

Note: This letter was cross referenced by [SR 91-29](#).



**BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM**

WASHINGTON, D. C. 20551

**DIVISION OF BANKING  
SUPERVISION AND REGULATION**

**SR 91-16 (FIS)  
July 16, 1991**

**TO THE OFFICER IN CHARGE OF SUPERVISION  
AT EACH FEDERAL RESERVE BANK**

**SUBJECT: Supplementary Examination Guidelines on Real Estate Loans and Certain Reporting  
Issues Pertaining to Nonaccrual Loans**

On March 1, 1991, the Federal bank and thrift regulatory agencies jointly issued a statement clarifying certain supervisory and accounting policies. The statement was issued in response to concerns that some supervisory policies, or depository institutions' misunderstandings about the policies, were inhibiting the extension of loans to sound, creditworthy borrowers. The guidelines and clarifications contained in the March 1st statement establish a framework, consistent with safe and sound banking practices, within which banking organizations can make loans to creditworthy borrowers and work in a constructive and prudent fashion with borrowers experiencing temporary financial difficulties. The statement was based upon the principle that prudent lending practices on the part of banks and timely and effective supervisory actions on the part of regulators should not inhibit banking organizations from playing an active role in financing the needs of creditworthy borrowers.

This letter supplements the contents of the March 1st statement and provides guidance to supervisory and examination personnel regarding certain supervisory policies or practices that may have an impact on credit availability. As was true with the earlier interagency statement, the guidance contained in this letter is consistent with sound banking practices and generally accepted accounting principles.

**Supervisory asset assessments**

Concerns have been expressed that problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, could lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors. The March 1st statement reiterates that real estate loans should not be assessed solely on the basis of the liquidation value of the underlying collateral; rather, consideration should also be given to a property's stabilized capacity to generate cash flow to service its debt. Consistent with this principle and longstanding supervisory practice, loans or credits that are adequately protected by the current sound worth and debt-service capacity of the borrower or the underlying collateral generally should not be subject to examiner classification.

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamentals of the particular credit, that is, the borrower's (or the collateral's) current and stabilized cash flow, earning and debt service capacity, financial performance, net worth, guarantees, future prospects, and other factors relevant to the borrower's ability to service and retire its

debt.

### Real estate construction and mini-perm loans

The March 1st guidance states that institutions that have in place effective controls to manage and reduce undue concentrations over time, need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. It is important to emphasize that this principle applies to prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner.

Many banks have made construction loans that upon completion of the construction phase of the project will require longer-term or take-out financing. In addition, during the 1980s some banks made medium term (up to 7 years to maturity) loans to finance commercial real estate after completion of the construction phase. Many of these construction and so-called "mini-perm" loans are now coming due or will be coming due over the next 12 to 24 months.

Under current conditions, obligors on these loans may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to rollover or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who may not be in a position, at the present time, to obtain long-term financing for the principal. The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

### Assessment of asset concentrations

The March 1st statement indicates that while the regulatory agencies have not established specific rules on asset concentrations, depository institutions should establish and adhere to policies that control concentration risk. One aspect of such a system of risk control is the definition of asset concentrations. Traditionally, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry often have been included in homogeneous risk groupings when assessing asset concentrations.

In identifying asset concentrations, commercial real estate loans and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not necessarily be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

Institutions with asset concentrations are expected to put in place effective internal policies, systems, and controls to monitor and manage this risk. Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. Banking organizations with a need to reduce asset concentrations are normally expected to develop a plan that is realistic, prudent, and achievable in view of the bank's particular circumstances and

market conditions. In situations where concentration levels have been built up over an extended period, it may take time, in some cases several years, to achieve a more balanced and diversified portfolio mix. What is critical is that banking organizations have in place adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan, strong credit policies and loan administration standards to control the risks associated with new loans, and adequate capital to protect the institution while its portfolio is being restructured.

#### Issues relating to restructured debt and partially charged-off loans

Working in a prudent manner with borrowers experiencing financial difficulties may involve formally restructuring loans and taking other measures in recognition of the borrowers' condition and repayment prospects. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve a bank's prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements, provide a framework for reporting that, in some cases, may alleviate certain concerns that lenders may have about working in a constructive fashion with borrowers experiencing financial difficulties.

The March 1, 1991 interagency policy statement presented a number of clarifications of supervisory policies regarding issues relating to nonaccrual assets and restructured loans. Three of these clarifications indicated that when certain criteria are met, (i) interest payments on nonaccrual assets can be recognized as income on a cash basis without first recovering any prior partial charge-offs, (ii) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with Financial Accounting Standards Board (FASB) Statement No. 15, and (iii) restructurings that yield a market rate of interest would not have to be included in restructured loan amounts reported in the years subsequent to the year of the restructuring. These clarifications, which are consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income ("Call Reports") filed by banks and the "Y Reports" filed by bank holding companies, as of June 30, 1991. Additional clarifications on issues relating to the restoration to accrual status of restructured debt and nonaccrual assets with partial charge-offs are set forth below.

Nonaccrual assets subject to FASB Statement No. 15 restructurings. The March 1st policy statement indicated that a loan or other debt instrument that has been formally restructured so as to be reasonably assured of repayment and performance according to its modified terms need not be maintained in nonaccrual status. Furthermore, the interagency policy indicated that in returning the asset to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account.

For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. In so doing, the borrower's restructured terms may require payments that do not exceed the amount and frequency that have been demonstrated by the sustained historical payment performance of the borrower for a reasonable time before the loan was restructured. In this situation, assuming that the restructured loan is reasonably assured of repayment and performance according to its modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether prior to or subsequent to the date of the restructuring, is a very important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the borrower that may be sufficient to demonstrate a relative improvement in the borrower's condition and debt service capacity, thereby reducing the degree of reliance on the borrower's performance to date in assessing prospects for future performance and collectibility under the modified terms. For example, substantial and reliable sales, lease or rental contracts obtained by the borrower or other important developments that are expected to significantly increase the borrower's cash flow and debt service capacity and strengthen the borrower's commitment

to repay may be sufficient to provide this assurance. In certain circumstances, a preponderance of such evidence, in and of itself, may be sufficient to warrant returning a restructured loan to accrual status, provided the loan under its restructured terms is reasonably assured of performance and full collectibility.

It is imperative that the reasons for the restoration of restructured debt to accrual status be documented. Such actions should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This documentation will be subject to review by examiners.

The formal 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.[See footnote 1] When restructuring loans, regulatory reporting requirements and GAAP do not require banking organizations to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay, in order to use the reporting treatment specified in FASB Statement No. 15. Furthermore, regulatory reporting requirements and GAAP do not preclude institutions from including in the restructured terms prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions involved in the restructuring should the borrower's condition substantially improve.

**Treatment of Nonaccrual Loans with Partial Charge-offs.** Questions have been raised regarding whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must first be fully recovered before a loan can be restored to accrual status. GAAP and regulatory reporting requirements do not explicitly address this issue.

In accordance with the Call Report instructions, restoration to accrual status is permitted when (a) the loan has been brought fully current with respect to principal and interest and (b) the bank expects that the full contractual balance of the loan (including any amounts charged-off) plus interest will be fully collectible under the terms of the loan.[See footnote 2] Thus, in determining whether a partially charged-off loan that has been brought fully current can be returned to accrual status, it is important to determine whether the bank expects to receive the full amount of principal and interest called for by the loan's terms.

When a loan has been brought fully current with respect to contractual principal and interest, and the borrower's financial condition and prospects for repayment have improved so that the full amount of contractual principal (including any amounts charged-off) and interest is expected to be repaid, the loan may be restored to accrual status without having to first recover the charge-off. On the other hand, this treatment would not be appropriate when the charge-off is indicative of continuing doubt regarding the collectibility of principal or interest. Since the criteria for nonaccrual status include the requirement that loans or other assets be placed in nonaccrual status when repayment in full of principal or interest is not expected, such nonaccrual loans could not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be documented. Such actions should be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged-off) and interest. This documentation will be subject to review by examiners.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FASB Statement No. 15 so that it meets the criteria for restoration to accrual status presented in the previous section (that addresses restructured loans). Under GAAP, when a charge-off was taken prior to the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the

considerations and treatments discussed in the previous paragraphs in this section are applicable.

**Richard Spillenkothen**  
**Deputy Associate Director**

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**Footnote: 1** When a restructured loan is not reasonably assured of repayment and performance under its modified terms in accordance with a reasonable repayment schedule, the loan may not be restored to accrual status.

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**Footnote: 2** The instructions for the Call Reports and "Y Reports" discuss the criteria for restoration to accrual status in the glossary entries for "nonaccrual status." This guidance also permits restoration to accrual status for nonaccrual assets that are both well secured and in the process of collection. In addition, this guidance permits restoration to accrual status, when certain criteria are met, for formally restructured debt and acquired nonaccrual assets.