
Joint Release

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

For immediate release

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

June 10, 1993

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

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

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

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

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

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

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

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

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