Policy Statement on
Prudent Commercial Real Estate Loan Workouts

The financial regulators[1] recognize that financial institutions face significant challenges when working with commercial real estate (CRE)[2] borrowers that are experiencing diminished operating cash flows, depreciated collateral values, or prolonged sales and rental absorption periods. While CRE borrowers may experience deterioration in their financial condition, many continue to be creditworthy customers who have the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work constructively together.

The regulators have found that prudent CRE loan workouts are often in the best interest of the financial institution and the borrower. Examiners are expected to take a balanced approach in assessing the adequacy of an institution's risk management practices for loan workout activity. Financial institutions that implement prudent CRE loan workout arrangements after performing a comprehensive review of a borrower's financial condition will not be subject to criticism for engaging in these efforts even if the restructured loans have weaknesses that result in adverse credit classification. In addition, renewed or restructured loans to borrowers who have the ability to repay their debts according to reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

I. Purpose

This statement updates and replaces existing supervisory guidance to assist examiners in evaluating institutions' efforts to renew or restructure loans to creditworthy CRE borrowers.[3] It is intended to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. This guidance addresses supervisory expectations for an institution's risk management elements for loan workout programs, loan workout arrangements, classification of loans, and regulatory reporting and accounting considerations.

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[1] The financial regulators consist of the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Financial Institutions Examination Council (FFIEC) State Liaison Committee (collectively, the regulators).

[2] Consistent with the FRB, FDIC, and OCC joint guidance and the OTS guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* (December 2006), CRE loans include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. CRE loans also include land development and construction loans (including 1- to 4-family residential and commercial construction loans), other land loans, loans to real estate investment trusts (REITs), and unsecured loans to developers. For credit unions, "commercial real estate loans" refers to "member business loans," as defined in Section 723.1 of the NCUA Rules and Regulations, secured by real estate.

[3] This statement replaces the Interagency Policy Statements on *the Review and Classification of Commercial Real Estate Loans* (November 1991) and *Review and Classification of Commercial Real Estate Loans* (June 1993).

The statement also includes references and materials related to regulatory reporting,[4] but it does not change existing regulatory reporting guidance provided in relevant interagency statements issued by the regulators or accounting requirements under generally accepted accounting principles (GAAP). These general principles also could apply to commercial loans that are secured by real property or other business assets of a commercial borrower.

Attachment 1 of this document contains examples of CRE loan workouts illustrating application of this statement to credit classification, determination of accrual versus nonaccrual status, and identification and reporting of troubled debt restructurings. Attachment 2 lists a summary of references to relevant supervisory and accounting guidance for real estate lending, appraisals, allowance for loan and lease losses (ALLL), restructured loans, fair value measurement, and regulatory reporting matters such as nonaccrual status. This statement should be used in conjunction with materials identified in Attachment 2 to reach appropriate conclusions regarding credit classification and regulatory reporting. Attachment 3 discusses valuation concepts for income producing real property.[5] Attachment 4 provides the classification definitions.

II. Risk Management Elements for Loan Workout Programs

An institution's risk management practices for renewing and restructuring[6] CRE loans should be appropriate for the complexity and nature of its lending activity and should be consistent with safe and sound lending practices and relevant regulatory reporting requirements. These practices should address:

- Management infrastructure to identify, control, and manage the volume and complexity of the workout activity
- Documentation standards to verify the borrower's financial condition and collateral values
- Adequacy of management information systems and internal controls to identify and track loan performance and risk, including concentration risk
- Management's responsibility to ensure that the regulatory reports of the institution are consistent with regulatory reporting requirements (including GAAP) and supervisory guidance
- Effectiveness of loan collection procedures
- Adherence to statutory, regulatory and internal lending limits

[4] For banks, the FFIEC Consolidated Reports of Condition and Income (FFIEC Call Report); for savings associations, the Thrift Financial Report (TFR); and for credit unions, the NCUA 5300 Call Report.

[5] Valuation concepts applied to regulatory reporting processes also should be consistent with Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures.*

[6] A restructuring involves a formal modification in the loan's terms with written and legally enforceable documentation.

- Collateral administration to ensure proper lien perfection of the institution’s collateral interests for both real and personal property
- An ongoing credit review function

III. Loan Workout Arrangements

Loan workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions. A renewal or restructuring should improve the lender’s prospects for repayment of principal and interest and be consistent with sound banking, supervisory, and accounting practices. Institutions should consider loan workouts after analyzing a borrower’s repayment capacity, evaluating the support provided by guarantors, and assessing the value of the collateral pledged on the debt. Loan workout arrangements need to be designed to help ensure that the institution maximizes its recovery potential. Further, renewed or restructured loans to borrowers who have the ability to repay their debts under reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

While institutions may enter into restructurings with borrowers that result in an adverse classification, an institution will not be criticized for engaging in loan workout arrangements so long as management has:

- A prudent workout policy that establishes appropriate loan terms and amortization schedules and that permits the institution to modify the workout plan if sustained repayment performance is not demonstrated or if collateral values do not stabilize
- A well-conceived and prudent workout plan for an individual credit that analyzes the current financial information on the borrower or guarantor and that supports the ultimate collection of principal and interest. The key elements of a workout plan include:
    - Updated and comprehensive financial information on the borrower, real estate project, and any guarantor
    - Current valuations of the collateral supporting the loan and the workout plan
    - Analysis and determination of appropriate loan structure (e.g., term and amortization schedule), curtailment, covenants, or re-margining requirements
    - Appropriate legal documentation for any changes to loan terms
- An analysis of the borrower’s global debt[7] service that reflects a realistic projection of the borrower’s and guarantor’s expenses
- The ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout

[7] Global debt represents the aggregate of a borrower’s or guarantor’s financial obligations, including contingent obligations.

- An internal loan grading system that accurately and consistently reflects the risk in the workout arrangement
- An ALLL methodology that covers estimated credit losses in the restructured loan, measured in accordance with GAAP, and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate[8]

A. ***Analyzing Repayment Capacity of the Borrower***

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

- The character, overall financial condition, resources, and payment record of the borrower
- The nature and degree of protection provided by the cash flow from business operations or the collateral on a global basis that considers the borrower's total debt obligations
- Market conditions that may influence repayment prospects and the cash flow potential of the business operations or underlying collateral
- The prospects for repayment support from any financially responsible guarantors

B. ***Evaluating Guarantees***

The support provided by guarantees is a consideration in determining the credit classification for a workout. The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation and may be sufficient to preclude classification or reduce the severity of classification. The attributes of a financially responsible guarantor include:

- The guarantor has both the financial capacity and willingness to provide support for the credit through ongoing payments, curtailments or re-margining
- The guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term
- The guarantee is written and legally enforceable

[8] Additionally, if applicable, institutions should recognize in other liabilities an allowance for estimated credit losses on off-balance sheet credit exposures related to restructured loans (e.g., loan commitments) and should reverse interest accruals on loans that are deemed uncollectible.

The institution should have sufficient information on the guarantor's global 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. This assessment includes consideration of the total number and amount of guarantees currently extended by a guarantor in order to assess whether the guarantor has the financial capacity to fulfill the contingent claims that exist.

Examiners should consider whether a guarantor has demonstrated its willingness to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. 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.

C. *Assessing Collateral Values*

As the primary sources of loan repayment decline, the importance of the collateral's value as a secondary repayment source increases in analyzing credit risk and developing an appropriate workout plan. The institution is responsible for reviewing current collateral valuations (i.e., an appraisal or evaluation) to ensure that their assumptions and conclusions are reasonable. Further, the institution should have policies and procedures that dictate when collateral valuations should be updated as part of its ongoing credit review, as market conditions change, or a borrower's financial condition deteriorates.

For CRE loans involved in a workout situation, a new or updated appraisal or evaluation, as appropriate, should address current project plans and market conditions that were considered in the development of the workout plan. The consideration should include whether there has been material deterioration in the following factors: the performance of the project; conditions for the geographic market and property type; variances between actual conditions and original appraisal assumptions; changes in project specifications (e.g., changing a planned condominium project to an apartment building); loss of a significant lease or a take-out commitment; or increases in pre-sales fallout. A new appraisal may not be necessary in instances where an internal evaluation by the institution appropriately updates the original appraisal assumptions to reflect current market conditions and provides an estimate of the collateral's fair value for impairment analysis.[9]

The market value in a collateral valuation and the fair value in an impairment analysis are based on similar valuation concepts. However, the market valuation may differ from the collateral's fair value for regulatory reporting purposes. For example, differences may result if the market value and the fair value estimates are determined as of different dates or the fair value estimate reflects different assumptions than those in the market valuation. Such situations may occur as a result of changes in market conditions and property use since the "as of" date of the appraisal.

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

The documentation on the collateral's market value should demonstrate a full understanding of the property's current "as is" condition (considering the property's highest and best use) and other relevant risk factors affecting value. Collateral valuations of commercial properties typically contain more than one value conclusion and could include an "as is" market value, a prospective "as complete" market value, and a prospective "as stabilized" market value.

The institution should use the market value conclusion (and not the fair value) that corresponds to the workout plan and the loan commitment. For example, if the institution intends to work with the borrower to get a project to stabilized occupancy, then the institution can consider the "as stabilized" market value in its collateral assessment for credit risk grading after reviewing the reasonableness of the appraisal's assumptions and conclusions. Conversely, if the institution intends to foreclose, then the institution should use the fair value (less costs to sell) of the property in its current "as is" condition in its collateral assessment.

Examiners will analyze collateral values based on the institution's original appraisal or internal evaluation, any subsequent updates, additional information, and relevant market conditions. An examiner should review the appropriateness of the major facts, assumptions, and valuation approaches in the collateral valuation and in the institution's internal credit review and impairment analysis.

If weaknesses are noted in the institution's supporting documentation or appraisal or evaluation review process, examiners should direct the institution to address the weaknesses, which may require the institution to obtain a new collateral valuation. However, if the institution is unable or unwilling to address these deficiencies in a timely manner, examiners will have to assess the degree of protection that the collateral affords in analyzing and classifying a credit. This may result in examiners making adjustments, if applicable, to the collateral's value to reflect current market conditions and events. When reviewing the reasonableness of the facts and assumptions associated with the value of an income-producing property, examiners should evaluate:

- Current and projected vacancy and absorption rates
- Lease renewal trends and anticipated rents
- Effective rental rates or sale prices, considering sales and financing concessions
- Time frame for achieving stabilized occupancy or sellout
- Volume and trends in past due leases
- Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs
- Discount rates and direct capitalization rates (refer to Attachment 3 for more information)

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

Examiners generally are not expected to challenge the underlying valuation assumptions, including discount rates and capitalization rates, used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral 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 or can support alternative assumptions.

Many CRE borrowers may have other indebtedness secured by other business assets such as furniture, fixtures, equipment, inventory, and accounts receivable. For these commercial loans, the institution should have appropriate policies and practices for quantifying the value of such assets, determining the acceptability of the collateral, and perfecting its security interest. The institution also should have appropriate procedures for ongoing monitoring of the value of its collateral interests and security protection.

IV. Classification of Loans

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 adversely classified.[10] Similarly, loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards should not be adversely classified or criticized unless well-defined weaknesses exist that jeopardize repayment.

Further, loans should not be adversely classified solely because the borrower is associated with a particular industry that is experiencing financial difficulties. When an institution's restructurings are not supported by adequate analysis and documentation, examiners are expected to exercise reasonable judgment in reviewing and determining loan classifications until such time as the institution is able to provide information to support management's conclusions and internal loan grades. Refer to Attachment 4 for the classification definitions.[11]

[10] For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system, i.e., those loans that tend to be included in the credit union's "watch lists."

[11] The NCUA does not require credit unions to adopt a uniform regulatory classification schematic of loss, doubtful, substandard or special mention. A credit union should apply an internal loan grade based on its evaluation of credit risk. The term "classify" within the credit union industry has typically meant "individually review to apply a percentage reserve" for ALLL purposes. As used in this statement, "classify" and "classification" in relation to a credit union's evaluation of a credit for risk mean "grade" and "assign a credit risk grade."

A. *Loan Performance Assessment for Classification Purposes*

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

One perspective of loan performance is based upon an assessment as to whether the borrower is contractually current on all principal and interest payments. In many cases, this definition is sufficient for a particular credit relationship and accurately portrays the status of the loan. In other cases, being contractually current on payments can be misleading as to the credit risk embedded in the loan. This situation can occur when the loan's underwriting structure or the liberal use of extensions and renewals mask credit weaknesses and obscure a borrower's inability to meet reasonable repayment terms.

For example, in many acquisition, development and constructions loans, it is common for a loan to be structured with an "interest reserve" for the construction phase of the project. The interest reserve is established at the time the loan is originated as a portion of the initial loan commitment. The lender recognizes interest income from the reserve during the construction phase. Proceeds from the sale of lots, homes, or buildings or permanent financing based on stabilized occupancy are used for the repayment of principal, which includes any draws from the interest reserve that have been capitalized into the loan balance.

However, if the development project stalls for any number of reasons and management fails to evaluate the collectibility of the loan, interest income will continue to be recognized from the initial interest reserve and capitalized into the loan balance even though the project is not generating sufficient cash flows to repay the principal. In such cases, the loan will be contractually current due to the interest payments being funded from the reserve, but the repayment of principal may be in jeopardy, especially when expected leases or sales have not occurred as projected and property values have dropped below the market value reported in the original collateral valuation. In these situations, adverse classification of the loan may be appropriate.

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

Loans to commercial borrowers can have short maturities, including short-term working capital loans to businesses, financing for CRE construction projects, or loans to finance recently completed CRE projects for the period to achieve stabilized occupancy. Many borrowers whose loans mature in the midst of an economic crisis have difficulty obtaining short-term financing or adequate sources of long-term credit due to deterioration in collateral values despite their current ability to service the debt.

In such cases, institutions may determine that the most appropriate and prudent course is to restructure or renew loans to existing borrowers who have demonstrated an ability to pay their debts, but who may not be in a position, at the time of the loan's maturity, to obtain long-term financing. The regulators recognize that prudent loan workout agreements or restructurings are generally in the best interest of both the institution and the borrower.

Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. The assessment of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. In general, renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not be subject to adverse classification, but should be identified in the institution's internal credit grading system and may warrant close monitoring. However, adverse classification of a 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.

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

As a general classification principle, for a troubled CRE loan that is dependent on the sale of the collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the market value of the real estate collateral less the costs to sell should be classified "loss." This principle applies when repayment of the debt will be provided solely by the sale of the underlying real estate collateral and there are no other available and reliable sources of repayment.[12]

The portion of the loan balance that is adequately secured by the fair value of the real estate collateral less the costs to sell generally should be adversely classified no worse than "substandard." The amount of the loan balance in excess of the fair value of the real estate collateral, or portions thereof, should be adversely classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, examiners should use a "doubtful" classification infrequently and for a limited time period to permit the pending events to be resolved.

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

Based on consideration of all relevant factors, an assessment may indicate that a credit has well-defined weaknesses that jeopardize collection in full and may result in a partial charge-off as part of a restructuring. When well-defined weaknesses exist, and a partial charge-off has been taken, the remaining recorded balance for the restructured loan generally should be classified no more severely than "substandard."

[12] In contrast, for impairment measurement purposes under GAAP, a loan is collateral dependent if repayment of the loan is expected to be provided solely by sale or operation of the underlying collateral. For further guidance on impairment measurement on impaired collateral dependent loans, see the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (December 2006).

A more severe classification than “substandard” for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined. Such situations may occur where significant risk exposures are perceived, such as a borrower’s bankruptcy or a loan collateralized by a property subject to environmental hazards.

A restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes. Lenders may separate a portion of the current outstanding debt into a new legally enforceable note (i.e., the first note) that is reasonably assured of repayment and performance according to prudently modified terms. This note may be placed back on accrual status in certain situations. In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account. The portion of the debt that is not reasonably assured of repayment (i.e., the second note) should be adversely classified and charged-off as appropriate.

In contrast, the loan should remain or be placed on nonaccrual status if the lender does not split the loan into separate notes, but internally recognizes a partial charge-off. A partial charge-off would indicate that the institution does not expect full repayment of the amounts contractually due. If facts change after the charge-off is taken such that the full amounts contractually due, including the amount charged-off, are expected to be collected and the loan has been brought contractually current, the remaining balance of the loan may be returned to accrual status without having to first receive payment of the charged-off amount.[13] The institution should have well-documented support for its credit assessment of the borrower’s financial condition and the prospects for full repayment.

V. Regulatory Reporting and Accounting Considerations

Institution management is responsible for preparing regulatory reports in accordance with GAAP and regulatory reporting requirements and supervisory guidance. Management also is responsible for establishing and maintaining an appropriate governance and internal control structure over the preparation of regulatory reports. This structure includes written policies and procedures that provide clear guidelines on accounting matters. Accurate regulatory reports are critically important to enhancing the transparency of an institution’s risk profile and financial position and imperative for effective supervision. Decisions related to loan workout arrangements may affect regulatory reporting, particularly interest accruals, troubled debt restructuring treatment, and credit loss estimates. Management should ensure that loan workout staff appropriately communicate with the accounting and regulatory reporting staff concerning the institution’s loan restructurings and that the reporting consequences of restructurings are presented accurately in regulatory reports.

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

[13] The charged-off amount should not be reversed or re-booked when the loan is returned to accrual status.

Examiners need to have a clear understanding of the differences between the credit risk management and accounting and regulatory reporting concepts (such as accrual status, restructurings, and the ALLL) when assessing the adequacy of the institution's reporting practices.[14] The following sections provide a summary of these reporting topics. However, examiners should refer to regulatory reporting instructions and guidance and applicable GAAP for further information.

A. *Implications for Interest Accrual*

For a restructured loan that is not already in nonaccrual status before the restructuring, the institution needs to consider whether the loan should be placed in nonaccrual status to ensure that income is not materially overstated. A loan that has been restructured so as to be reasonably assured of repayment and of performance according to prudent modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the loan are supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must remain in nonaccrual status.

The assessment of accrual status should include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents.[15] A restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule and does not relieve the institution from the responsibility to promptly charge off all identified losses. For more detailed criteria about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, see the FFIEC Call Report, TFR, and NCUA 5300 Call Report instructions.

B. *Restructured Loans*

The restructuring of a loan or other debt instrument should be undertaken in ways which improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. All restructured loans should be evaluated to determine whether the loan should be reported as a TDR. For reporting purposes, a restructured loan is considered a TDR when the institution, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the institution would not otherwise consider. To make this determination, the lender assesses whether (a) the borrower is *experiencing financial difficulties*, <u>and</u> (b) the lender has

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[14] These factors also apply when considering loss estimates for off-balance sheet credit exposures (e.g., loan commitments).

[15] In returning a loan to an accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account.

granted a *concession.*[16] Guidance on reporting TDRs, including characteristics of modifications, is included in the FFIEC Call Report, TFR, and NCUA 5300 Call Report instructions.

The determination of whether a restructured loan is a TDR requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a restructuring is a TDR. An overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean that the borrower is *experiencing financial difficulties*. Accordingly, lenders and examiners should use judgment in evaluating whether a modification is a TDR.

For more detailed information about determining whether a borrower is *experiencing financial difficulties* and the attributes of a *concession*, see the sources of relevant supervisory and accounting guidance listed in Attachment 2.

C. *Allowance for Loan and Lease Losses (ALLL)*

Guidance for the institution's estimate of loan losses and examiners' responsibilities to evaluate these estimates is presented in *Interagency Policy Statement on the Allowance for Loan and Lease Losses (December 2006)* and *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (July 2001)*.[17]

Institutions are required to estimate credit losses based on a loan-by-loan assessment for certain loans and on a group basis for the remaining loans in the held-for-investment loan portfolio. All loans that are reported as TDRs are deemed to be impaired and should generally be evaluated on an individual loan basis in accordance with FASB ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors*[18] and FASB ASC 310-10-35-2 through 30, *Receivables – Overall - Subsequent Measurement – Impairment*.[19] Generally, if the recorded amount of an individually assessed loan that is impaired, but is not collateral dependent, exceeds the present value of expected future cash flows, discounted at the original loan's effective interest rate, this excess is reported as a valuation allowance.

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[16] Refer to FASB ASC 310-40, *Receivables – Troubled Debt Restructurings by Creditors* and FASB ASC 470-60, *Debt – Troubled Debt Restructurings by Debtors* for the characteristics of "*experiencing financial difficulties*" and "*concession.*"

[17] Credit unions should follow interagency supervisory guidance relative to the ALLL in the financial and regulatory reporting of loans.

[18] This guidance was formerly referred to as FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings.*

[19] This guidance was formerly referred to as FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan.*

For an individually evaluated impaired collateral dependent loan, the regulators require that if the recorded amount of the loan exceeds the fair value[20] of the collateral (less costs to sell if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan), this excess is included when estimating the ALLL. However, some or all of this difference may represent a confirmed loss, which should be charged against the ALLL in a timely manner.[21] Institutions also should consider the need to recognize an allowance for estimated credit losses on off-balance sheet credit exposures, such as loan commitments, in other liabilities consistent with FASB ASC 825-10-35- 1 through 3, *Financial Instruments – Overall - Subsequent Measurement - Credit Losses on Financial Instruments with Off-Balance-Sheet Credit Risk*.[22]

For performing CRE loans, supervisory policies do not require automatic increases in the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance. However, declines in collateral values should be considered when calculating loss rates for affected groups of loans when estimating loan losses under the FASB ASC 450-20, *Loss Contingencies*.[23]

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[20] The fair value of collateral should be measured in accordance with FASB ASC 820, *Fair Value Measurements and Disclosures*. For impairment analysis purposes, the fair value of collateral should reflect the current condition of the property, not the potential value of the collateral at some future date.

[21] Purchased loans with evidence of deterioration in credit quality since the origination of the loan, loans held for sale, and loans accounted for under the fair value option are subject to different accounting rules than originated loans that are accounted for at their amortized cost. When reviewing these other types of loans, examiners should understand the implications of other accounting rules when determining whether a loan is a TDR, what amount should be reported as a TDR, and how to estimate an associated credit loss for a TDR.

[22] This guidance was formerly included in American Institute of Certified Public Accountants Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others.*

[23] This guidance was formerly referred to as FASB Statement No. 5, *Accounting for Contingencies.*

Attachment 1
Examples of CRE Loan Workouts

The following examples are provided for illustrative purposes only and are designed to demonstrate the examiner's analytical thought process to identify appropriate classification, implications for interest accrual, and whether a loan should be reported as a troubled debt restructuring (TDR) for regulatory reporting purposes.[24] Although not discussed in the illustrations below, examiners also need to consider the adequacy of the lender's supporting documentation, internal analysis, and business decision to enter into a loan workout arrangement and its effect on the allowance for loan and lease losses (ALLL), including any impairment measurements, and subsequent reporting requirements related to the loan.

Examiners should use caution when applying these examples to "real-life" situations because all facts and circumstances should be considered and judgment should be exercised before reaching conclusions related to credit classifications, accrual versus nonaccrual status, and TDR reporting.[25] The determination of whether a loan modification is a TDR requires consideration of all of the facts and circumstances surrounding the modification. No single factor, by itself, is determinative of whether a modification is a TDR. To make this determination, the lender assesses whether (a) the borrower is *experiencing financial difficulties*, <u>and</u> (b) the lender has granted a *concession.* For purposes of these examples, if the borrower was not *experiencing financial difficulties*, the example does not assess whether a *concession* was granted. However, in distressed markets, lenders may make *concessions* because borrowers are *experiencing financial difficulties*. Accordingly, lenders and examiners should exercise judgment in evaluating whether a restructuring is a TDR.

A. *Income Producing Property – Office Building*

BASE CASE: A lender originated a $15 million loan for the purchase of an office building with monthly payments based on an amortization of 20 years and a balloon payment of $13.6 million at the end of year three. At origination, the loan had a 75 percent loan-to-value (LTV) based on an appraisal reflecting a $20 million market value on an "as stabilized" basis, a debt service coverage ratio of 1.35x, and a market interest rate. The lender expected to renew the loan when the balloon payment became due at the end of year three. The project's cash flow has declined, as the borrower granted rental concessions to existing tenants in order to retain the tenants and compete with other landlords in a weak economy.

SCENARIO 1: At maturity, the lender renewed the $13.6 million loan at a market rate of interest that provides for the incremental credit risk and amortized the principal over the remaining 17 years. The borrower had not been delinquent on prior payments and has sufficient cash flow to service the market rate terms at a debt service coverage ratio of 1.12x.

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[24] The regulators believe that the accrual and TDR treatments in these illustrations fall within the range of acceptable practices under GAAP.

[25] In addition, estimates of the fair value of collateral for regulatory reporting purposes require the use of judgment and should be consistent with FASB ASC 820, *Fair Value Measurements and Disclosures*; see Attachment 2.

A review of the leases reflects the majority of tenants are now stable occupants with long-term leases and sufficient cash flow to pay their rent. A recent appraisal reported an "as stabilized" market value of $13.1 million for the property, reflecting an increase in market capitalization rates, which results in a 104 percent LTV.

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

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

TDR Treatment: The lender determined that the renewed loan should not be reported as a TDR. While the borrower is experiencing some financial deterioration, the borrower has sufficient cash flow to service the debt and has no record of payment default; therefore, the borrower is not *experiencing financial difficulties.* The examiner concurred with the lender's TDR treatment.

SCENARIO 2: At maturity, the lender renewed the $13.6 million loan at a market rate of interest that provides for the incremental risk and amortized the principal over the remaining 17 years. The borrower had not been delinquent on prior payments. The building's net operating income has decreased and current cash flow to service the new loan has declined, resulting in a debt service coverage ratio of 1.12x. Some of the leases are coming up for renewal and additional rental concessions may be necessary to keep the existing tenants in a weak economy. However, the project's debt service coverage is not expected to drop below 1.05x. A current valuation has not been ordered. The lender estimates the property's current "as stabilized" market value is $14.5 million, which results in a 94 percent LTV. In addition, the lender has not asked the borrower to provide current financial statements to assess the borrower's ability to service the debt with cash from other sources.

Classification: The lender internally graded the loan pass and is monitoring the credit. The examiner disagreed with the internal grade and listed the credit as special mention. While the borrower has the ability to continue to make payments, there has been a declining trend in the property's income stream, continued potential rental concessions, and a reduced collateral margin. In addition, the lender's failure to request current financial information and to obtain an updated collateral valuation represents administrative deficiencies.

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

TDR Treatment: The lender determined that the renewed loan should not be reported as a TDR. While the borrower is experiencing some financial deterioration, the borrower is not *experiencing financial difficulties* as the borrower has sufficient cash flow to service the debt, and there was no history of default. The examiner concurred with the lender's TDR treatment.

SCENARIO 3: At maturity, the lender restructured the $13.6 million loan on a 12-month interest-only basis at a below market rate of interest. The borrower has been sporadically delinquent on prior payments and projects a debt service coverage ratio of 1.12x based on the preferential terms. A review of the leases, which were available to the lender at the time of the restructuring, reflects the majority of tenants have short-term leases and that some were behind on their rental payments to the borrower. According to the lender, this situation has not improved since the restructuring. A recent appraisal reported a $14.5 million "as stabilized" market value for the property, which results in a 94 percent LTV.

Classification: The lender internally graded the loan pass and is monitoring the credit. The examiner disagreed with the internal grade due to the borrower's limited ability to service a below market rate loan on an interest-only basis, sporadic delinquencies, and the reduced collateral position, and classified the loan substandard.

Nonaccrual Treatment: The lender maintained the loan on accrual status due to the positive cash flow and collateral margin. The examiner did not concur with this treatment because the loan was not restructured with reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced estimate of cash flow from the property indicates that full repayment of principal and interest is not reasonably assured.

TDR Treatment: The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*: the project's ability to generate sufficient cash flows to service the debt is questionable, the lease income from the tenants is declining, loan payments have been sporadic, and collateral values have declined. In addition, the lender granted a *concession* (i.e., reduced the interest rate to a below market level and deferred principal payments). The examiner concurred with the lender's TDR treatment.

B. *Income Producing Property – Shopping Mall*

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

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

Due to weak economic conditions, the property only reached a 55 percent occupancy level at the end of the12-month lease up period and the original takeout commitment became void. Mainly due to a tightening of credit for these types of loans, the borrower is unable to obtain permanent financing elsewhere when the loan matured in February (i.e., due to market factors and not due to the borrower's financial condition).

SCENARIO 1: The lender renewed the loan for an additional year to allow for a higher lease-up rate and for the borrower to seek permanent financing. The extension is at a market rate that provides for the incremental credit risk and on an interest-only basis. While the property's historical cash flow was insufficient at 0.92x debt service ratio, recent improvements in the occupancy level now provides adequate coverage. Recent improvements include the signing of several new leases with other leases currently being negotiated.

In addition, current financial statements reflect that the builder, who personally guarantees the debt, has sufficient cash on deposit at the lender plus other liquid assets. These assets provide sufficient cash flow to service the borrower's global debt service requirements on a principal and interest basis, if necessary. The guarantor covered the initial cash flow shortfalls from the project and provided a good faith principal curtailment of $200,000 at renewal. A recent appraisal on the shopping mall reports an "as is" market value of $10 million and an "as stabilized" market value $11 million.

Classification: The lender internally graded the loan as a pass and is monitoring the credit. The examiner agreed with the lender's internal loan grade. The examiner concluded that the project continues to progress and now cash flows the interest payments. The guarantor currently has the ability and demonstrated willingness to supplement the project's cash flow and service the borrower's global debt service requirements. The examiner concurred that the interest-only terms were reasonable because the renewal was short-term and the project and the guarantor have demonstrated repayment capacity. In addition, this type of loan structure is commonly used to allow a project to achieve stabilized occupancy, but any subsequent loan terms should likely have a principal amortization component. The examiner also agreed that the LTV should be based on the "as stabilized" market value as the lender is financing the project through the lease-up period.

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

TDR Treatment: The lender concluded that while the borrower has been affected by declining economic conditions, the level of deterioration does not warrant TDR treatment. The borrower was not *experiencing financial difficulties* because the borrower and guarantor have the ability to service the renewed loan, which was prudently underwritten at a market rate of interest, plus the borrower's other obligations on a timely basis, and the lender's expectation to collect the full amount of principal and interest from the borrower's or guarantor's sources (i.e., not from interest reserves). The examiner concurred with the lender's rationale and TDR treatment.

SCENARIO 2: The lender restructured the loan on an interest-only basis at a below market rate for one year to provide additional time to increase the occupancy level and thereby enable the borrower to arrange permanent financing. The level of lease-up remains relatively unchanged at 55 percent and the shopping mall projects a debt service coverage ratio of 1.02x based on the preferential loan terms. At the time of the restructuring, the lender inappropriately based the selection of the below market interest rate on outdated financial information, which resulted in a positive cash flow projection even though file documentation available at the time of the restructuring reflected that the borrower anticipates the shopping mall's income stream will decline due to rent concessions, the loss of a tenant, and limited prospects for finding new tenants.

Current financial statements indicate the builder, who personally guarantees the debt, is highly leveraged, has limited cash or liquid assets, and has other projects with delinquent payments. A recent appraisal on the shopping mall reports an "as is" market value of $9 million, which results in a LTV ratio of 111 percent.

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

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

TDR Treatment: The lender reported the restructured loan as a TDR because (a) the borrower is *experiencing financial difficulties* as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe; and (b) the lender granted a *concession* as evidenced by the reduction in the interest rate to a below market rate. The examiner concurred with the lender's TDR treatment.

SCENARIO 3: Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this credit. The lender chose not to restructure the $10 million loan into a new single amortizing note of $10 million at a market rate of interest because the project's projected cash flow would only provide a 0.88x debt service coverage ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reported an "as is" market value of $9 million, which results in a LTV of 111 percent.

Therefore, at the original loan's maturity in February, the lender restructured the $10 million debt into two notes. The lender placed the first note of $7.2 million (i.e., the A note) on monthly payments that amortize the debt over 20 years at a market rate of interest that provides for the incremental credit risk. The project's debt service coverage ratio equals 1.20x for the $7.2 million loan based on the shopping mall's projected net operating income. The lender placed the second note of the remaining principal balance of $2.8 million (i.e., the B note) into a 2 percent interest-only loan that is scheduled to reset in five years to an amortizing payment. The lender then charged-off the $2.8 million note due to the project's lack of repayment capacity and to provide reasonable collateral protection for the remaining on-book loan of $7.2 million. Since the restructuring, the borrower has made payments on both loans for more than six consecutive months.

Classification: The lender internally graded the on-book loan of $7.2 million as a pass credit due to the fact that the borrower has demonstrated the ability to perform under the modified terms. The examiner agreed with the lender's grade as the lender restructured the original obligation into A and B notes, the lender charged off the B note, and the borrower has demonstrated the ability to repay the A note. Using this multiple note structure with the charge-off of the B note enables the lender to recognize interest income and limit the amount reported as a TDR in future periods. If the lender had restructured the loan into a single note, the credit classification and the nonaccrual and TDR treatments would have been different.

Nonaccrual Treatment: The lender restored the on-book loan of $7.2 million to accrual status as the borrower has the ability to repay the loan, has a record of performing at the revised terms for more than six months, and full repayment of principal and interest is expected. The examiner concurred with the lender's accrual treatment. Interest payments received on the off-book loan have been recorded as recoveries because, in this case, full recovery of principal and interest on this loan was not reasonably assured.

TDR Treatment: The lender reported the restructured on-book loan of $7.2 million as a TDR. The lender determined that the on-book loan should be reported as a TDR, consistent with the regulatory reporting guidance because (a) the borrower is *experiencing financial difficulties* as evidenced by the borrower's high leverage, delinquent payments on other projects, and failure to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe and the unlikely collectibility of the charged-off loan; and (b) the lender granted a *concession*. The concessions included a below market interest rate and protracted payment requirements on the charged-off portion of the debt and extending the on-book loan beyond expected timeframes.

If the borrower continues to perform according to the modified terms of the restructured loan, the lender plans to stop reporting the on-book loan as a TDR after the regulatory reporting defined time period expires because it was restructured with a market rate of interest. For example, since the restructuring occurred in February, the $7.2 million on-book loan should be reported as a TDR on the lender's March, June, September, and December regulatory reports. The TDR reporting could cease on the lender's following March regulatory report if the borrower continues to perform according to the modified terms. The examiner concurred with this planned treatment.

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

Classification: The lender internally graded the remaining $9 million on-book portion of the loan as a pass credit because the lender's analysis of the project's cash flow indicated a 1.05x debt service coverage ratio when just considering the on-book balance. The examiner disagreed with the internal grade and classified the $9 million on-book balance as substandard due to the borrower's marginal financial condition, lack of guarantor support, and uncertainty over the source of repayment.

Nonaccrual Treatment: The lender maintained the remaining $9 million on-book portion of the loan on accrual, as the borrower has the ability to repay the principal and interest on this balance. The examiner did not concur with this treatment. The examiner instructed the lender to place the loan on nonaccrual status. Because the lender restructured the debt into a single note and had charged-off a portion of the restructured loan, the repayment of the interest and principal contractually due on the entire debt is not reasonably assured.

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

TDR Treatment: The lender reported the restructured loan as a TDR according to the requirements of its regulatory reports because (a) the borrower is *experiencing financial difficulties* as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the original exit strategy because the borrower was unable to lease the property in a reasonable timeframe; and (b) the lender granted a *concession* as evidenced by deferring payment beyond the repayment ability of the borrower. The charge-off indicates that the lender does not expect full repayment of principal and interest, yet the borrower remains obligated for the full amount of the debt and payments, which is at a level that is not consistent with the borrower's repayment capacity. Because the borrower is not expected to be able to comply with the loan's restructured terms, the lender would likely continue to report the loan as a TDR. The examiner concurs with reporting the renewed loan as a TDR.

C. *Construction Loan – Single Family Residence*

BASE CASE: The lender originated a $400,000 construction loan on a single family "spec" residence with a 15-month maturity to allow for completion and sale of the property. The loan required monthly interest-only payments at a market rate and was based on a LTV of 70 percent at origination. During the original loan construction phase, the borrower made all interest payments from personal funds. At maturity, the home had not sold and the borrower was unable to find another lender willing to finance this property under similar terms.

SCENARIO 1: At maturity, the lender restructured the loan for one year on an interest-only basis at a below market rate to give the borrower more time to sell the "spec" home. Current financial information indicates the borrower has limited ability to continue to pay interest from personal funds. If the residence does not sell by the revised maturity date, the borrower plans to rent the home. In this event, the lender will consider modifying the debt into an amortizing loan with a 20-year maturity, which would be consistent with this type of income-producing investment property. Any shortfall between the net rental income and loan payments would be paid by the borrower. Due to declining home values, the LTV at the renewal date was 90 percent.

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

Nonaccrual Treatment: The lender maintained the loan on an accrual basis because the borrower demonstrated an ability to make interest payments during the construction phase. The examiner did not concur with this treatment because the loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is questionable.

TDR Treatment: The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal payments, at a below market rate (compared to the rate charged on an investment property) for an additional year when the loan was no longer in the construction phase. The examiner concurred with the lender's TDR treatment.

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

Classification: The lender internally graded the restructured loan substandard. The examiner agreed with the lender's initial substandard grade at the time of the restructuring, but now considered the loan as a pass due to the borrower's demonstrated ability to make payments according to the modified terms for over six consecutive months.

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

TDR Treatment: The lender reported the first restructuring as a TDR. However, the second restructuring would not be reported as a TDR. The lender determined that the borrower is *experiencing financial difficulties* as indicated by depleted cash resources and a weak financial condition; however, the lender did not grant a *concession* on the second restructuring as the loan is at market rate and terms. The examiner concurred with the lender.

SCENARIO 3: The lender restructured the loan for one year on an interest-only basis at a below market rate to give the borrower more time to sell the "spec" home. The restructured loan has become 90+ days past due and the borrower has not been able to rent the property. Based on current financial information, the borrower does not have the capacity to service the debt. The lender considers repayment to be contingent upon the sale of the property. Current market data reflects few sales and similar new homes in this property's neighborhood are selling within a range of $250,000 to $300,000 with selling costs equaling 10 percent, resulting in anticipated net sales proceeds between $225,000 and $270,000.

Classification: The lender graded $130,000 loss ($400,000 loan balance less estimated net sales proceeds of $270,000), $45,000 doubtful based on the range in the anticipated net sales proceeds, and the remaining balance of $225,000 substandard. The examiner agreed, as this classification treatment results in the recognition of the credit risk in the collateral dependent loan based on the property's value less costs to sell. The examiner instructed management to obtain a current valuation on the property.

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

TDR Treatment: The lender plans to continue reporting this loan as a TDR until the lender forecloses on the property, and transfers the asset to the other real estate owned category. The lender determined that the borrower was continuing to *experience financial difficulties* as indicated by depleted cash resources, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. In addition, the lender granted a *concession* by reducing the interest rate to a below market level. The examiner concurred with the lender's TDR treatment.

SCENARIO 4: The lender committed an additional $16,000 for an interest reserve and extended the $400,000 loan for 12 months at a below market rate of interest with monthly interest-only payments. At the time of the examination, $6,000 of the interest reserve had been added to the loan balance. Current financial information that the lender obtained at examiner request reflects the borrower has no other repayment sources and has not been able to sell or rent the property. An updated appraisal supports an "as is" value of $317,650. Selling costs are estimated at 15 percent, resulting in anticipated net sales proceeds of $270,000.

Classification: The lender internally graded the loan as pass and is monitoring the credit. The examiner disagreed with the internal grade and instructed the lender to reverse the $6,000 interest capitalized out of the loan balance and interest income, and adversely classified the loan. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower has limited capacity to service the debt and the reduced collateral margin indicated that full repayment of principal and interest is not assured. The examiner classified $130,000 loss based on the adjusted $400,000 loan balance less estimated net sales proceeds of $270,000, which was classified substandard. This classification treatment recognizes the credit risk in the collateral dependent loan based on the property's market value less costs to sell. The examiner also criticized management for the inappropriate use of interest reserves. The remaining interest reserve of $10,000 is not subject to adverse classification because the loan should be placed on nonaccrual.

Nonaccrual Treatment: The lender maintained the loan on accrual status. The examiner did not concur with this treatment. The loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is not assured. The examiner advised the lender that the loan should be placed on nonaccrual. The lender's decision to advance a $16,000 interest reserve was inappropriate given the borrower's inability to repay it. The lender should reverse the capitalized interest in a manner consistent with regulatory reporting instructions and should not recognize any further interest income from the interest reserve.

TDR Treatment: The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal payments, at a below market rate (compared to investment property) for an additional year when the loan was no longer in the construction phase. The examiner concurred with the lender's TDR treatment.

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

BASE CASE: The lender originally extended a $50 million loan for the purchase of vacant land and the construction of a condominium project. The loan was interest-only and included an interest reserve to cover the monthly payments. The developer bought the land and began construction after obtaining purchase commitments for about a third of the planned units.

Many of these pending sales were with speculative buyers who committed to buy multiple units with minimal down payments. As the real estate market softened, most of the speculative buyers failed to perform on their purchase contracts and only a limited number of the other planned units have been pre-sold.

The developer subsequently determined it was in the best interest to halt construction with the property 80 percent complete. The loan balance was drawn to $44 million to pay construction costs (including cost overruns) and interest and the borrower estimates another $10 million is needed to complete construction. Current financial information reflects that the developer does not have sufficient cash flow to service the debt; and while the developer does have equity in other assets, there is a question about the borrower's ability to complete the project.

SCENARIO 1: The borrower agrees to grant the lender a second lien on certain assets, which provides about $5 million in additional collateral support. In return, the lender advanced the borrower $10 million to finish construction and the condominium was completed. The lender also agreed to extend the $54 million loan for 12 months at a market rate of interest that provides for the incremental credit risk to give the borrower time to market the property. The borrower agreed to pay interest whenever a unit was sold with any outstanding balance due at maturity.

The lender obtained a recent appraisal on the condominium building that reported a prospective "as complete" market value of $65 million, reflecting a 24-month sell-out period and projected selling costs of 15 percent. The $65 million prospective "as complete" market value plus the $5 million in other collateral results in a LTV of 77 percent. The lender used the prospective "as complete" market value in its analysis and decision to fund the completion and sale of the units, and to maximize its recovery on the loan.

Classification: The lender internally graded the $54 million loan as substandard due to the project's limited ability to service the debt despite the 1.3x gross collateral margin. The examiner agreed with the lender's internal grade.

Nonaccrual Treatment: The lender maintained the loan on an accrual status due to the protection afforded by the collateral margin. The examiner did not concur with this treatment and determined the loan should be placed on nonaccrual due to the borrower's questionable ability to sell the units and service the debt, raising concerns as to the full repayment of principal and interest.

TDR Treatment: The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*, as demonstrated by the insufficient cash flow to service the debt, concerns about the project's viability, and the borrower's inability to obtain financing from other sources. In addition, the lender provided a *concession* by advancing additional funds to finish construction and deferring payments except from sold units until the maturity date when any remaining accrued interest plus principal are due. The examiner concurred with the lender's TDR treatment.

SCENARIO 2: A recent appraisal of the property reflects that the highest and best use would be conversion to an apartment building. The appraisal reports a prospective "as complete" market value of $60 million upon conversion to an apartment building and a $67 million prospective "as stabilized" market value upon the property reaching stabilized occupancy. The borrower agrees to grant the lender a second lien on certain assets, which provides about $5 million in additional collateral support.

In return, the lender advanced the borrower $10 million, which is needed to convert the project to an apartment complex and finish construction. The lender also agreed to extend the $54 million loan for 12 months at a market rate of interest that provides for the incremental credit risk to give the borrower time to lease the apartments. The $60 million "as complete" market value plus the $5 million in other collateral results in a LTV of 83 percent. The prospective "as complete" market value is used because the loan is funding the construction of the apartment building. The lender may utilize the prospective "as stabilized" market value when funding is provided for the lease-up period.

Classification: The lender internally graded the $54 million loan as substandard due to the project's limited ability to service the debt despite the 1.2x gross collateral margin. The examiner agreed with the lender's internal grade.

Nonaccrual Treatment: The lender determined the loan should be placed on nonaccrual due to the borrower's untested ability to lease the units and service the debt, raising concerns as to the full repayment of principal and interest. The examiner concurred with the lender's nonaccrual treatment.

TDR Treatment: The lender reported the restructured loan as a TDR because the borrower is *experiencing financial difficulties*, as demonstrated by the insufficient cash flow to service the debt, concerns about the project's viability, and the borrower's inability to obtain financing from other sources. In addition, the lender provided a *concession* by advancing additional funds to finish construction and deferring payments until the maturity date without a defined exit strategy. The examiner concurred with the lender's TDR treatment.

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

BASE CASE: Two years ago, the lender originated a CRE loan at a market rate to a borrower whose business occupies the property. The loan was based on a 20-year amortization period with a balloon payment due in three years. The LTV equaled 70 percent at origination. A year ago, the lender financed a $5 million interest-only operating line of credit for seasonal business operations at a market rate. The operating line of credit had a one-year maturity and was secured with a blanket lien on all the business assets. To better monitor the ongoing overall collateral position, the lender established a borrowing base reporting system, which included monthly accounts receivable aging reports. At maturity of the operating line of credit, the borrower's accounts receivable aging report reflects a growing trend of delinquency, which is causing the borrower some temporary cash flow difficulties. The borrower has recently initiated more aggressive collection efforts.

SCENARIO 1: The lender renewed the $5 million operating line of credit for another year, requiring monthly interest payments at a market rate of interest. The borrower's liquidity position has tightened but remains satisfactory, cash flow to service all debt is 1.2x, and both loans have been paid according to the contractual terms. The primary repayment source is from business operations, which remain satisfactory and an updated appraisal is not considered necessary.

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

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

TDR Treatment: The lender concluded that while the borrower has been affected by declining economic conditions, the renewal of the operating line of credit did not result in a TDR because the borrower is not *experiencing financial difficulties* and has the ability to repay both loans (which represent most of its outstanding obligations) at a market rate of interest. The lender expects full collection of principal and interest from the borrower's operating income. The examiner concurred with the lender's rationale and TDR treatment.

SCENARIO 2: The lender reduced the operating line of credit to $4 million and restructured the terms onto monthly interest-only payments at a below market rate. This action is expected to alleviate the business' cash flow problem. The borrower's company is still considered to be a going concern even though the borrower's financial performance has continued to deteriorate and sales and profitability are declining. The trend in delinquencies in accounts receivable is worsening and has resulted in reduced liquidity for the borrower.

Cash flow problems have resulted in sporadic delinquencies on the operating line of credit. The borrower's net operating income has declined, but reflects the capacity to generate a 1.08x debt service coverage ratio for both loans, based on the reduced rate of interest for the operating line of credit. The terms on the real estate loan remained unchanged. The lender internally updated the assumptions in the original appraisal and estimated the LTV on the real estate loan was 90 percent. The operating line of credit has an LTV of 80 percent with an overall LTV for the relationship of 85 percent for the relationship.

Classification: The lender internally graded both loans substandard due to deterioration in the borrower's business operations and insufficient cash flow to repay all debt. The examiner agreed with the lender's analysis and the internal grades with the understanding that the lender will monitor the trend in the business operations profitability and cash flow. The lender may need to order a new appraisal if the debt service coverage ratio continues to fall and the overall collateral margin further declines.

Nonaccrual Treatment: The lender reported both the restructured operating line of credit and the real estate loan on a nonaccrual basis. The operating line of credit was not renewed on market rate repayment terms, the borrower has an increasingly limited capacity to service the below market rate on an interest-only basis and there is insufficient support to demonstrate an ability to meet the new payment requirements. Since debt service for both loans is dependent on business operations, the borrower's ability to continue to perform on the real estate loan is not assured. In addition, the collateral margin indicates that full repayment of all of the borrower's indebtedness is questionable, particularly if the company fails to continue being a going concern. The examiner concurred with the lender's nonaccrual treatment.

TDR Treatment: The lender reported the restructured operating line of credit as a TDR because (a) the borrower is *experiencing financial difficulties* (as evidenced by the borrower's sporadic payment history, an increasing trend in accounts receivable delinquencies, and uncertain ability to repay the loans); and (b) the lender granted a *concession* on the line of credit through a below market interest rate. The lender concluded that the real estate loan should not be reported as TDR since that loan had not been restructured. The examiner concurred with the lender's TDR treatment.

F. *Land Loan*

BASE CASE: Three years ago, the lender originated a $3.25 million loan to a borrower for the purchase of raw land that the borrower was seeking to have zoned for residential use. The loan had a three-year term and required monthly interest-only payments at a market rate that the borrower has paid from existing financial resources. An appraisal obtained at origination reflected an "as is" market value of $5 million, which resulted in a 65 percent LTV. The borrower was successful in obtaining the zoning change and has been seeking construction financing for a townhouse development and to repay the land loan. At maturity, the borrower requested an extension to provide additional time to secure construction financing that would include repayment of the land loan.

SCENARIO 1: The borrower provided the lender with current financial information, demonstrating the ability to make principal and interest payments. Further, the borrower made a principal payment of $250,000 in exchange for an extension of the maturity date of the loan. The borrower also pledged additional unencumbered collateral, granting the lender a first lien on an office building with an "as stabilized" market value of $1 million. The financial information also demonstrates that cash flow from the borrower's personal assets and the office building generate sufficient stable cash flow to amortize the land loan over a reasonable period of time. A recent appraisal of the raw land reflects an "as is" market value of $3 million, which results in a 75 percent LTV when combined with the additional collateral and the principal reduction. The lender restructured a $3 million loan with monthly principal and interest payments for another year at a market rate that provides for the incremental credit risk.

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

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

***TDR Treatment*:** The lender concluded that while the borrower has been affected by declining economic conditions, the level of deterioration does not warrant TDR treatment. The borrower was not *experiencing financial difficulties* because the borrower has the ability to service the renewed loan, which was prudently underwritten and has a market rate of interest. The examiner concurred with the lender's rationale and TDR treatment.

SCENARIO 2: The borrower provided the lender with current financial information that indicated the borrower is unable to continue to make interest-only payments. The borrower has been sporadically delinquent up to 60 days on payments. The borrower is still seeking a loan to finance construction of the townhouse development, but has not been able to obtain a takeout commitment. A recent appraisal of the property reflects an "as is" market value of $3 million, which results in a 108 percent LTV. The lender extended a $3.25 million loan at a market rate of interest for one year with principal and interest due at maturity.

***Classification*:** The lender internally graded the loan as pass because the loan is currently not past due and at a market rate of interest. Also, the borrower is trying to obtain takeout construction financing. The examiner disagreed with the internal grade and adversely classified the loan. The examiner concluded that the loan was not restructured on reasonable repayment terms because the borrower does not have the capacity to service the debt and full repayment of principal and interest is not assured. The examiner classified $550,000 loss ($3.25 million loan balance less $2.7 million, based on the current appraisal of $3 million less estimated cost to sell of 10 percent or $300,000). The examiner classified the remaining $2.7 million balance substandard. This classification treatment recognizes the credit risk in the collateral dependent loan based on the property's market value less costs to sell.

***Nonaccrual Treatment*:** The lender maintained the loan on accrual status. The examiner did not concur with this treatment and advised the lender to place the loan on nonaccrual because the loan was not restructured on reasonable repayment terms, the borrower does not have the capacity to service the debt, and full repayment of principal and interest is not assured.

***TDR Treatment*:** The lender reported the restructured loan as a TDR. The borrower is *experiencing financial difficulties* as indicated by the inability to refinance this debt and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A *concession* was provided by renewing the loan with a deferral of principal and interest payments for an additional year when the borrower was unable to obtain takeout financing. The examiner concurred with the lender's TDR treatment.

Attachment 2
Sources of Relevant Supervisory and Accounting Guidance

Supervisory Guidance

- Federal regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: FDIC: 12 CFR part 365 and appendix A; FRB: 12 CFR part 208 subpart E and appendix C; OCC: 12 CFR part 34, subpart D and appendix A: and OTS: 12 CFR Parts 545 and 563. For NCUA, refer to 12 CFR part 723 for member business loan regulation which addresses commercial real estate lending.

- Federal appraisal regulations: FDIC: 12 CFR part 323; FRB: 12 CFR part 208 subpart E and 12 CFR part 225 subpart G; OCC: 12 CFR part 34, subpart C; OTS: 12 CFR Part 564; and NCUA: 12 CFR part 722.

- *FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031 and FFIEC 041 Instructions); *Thrift Financial Report (TFR) Instruction Manual*; and *NCUA 5300 Call Report Instructions*.

- FRB, FDIC, and OCC joint guidance and the OTS guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 2006.

- *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, issued December 2006.

- *Interagency FAQs on Residential Tract Development Len*ding, issued September 2005.

- *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, issued July 2001.[26]

- *Interagency Appraisal and Evaluation Guidelines*, issued October 1994.[27]

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[26] The guidance in the July 2001 Policy Statement was substantially adopted by the NCUA through its Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions*, in May 2002.

[27] The October 1994 guidance was issued by NCUA through its Letter to Credit Unions No. 03-CU-17, *Independent Appraisal and Evaluation Functions for Real Estate-Related Transactions*, in November 2003.

Authoritative Accounting Guidance

New Accounting Standards Codification (ASC) References	**Former References**
FASB ASC 450-20, *Contingencies - Loss Contingencies*	FASB Statement No. 5, *Accounting for Contingencies*
FASB ASC 310-10-35-2 through 30, *Receivables – Overall - Subsequent Measurement – Impairment*	FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
FASB ASC 310-20-35, *Receivables – Nonrefundable Fees and Other Costs – Subsequent Measurement*	FASB Emerging Issues Task Force (EITF) No. 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*
FASB ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors*	FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring;* and FASB Technical Bulletin No. 80-2 *Classification of Debt Restructurings by Debtors and Creditors*
FASB ASC 470-60, *Debt – Troubled Debt Restructurings by Debtors*	FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*; and FASB EITF No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instrument is within the Scope of FASB Statement No. 15*
FASB ASC 820, *Fair Value Measurements and Disclosures*	FASB Statement No. 157, *Fair Value Measurements*
FASB ASC 825-10-35-1 through 3, *Financial Instruments – Overall - Subsequent Measurement - Credit Losses on Financial Instruments with Off-Balance-Sheet Credit Risk*	American Institute of Certified Public Accountants (AICPA) Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*

Non-authoritative Accounting Guidance

- In December 2008, the Center for Audit Quality, an affiliate of the AICPA, issued *Application of Statement 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructurings*

Attachment 3
Valuation Concepts for Income Producing Real Estate

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

The 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 annual income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate, usually defined for each property type in a market area, is viewed by some analysts as the required rate of return stated in terms of current income. 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 either the stabilized annual income or the "cap" rate used accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, the net present value approach and the direct capitalization technique will yield the same results.

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

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

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, have to be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is 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 extent of debt financing and the related costs are also taken into account.

Selecting Discount and Cap Rates: The choice of the appropriate values for discount and "cap" rates is a key aspect of income analysis. 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 an income analysis generally should fall within a fairly narrow range for comparable properties.

Holding Period versus Marketing Period: When the net present value approach is applied to troubled properties, the chosen time frame should reflect the period over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That 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 marketing period is the length of time that may be required to sell the property in an open market.

Attachment 4
Classification Definitions[28]

The federal bank and thrift regulatory agencies utilize the following definitions for assets adversely classified for supervisory purposes as well as those assets listed as special mention:

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

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

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.

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

[28] The NCUA does not require credit unions to adopt a uniform regulatory classification schematic of loss, doubtful, substandard or special mention. A credit union should apply an internal loan grade based on its evaluation of credit risk. The term "classify" within the credit union industry has typically meant "individually review to apply a percentage reserve" for allowance for loan and lease losses ("ALLL") purposes. As used in this paper, "classify" and "classification" in relation a credit union's evaluation of a credit for risk mean "grade" and "assign a credit risk grade."