of similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling price. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.

The Income Approach

The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of the property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to

disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method of valuing the property.

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

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity) not just in today's market but over time) offers the most appropriate method of valuation in the supervisory process.

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

Technical Notes

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

The Discount Rate

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

The Direct Capitalization ("Cap" Rate) Technique

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

The direct income capitalization method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. 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. That is to say, 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 appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that both the stabilized income and the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

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

Differences Between Discount and Cap Rates

When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used only 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 principle difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investments, must 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 is the annual income required by the investor, and the lower is the "cap" rate. Differences in terms and the extend of debt financing and the related costs must also be 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. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

Holding Period vs. Marketing Period

When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). The time period is sometimes referred to as the "holding period."

The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period") a term used in estimating the value of a property under the sales comparison approach and in discussions of property value when real estate is being sold. The marketing period is the length of time that may be required to sell the property in an open market.

Attachment 3
Classification Definitions[1]

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

Substandard Assets

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

Doubtful Assets

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

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.

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

Interagency Guidelines for Real Estate Lending Policies

December 1992

The agencies' regulations[1] require that each insured depository institution adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements. These guidelines are intended to assist institutions in the formulation and maintenance of a real estate lending policy that is appropriate to the size of the institution and the nature and scope of its individual operations, as well as satisfies the requirements of the regulation.

Each institution's policies must be comprehensive, and consistent with safe and sound lending practices, and must ensure that the institution operates within limits and according to standards that are reviewed and approved at least annually by the board of directors. Real estate lending is an integral part of many institutions' business plans and, when undertaken in a prudent manner, will not be subject to examiner criticism.

Loan Portfolio Management Considerations

The lending policy should contain a general outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made, serviced, and collected. In particular, the institution's policies on real estate lending should:

- Identify the geographic areas in which the institution will consider lending.
- Establish a loan portfolio diversification policy and set limits for real estate loans by type and geographic market (e.g., limits on higher risk loans).
- Identify appropriate terms and conditions by type of real estate loan.
- Establish loan origination and approval procedures, both generally and by size and type of loan.
- Establish prudent underwriting standards that are clear and measurable, including loan-to-value limits, that are consistent with these supervisory guidelines.
- Establish review and approval procedures for exception loans, including loans with loan-to-value percentages in excess of supervisory limits.

[1] The agencies have adopted a uniform rule on real estate lending. See 12 CFR Part 365, (FDIC), 12 CFR Part 208, Subpart C (FRB); 12 CFR Part 34, Subpart D (OCC); and 12 CFR 563.100-101 (OTS).

- Establish loan administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review.
- Establish real estate appraisal and evaluation programs.
- Require that management monitor the loan portfolio and provide timely and adequate reports to the board of directors.

The institution should consider both internal and external factors in the formulation of its loan policies and strategic plan. Factors that should be considered include:

- The size and financial condition of the institution.
- The expertise and size of the lending staff.
- The need to avoid undue concentrations of risk.
- Compliance with all real estate related laws and regulations, including the Community Reinvestment Act, anti-discrimination laws, and for savings associations, the Qualified Thrift Lender test.
- Market conditions.

The institution should monitor conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to its lending decisions. Market supply and demand factors that should be considered include:

- Demographic indicators, including population and employment trends.
- Zoning requirements.
- Current and projected vacancy, construction, and absorption rates.
- Current and projected lease terms, rental rates, and sales prices, including concessions.
- Current and projected operating expenses for different types of projects.
- Economic indicators, including trends and diversification of the lending area.
- Valuation trends, including discount and direct capitalization rates.

Underwriting Standards

Prudently underwritten real estate loans should reflect all relevant credit factors, including:

- The capacity of the borrower, or income from the underlying property, to adequately service the debt.
- The value of the mortgaged property.
- The overall creditworthiness of the borrower.
- The level of equity invested in the property.
- Any secondary sources of repayment.
- Any additional collateral or credit enhancements (such as guarantees, mortgage insurance or take-out commitments).

The lending policies should reflect the level of risk that is acceptable to the board of directors and provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate these credit factors. The underwriting standards should address:

- The maximum loan amount by type of property.
- Maximum loan maturities by type of property.
- Amortization schedules.
- Pricing structure for different types of real estate loans.
- Loan-to-value limits by type of property.

For development and construction projects, and completed commercial properties, the policy should also establish, commensurate with the size and type of the project or property:

- Requirements for feasibility studies and sensitivity and risk analyses (e.g., sensitivity of income projections to changes in economic variables such as interest rates, vacancy rates, or operating expenses).
- Minimum requirements for initial investment and maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property).
- Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- Standards for the acceptability of and limits on non-amortizing loans.
- Standards for the acceptability of and limits on the use of interest reserves.
- Pre-leasing and pre-sale requirements for income-producing property.
- Pre-sale and minimum unit release requirements for non- income-producing property loans.
- Limits on partial recourse or nonrecourse loans and requirements for guarantor support.
- Requirements for takeout commitments.
- Minimum covenants for loan agreements.

Loan Administration

The institution should also establish loan administration procedures for its real estate portfolio that address:

- Documentation, including:
    - Type and frequency of financial statements, including requirements for verification of information provided by the borrower.
    - Type and frequency of collateral evaluations (appraisals and other estimates of value).
- Loan closing and disbursement.
- Payment processing.
- Escrow administration.
- Collateral administration.

- Loan payoffs.
- Collections and foreclosure, including:
  -) Delinquency follow-up procedures.
  -) Foreclosure timing.
  -) Extensions and other forms of forbearance.
  -) Acceptance of deeds in lieu of foreclosure.
- Claims processing (e.g., seeking recovery on a defaulted loan covered by a government guaranty or insurance program).
- Servicing and participation agreements.

Supervisory Loan-to-Value Limits

Institutions should establish their own internal loan-to-value limits for real estate loans. These internal limits should not exceed the following supervisory limits:

Loan Category	Loan-to-Value Limit
Raw Land	65%
Land Development	75%
Construction:	
Commercial, Multifamily*, and other Nonresidential	80%
1- to 4-Family Residential	85%
Improved Property	85%
Owner-occupied 1- to 4-family and home equity	**

The supervisory loan-to-value limits should be applied to the underlying property that collateralizes the loan. For loans that fund multiple phases of the same real estate project (e.g., a loan for both land development and construction of an office building), the appropriate loan-to-value limit is the limit applicable to the final phase of the project funded by the loan; however, loan disbursements should not exceed actual development or construction outlays. In situations where a loan is fully cross-collateralized by two or more properties or is secured by a collateral pool of two or more properties, the maximum loan amount is the sum of the results of each property's collateral value multiplied by the appropriate LTV limit for that type of property, minus any existing senior liens associated with that property. To ensure that collateral margins remain within the supervisory limits, lenders should redetermine conformity whenever collateral substitutions

* Multifamily construction includes condominiums and cooperatives.

** A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied, 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

are made to the collateral pool.

In establishing internal loan-to-value limits, each lender is expected to carefully consider the institution-specific and market factors listed under "Loan Portfolio Management Considerations," as well as any other relevant factors, such as the particular subcategory or type of loan. For any subcategory of loans that exhibits greater credit risk than the overall category, a lender should consider the establishment of an internal loan-to-value limit for that subcategory that is lower than the limit for the overall category.

The loan-to-value ratio is only one of several pertinent credit factors to be considered when underwriting a real estate loan. Other credit factors to be taken into account are highlighted in the "Underwriting Standards" section above. Because of these other factors, the establishment of these supervisory limits should not be interpreted to mean that loans at these levels will automatically be considered sound.

Loans in Excess of the Supervisory Loan-to-Value Limits

The agencies recognize that appropriate loan-to-value limits vary not only among categories of real estate loans but also among individual loans. Therefore, it may be appropriate in individual cases to originate or purchase loans with loan-to-value ratios in excess of the supervisory loan-to-value limits, based on the support provided by other credit factors. Such loans should be identified in the institution's records, and their aggregate amount reported at least quarterly to the institution's board of directors. (See additional reporting requirements described under "Exceptions to the General Policy.")

The aggregate amount of all loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total capital.[2] Moreover, within the aggregate limit, total loans for all commercial, agricultural, multifamily or other non-1- to 4-family residential properties should not exceed 30 percent of total capital. An institution will come under increased supervisory scrutiny as the total of such loans approaches these levels.

In determining the aggregate amount of such loans, institutions should: (a) include all loans secured by the same property if any one of those loans exceeds the supervisory loan-to-value limits; and (b) include the recourse obligation of any such loan sold with recourse. Conversely, a loan should no longer be reported to the directors as part of aggregate totals when reduction in principal or senior liens, or additional contribution

[2] For state member banks, the term "total capital" means "total risk-based capital" as defined in Appendix A to 12 CFR Part 208. For insured state non-member banks, "total capital" refers to that term as described in Table I of Appendix A to 12 CFR Part 325. For national banks, the term "total capital" is defined at 12 CFR 3.2(e). For savings associations, the term "total capital" is defined at 12 CFR 567.5(c).

of collateral or equity (e.g., improvements to the real property securing the loan), bring the loan-to-value ratio into compliance with supervisory limits.

Excluded Transactions

The agencies also recognize that there are a number of lending situations in which other factors significantly outweigh the need to apply the supervisory loan-to-value limits. These include:

- Loans guaranteed or insured by the U.S. government or its agencies, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit.
- Loans backed by the full faith and credit of a state government, provided that the amount of the assurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit.
- Loans guaranteed or insured by a state, municipal or local government, or an agency thereof, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory loan-to-value limit, and provided that the lender has determined that the guarantor or insurer has the financial capacity and willingness to perform under the terms of the guaranty or insurance agreement.
- Loans that are to be sold promptly after origination, without recourse, to a financially responsible third party.
- Loans that are renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs), or loans that are renewed, refinanced, or restructured in connection with a workout situation, either with or without the advancement of new funds, where consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery on the loan.
- Loans that facilitate the sale of real estate acquired by the lender in the ordinary course of collecting a debt previously contracted in good faith.
- Loans for which a lien on or interest in real property is taken as additional collateral through an abundance of caution by the lender (e.g., the institution takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral).
- Loans, such as working capital loans, where the lender does not rely principally on real estate as security and the extension of credit is not used to acquire, develop, or construct permanent improvements on real property.
- Loans for the purpose of financing permanent improvements to real property, but not secured by the property, if such security interest is not required by prudent underwriting practice.

Exceptions to the General Lending Policy

Some provision should be made for the consideration of loan requests from creditworthy borrowers whose credit needs do not fit within the institution's general lending policy. An institution may provide for prudently underwritten exceptions to its lending policies, including loan-to-value limits, on a loan-by-loan basis. However, any exceptions from the supervisory loan-to-value limits should conform to the aggregate limits on such loans discussed above.

The board of directors is responsible for establishing standards for the review and approval of exception loans. Each institution should establish an appropriate internal process for the review and approval of loans that do not conform to its own internal policy standards. The approval of any such loan should be supported by a written justification that clearly sets forth all of the relevant credit factors that support the underwriting decision. The justification and approval documents for such loans should be maintained as a part of the permanent loan file. Each institution should monitor compliance with its real estate lending policy and individually report exception loans of a significant size to its board of directors.

Supervisory Review of Real Estate Lending Policies and Practices

The real estate lending policies of institutions will be evaluated by examiners during the course of their examinations to determine if the policies are consistent with safe and sound lending practices, these guidelines, and the requirements of the regulation. In evaluating the adequacy of the institution's real estate lending policies and practices, examiners will take into consideration the following factors:

- The nature and scope of the institution's real estate lending activities.
- The size and financial condition of the institution.
- The quality of the institution's management and internal controls.
- The expertise and size of the lending and loan administration staff.
- Market conditions.

Lending policy exception reports will also be reviewed by examiners during the course of their examinations to determine whether the institutions' exceptions are adequately documented and appropriate in light of all of the relevant credit considerations. An excessive volume of exceptions to an institution's real estate lending policy may signal a weakening of its underwriting practices, or may suggest a need to revise the loan policy.

Definitions

For the purposes of these Guidelines:

"Construction loan" means an extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

"Extension of credit" or "loan" means:

(1) The total amount of any loan, line of credit, or other legally binding lending commitment with respect to real property; and

(2) The total amount, based on the amount of consideration paid, of any loan, line of credit, or other legally binding lending commitment acquired by a lender by purchase, assignment, or otherwise.

"Improved property loan" means an extension of credit secured by one of the following types of real property:

(1) Farmland, ranchland or timberland committed to ongoing management and agricultural production;

(2) 1- to 4-family residential property that is not owner- occupied;

(3) Residential property containing five or more individual dwelling units;

(4) Completed commercial property; or

(5) Other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied 1- to 4-family residential property.

"Land development loan" means an extension of credit for the purpose of improving unimproved real property prior to the erection of structures. The improvement of unimproved real property may include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development.

"Loan origination" means the time of inception of the obligation to extend credit (i.e., when the last event or prerequisite, controllable by the lender, occurs causing the lender to become legally bound to fund an extension of credit).

"Loan-to-value" or "loan-to-value ratio" means the percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secures the extension of credit. The total amount of all senior liens on or interests in such property(ies) should be

included in determining the loan-to-value ratio. When mortgage insurance or collateral is used in the calculation of the loan-to-value ratio, and such credit enhancement is later released or replaced, the loan-to-value ratio should be recalculated.

"Other acceptable collateral" means any collateral in which the lender has a perfected security interest, that has a quantifiable value, and is accepted by the lender in accordance with safe and sound lending practices. Other acceptable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral. Other acceptable collateral includes, among other items, unconditional irrevocable standby letters of credit for the benefit of the lender.

"Owner-occupied," when used in conjunction with the term "1- to 4-family residential property" means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence of the owner.

"Readily marketable collateral" means insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be salable under ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions, on an auction or similarly available daily bid and ask price market. Readily marketable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral.

"Value" means an opinion or estimate, set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agency's appraisal regulations and guidance. For loans to purchase an existing property, the term "value" means the lesser of the actual acquisition cost or the estimate of value.

"1- to 4-family residential property" means property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property (when deemed to be real property under state law).

Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status

June 10, 1993

Introduction

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

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

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

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

TDR Multiple Note Structure

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

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

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

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

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

Nonaccrual Loans That Have Demonstrated Sustained Contractual Performance

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

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

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

Additional Guidance

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

Interagency Guidance on
Reporting of In-Substance Foreclosures

June 10, 1993

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

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

The Financial Accounting Standards Board (FASB) recently issued Statement No. 114 "Accounting by Creditors for Impairment of a Loan," addressing the accounting for impaired loans. This Standard also clarifies the existing accounting for in-substance foreclosures. Under the new impairment standard and related amendments to Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" (FAS 15), a collateral dependent real estate loan (i.e., a loan for which repayment is expected to be provided solely by the underlying collateral) would be reported as OREO only if the lender had taken possession of the collateral. For other collateral dependent real estate loans, loss recognition would be based on the fair value[1] of the collateral if foreclosure is probable. However, such loans would no longer be reported as OREO. Rather, they would remain in the loan category.

Accordingly, the agencies have concluded that losses[2] must be recognized on real estate loans that meet the existing ISF criteria based on the fair value of the collateral, but such loans need not be reported as OREO unless possession of the underlying collateral has been obtained. The agencies believe that this interagency guidance, coupled with other agency actions currently being taken, will reduce impediments to the availability of credit.

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

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

Interagency Appraisal and Evaluation Guidelines

October 27, 1994

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are jointly issuing these guidelines, which supersede each of the agencies' appraisal and evaluation guidelines issued in 1992.[1] These guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions.[2] Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective state supervision.

Common agency regulations[3] issued pursuant to Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) also require each regulated institution to adopt and maintain written real estate lending policies that are consistent with safe and sound banking practices and that reflect consideration of the real estate lending guidelines attached to the regulation. The real estate lending guidelines state that

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[1] FRB: "Guidelines for Real Estate Appraisal and Evaluation Programs," September 28, 1992; OCC: BC-225, "Real Estate Appraisal and Evaluation Guidelines," September 28, 1992; FDIC: FIL-69-92, "Guidelines for Real Estate Appraisals and Evaluation Programs," September 30, 1992; OTS: Thrift Bulletin 55, "Real Estate Appraisal and Evaluation Guidelines," October 13, 1992.

[2] OCC: 12 CFR Part 34, subpart C; FRB: 12 CFR 208.18 and 12 CFR 225, subpart G; FDIC: 12 CFR 323; and OTS: 12 CFR Part 564.

[3] OCC: 12 CFR 34, subpart D; FRB: 12 CFR Part 208, subpart C; FDIC: 12 CFR Part 365; and OTS: 12 CFR Parts 545 and 563.

a real estate lending program should include an appropriate real estate appraisal and evaluation program.

Supervisory Policy

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies,[4] supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:

- Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations.
- Provide for the independence of the person performing appraisals or evaluations.
- Identify the appropriate appraisal for various lending transactions.
- Establish criteria for contents of an evaluation.
- Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision.
- Assess the validity of existing appraisals or evaluations to support subsequent transactions.
- Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations.

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[4] The appraisal guidance contained in the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," November 7, 1991, generally applies to all transactions.

- Establish internal controls that promote compliance with these program standards.

Selection of Individuals Who May Perform Appraisals and Evaluations

An institution's program should establish criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. The criteria should ensure that:

- The institution's selection process is non-preferential and unbiased.
- The individual selected possesses the requisite education, expertise and competence to complete the assignment.
- The individual selected is capable of rendering an unbiased opinion.
- The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal And Evaluation Function

Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals

Although the agencies' appraisal regulations exempt certain categories of real estate-related financial transactions from the appraisal requirements, most real estate transactions over $250,000 are considered federally related transactions and thus require appraisals.[5] A "federally related transaction" means any real estate-related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.[6]

Minimum Appraisal Standards

The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must:

- Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards.

  Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise.

- Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction.

  As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.

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[5] In order to facilitate recovery in designated major disaster areas, subject to safety and soundness considerations, Section 2 of the Depository Institutions Disaster Relief Act of 1992 authorized the agencies to waive certain appraisal requirements for up to three years after a Presidential declaration of a natural disaster.

[6] As a matter of policy, OTS requires problem associations and associations in troubled condition to obtain appraisals for all real estate-related transactions over $100,000 (unless the transaction is otherwise exempt).

- Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units.

  This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.

- Be based upon the definition of market value set forth in the regulation.

  Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.

- Be performed by state-licensed or certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options

An appraiser typically uses three market value approaches to analyze the value of a property) cost, income, and comparable sales) and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal.[7] When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited

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[7] USPAP Statement on Appraisal Standards No. 7 (SMT-7)) Permitted Departure from Specific Guidelines for Real Property Appraisal, issued March 30, 1994, effective July 1, 1994.

Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value. Departure from standards designated as binding requirements is not permitted.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations

A formal opinion of market value prepared by a state-licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate

rather than an appraisal when the transaction:

- Has a value of $250,000 or less.
- Is a business loan of $1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
- Involves an existing extension of credit at the lending institution, provided that: (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

Institutions should also establish criteria for obtaining appraisals or evaluations for safety and soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content

An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should:

- Be written.
- Include the preparer's name, address, and signature, and the effective date of the evaluation.
- Describe the real estate collateral, its condition, its current and projected use;
- Describe the source(s) of information used in the analysis.
- Describe the analysis and supporting information.
- Provide an estimate of the real estate's market value, with any limiting conditions.

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations

Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use state-licensed or certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate-related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations

The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions

While the agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, an institution would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions.

Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance

An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these

reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state-licensed or certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring

The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques) even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals

Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state-licensed or certified appraiser violates USPAP, applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

Troubled Loan Workouts and Loans to Borrowers in Troubled Industries

It is important that the bank understand supervisory and reporting requirements when assessing the options available to it in working with troubled borrowers. Understanding these requirements will help the bank avoid unnecessarily restricting the availability of credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems. The OCC supports banks making loans on sound terms to creditworthy borrowers. Similarly, the OCC supports banks' efforts to develop a strategy to minimize losses on troubled loans) which frequently means working with the borrower. It is important that lack of understanding or misunderstandings about supervisory policies not adversely affect the availability of credit to sound borrowers or the prudent working out of loans to troubled borrowers.

Loan workouts can take a number of forms: simple renewal or extension of the loan terms; extension of additional credit; formal restructuring of the loan terms with or without concessions; or, in some cases, foreclosure on underlying collateral. The bank should choose the alternative that will maximize the recovery on each troubled loan.

Accurate reporting of troubled loans is also important. A bank's disclosure of its troubled loans should enable analysts and other readers of its financial statements to understand fully the effects, both positive and negative, that such loans have on the bank's financial condition and results of operations.

Loan Workouts

When a borrower becomes troubled, the bank is faced with the choice of renewing a loan it had not planned to renew, restructuring the loan, or foreclosing on the collateral. The OCC recognizes that, in many cases, the most effective way for a bank to minimize its loss on a loan to a troubled borrower may be to renew or extend the loan beyond the original plan. In other cases, it may make sense to restructure the loan terms.

As with any credit, these renewals, extensions, or restructurings must be based on sound underwriting standards and are subject to normal loan classification rules. A bank should not be criticized, however, for continuing to carry such loans as long as it has:

- A well conceived and effective workout plan for the borrower.
- Effective internal controls to manage the level of such loans.
- Classified the loan in cases where weaknesses exist.
- Properly considered the loans when determining the level of the allowance for loan and lease losses.

Troubled Debt Restructurings

In some cases the bank, recognizing that a borrower will be unable to meet the original terms of a loan, will formally renegotiate the loan in order to obtain a renewed commitment for repayment from the borrower. If a loan is renegotiated on terms that are concessionary (e.g., reduced principal or a below market interest rate) the transaction is considered to be a "troubled debt restructuring" (TDR) and must be accounted for in accordance with Statement of Financial Accounting Standards No. 15 (SFAS 15) (as amended by Statement of Financial Accounting Standards No. 114).

Restructurings should be undertaken in a way that improves the likelihood that the loan will be repaid in full. The nature and amount of concessions that are made in a TDR will depend on the nature of the loan and the financial condition of the borrower. Regulatory reporting policies and generally accepted accounting principles (GAAP) do not require banks to grant excessive concessions, forgive principal, or take other steps that are not commensurate with the borrower's ability to repay. The only concessions required in a TDR are those needed to restore the expectation of full collectibility. Charge-offs associated with TDRs should be taken prior to or at the time of the restructuring.

Regulatory reporting requirements and GAAP do not prevent banks from including contingent payment provisions in the restructured terms. For example, a bank may reduce the interest rate on a troubled loan but require the borrower to pay the bank a percentage of any gain realized if the collateral is sold. Or, the bank may require that the reduced rate will automatically revert to a market rate if the borrower meets certain profit levels. Thus, the bank can recover concessions granted during periods of economic troubles if the borrower's financial condition improves.

After a loan has been restructured, it must be analyzed in accordance with its new, restructured terms. If the lender believes that the recorded amount of the restructured loan is fully collectible, the loan can be returned to accrual status. However, before the loan is placed back on accrual, the borrower should first demonstrate the ability to perform according to the restructured terms. For example, on a loan requiring monthly payments, receipt of six payments would be evidence of the borrower's ability to perform.

However, it is not always necessary for the bank to wait an extended period of time after the restructuring before returning a restructured loan to accrual status. In some situations, the loan can return to accrual status immediately after the restructuring if the return is supported by a well documented credit evaluation of the borrower's financial condition and the prospects for full repayment. An early return to accrual status may be supported by:

- Payment performance immediately prior to the restructuring.
- Other significant factors that preclude the need for demonstrated performance.

Payment performance in accordance with the newly restructured terms is one of the most important forms of evidence used to decide whether the borrower can fully meet the restructured terms. The performance to be assessed should not be limited to that occurring after the restructuring. Performance immediately prior to the restructuring should also be considered. Often, the reduced level of debt service required on a restructured loan equals the payment the borrower was making before the restructuring. If this is the case, and the borrower is expected to be able to continue this level of performance and fully repay the new contractual amounts due, the loan can immediately return to accrual status.

Other significant factors may constitute a preponderance of evidence that the loan will be repaid in full. Those factors may be sufficient to allow the loan to return immediately to accrual status without demonstrated performance under the restructured terms. Such factors include substantial and reliable new sales, lease or rental contracts, or other important developments that significantly increase the borrower's net cash flow and debt service capacity and strengthen the borrower's commitment to repay. If such factors are not enough to eliminate entirely the need for demonstrated performance, they may reduce the period of performance otherwise considered necessary.

The return to accrual status must always be supported by well documented evidence of the borrower's financial condition and the expectation of complete repayment under the revised terms. The restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule. The amount of charge-off must be based on a good faith evaluation of collectibility and cannot be calculated simply to achieve a specified rate of interest or avoid future troubled debt disclosures. In every TDR, the bank must make a good faith evaluation of the collectibility of the new contractual principal and interest, maintain the allowance for loan and lease losses at an appropriate level, and charge off all identified losses in a timely manner.

Concentrations of Credit in Troubled Industries

Fear of regulatory criticism has caused some banks to hesitate to extend new loans or to renew existing sound loans to creditworthy borrowers in troubled industries. Concentration risk, however, is only one consideration in managing the risks associated with troubled borrowers and industries. The OCC recognizes that it may be appropriate for a bank to make additional loans, on prudent terms, in an industry where the bank has a concentration, if it has effective internal systems and controls in place to manage concentration risk.

When management believes the renewal, extension, or restructuring of credit is the best way to workout an existing troubled relationship and avoid further losses, the level of loans to that particular industry should not deter management from exercising its best judgment. Examiners should criticize a bank for failing to recognize the reality of a troubled loan but should not criticize a bank that manages a troubled loan using a well conceived and effective workout strategy.

Glossary

Glossary entries marked with an asterisk (*) are defined for purposes of the "Interagency Guidelines for Real Estate Lending Policies."

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

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

Construction loan.* An extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

Debt service coverage ratio. The number of times net operating income will cover annual debt service.

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

Extension of credit or **loan.***

(1) The total amount of any loan, line of credit, or other legally binding lending commitment with respect to real property; and

(2) The total amount, based on the amount of consideration paid, of any loan, line of credit, or other legally binding lending commitment acquired by a lender by purchase, assignment, or otherwise.

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

Improved property loan.* An extension of credit secured by one of the following types of real property:

- Farmland, ranchland, or timberland committed to ongoing management and agricultural production.
- 1- to 4-family residential property that is not owner-occupied.
- Residential property containing five or more individual dwelling units.
- Completed commercial property.
- Other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied 1- to 4-family residential property.

Land development loan.* An extension of credit for the purpose of improving unimproved real property prior to the erection of structures. The improvement of unimproved real property may include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development. Loans secured by already improved residential building lots are subject to the same 75 percent LTV as land development loans.

Loan origination.* The time of inception of the obligation to extend credit (i.e., when the last event or prerequisite, controllable by the lender, occurs causing the lender to become legally bound to fund an extension of credit).

Loan-to-value* or **Loan-to-value ratio.*** The percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable or other acceptable non-real estate collateral. The total amount of all senior liens on or interests in such property(ies) should be included in determining the loan-to-value ratio. When mortgage insurance or collateral is used in the calculation of the loan-to-value ratio, and such credit enhancement is later released or replaced, the loan-to-value ratio should be recalculated.

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

- Buyer and seller are typically motivated (i.e., motivated by self-interest).
- Both parties are well informed or well advised, and acting in what they consider their own best interests.
- A reasonable time is allowed for exposure in the open market.
- Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto.
- The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

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

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

Non-real estate collateral.* Such collateral is considered acceptable for purposes of computing the loan-to-value ratio if the following conditions are met:

- The lender has a perfected security interest.
- The collateral has a quantifiable value and is accepted by the lender in accordance with safe and sound lending practices.
- The lender has appropriately discounted the value of the collateral consistent with the lender's usual practices.
- The collateral is saleable under ordinary circumstances with reasonable promptness at market value.

For purposes of computing the loan-to-value ratio, other acceptable non-real estate collateral also includes unconditional irrevocable standby letters of credit for the benefit of the lender. The lender may not consider the general net worth of the borrower, which might be a determining factor for an unsecured loan, as an equivalent to other acceptable collateral for determining the LTV on a secured real estate loan.

1- to 4-family residential property.* Property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property (when deemed to be real property under state law).

Owner-occupied.* When used in conjunction with the term "1- to 4-family residential property," at least one unit of the real property is occupied as a principal residence of the owner.

Readily marketable collateral.* Insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be salable under ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions, on an auction or similarly available daily bid and ask price market. Readily marketable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral. Examples of readily marketable financial instruments include, stocks, bonds, debentures, commercial paper, negotiable certificates of deposit, and shares in mutual funds.

Reversion value or **Terminal value.** The lump-sum amount an investor expects to receive when an investment is sold. In the context of a real estate appraisal, reversion or terminal values represent the capitalization of all future income streams of the property after the projected occupancy level is achieved.

Value.* An opinion or estimate, set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agency's appraisal regulations and guidance. For loans to purchase an existing property, the term "value" means the lesser of the actual acquisition cost or the estimate of value.

Accounting and Official Reports

Interagency Issuances	Interagency Guidance on Reporting of In-Substance Foreclosures (June 10, 1995)
	Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status (June 10, 1993)

Appraisals and Evaluations

Regulations	12 CFR 34, Subpart C
Interagency Issuances	Interagency Appraisal and Evaluation Guidelines (October 7, 1994)

Classification of Real Estate Loans

Interagency Issuances	Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans (November 7, 1991)

Real Estate Lending (Authority)

Laws	12 USC 371
Regulations	12 CFR 34, Subpart A

Real Estate Lending (Standards)

Regulations	12 CFR 34, Subpart D
Interagency Issuances	Interagency Guidelines for Real Estate Lending Policies (December 31, 1992)