Office of Thrift Supervision

RB 32 was rescinded 12/29/94. It was incorporated into Thrift Activities 260.

Regulatory Bulletin

Handbook: Thrift Activities **Section: 260**
Subject: Classification of Assets **RB 32**

December 29, 1994

RESCINDED

Valuation and Classification of Troubled, Collateral-Dependent Loans

Summary: This Bulletin revises the OTS policy, "Valuation and Classification of Troubled, Collateral-Dependent Loans," and provides for the distribution of the relevant replacement page in the Thrift Activities Regulatory Handbook, Section 260, "Classification of Assets."

For Further Information Contact: The OTS Regional Office in which you are located; or the Thrift Supervision Policy Division (Credit Risk), Washington, D.C.

Regulatory Bulletin 32

In May 1994, the Federal Financial Institutions Examination Council (FFIEC)[1] published the Request for Comment, "Implementation Issues Arising from FASB Statement No. 114 (FAS 114), 'Accounting by Creditors for Impairment of a Loan'." In that document, the FFIEC sought public comment on certain issues arising from the adoption of FAS 114 and provided certain regulatory reporting guidance.

Under FAS 114, issued in May 1993, a loan is impaired when it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is impaired, a creditor shall measure impairment based on either (1) the present value of expected future cash flows, discounted at the loan's effective interest rate; (2) the loan's observable market price, or (3) the fair value of the collateral, if the loan is collateral-dependent.

In the May 1994 FFIEC Request for Comment, it was announced that the FFIEC and the agencies intend to adhere to the FAS 114 measurement standards discussed above for regulatory reporting purposes in most cases. However, consistent with the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," issued in November 1991, the FFIEC and the agencies will expect institutions to measure impaired, collateral-dependent loans for purposes of regulatory reports at the fair value of the collateral.

This FFIEC guidance differs from the OTS policy, "Valuation and Classification of Troubled, Collateral-Dependent Loans," issued in August 1993 and included in Thrift Activities Regulatory Handbook Section 260, "Classification of Assets."

Under the OTS policy, consistent with FAS 114, the valuation and classification of troubled, collateral-dependent loans has been based on either (1) the present value of expected future cash flows, discounted at the loan's effective interest rate; (2) the loan's observable market price; or (3) the fair value of the collateral.

With the issuance of this Bulletin, the OTS is revising its policy to reflect the FFIEC guidance. Accordingly, effective March 31, 1995, the valuation and classification of troubled, collateral-dependent loans should be based on the fair value of the collateral, and not on the present value of expected future cash flows nor on the loan's observable market price.

Attached to this Bulletin is a revised page 260.5 of the Thrift Activities Regulatory Handbook which will replace the existing page in your handbook. Changes are shown in bolded italics.

Attachment

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Director of Supervision

[1]The FFIEC consists of representatives from the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) (referred to as the "agencies"), and the National Credit Union Administration (NCUA). However, the FFIEC reporting guidance was not directed to credit unions.

appropriate. Rather, all slow mortgage loans are presumed to be Substandard, with the burden placed on management to provide reasons for nonadverse classification of individual credits. Possible reasons for not adversely classifying a slow mortgage loan might be the imminent sale of the property (evidenced by a signed agreement) that will liquidate the loan, or payments received during the examination that eliminate the loan from a slow status.[2]

Loans or contracts to facilitate the sale of foreclosed mortgages, though generally of higher risk due to high loan-to-value ratios, are not, by definition, slow loans. These loans are not presumed Substandard. The loan should be evaluated on the borrower's perceived ability to service the debt. Loans should not be adversely classified merely due to high loan-to-value ratios. In those associations with a material volume of loans to facilitate, the regulator should sample such loans to assure that sound underwriting criteria are followed; if sound underwriting criteria are not followed, all such loans may be reviewed. If a review of these loans provides the regulator with a sufficient degree of confidence that loans to facilitate are granted to borrowers with an ability to service the debt, then adverse classification may be limited to those loans that are slow. Again, management has the opportunity to provide documentation to support a Pass classification.

Consumer Loans

Consumer loans are credits extended to individuals for personal, family, or household expenditures, as defined in 12 CFR § 561.12. Evidence of the soundness of a consumer loan is best indicated by the repayment performance demonstrated by the borrower. This consideration, coupled with the fact that consumer loans are typically small in size and large in number, mandate a different approach to classification. Regulators are to follow 12 CFR §§ 561.13 and 561.47 when open-end and closed-end consumer credit are classified.

These regulations provide that: closed-end consumer installment credit delinquent 120 days or more (five monthly payments) will be classified Loss, and loans delinquent 90 to 119 days (four monthly payments) will be categorized as Slow. Open-end consumer installment credit (credit cards) delinquent 180 days or more (seven zero billing cycles) will be classified Loss, and loans delinquent 90 to 179 days (four to six zero billing cycles) will be categorized as Slow. As with owner-occupied mortgage loans, Slow credits are presumed Substandard, subject to management providing documentation that such an adverse classification is not warranted.

If an association can clearly demonstrate that repayment will occur regardless of delinquency status, then such loan need not be classified as Substandard or Loss. Examples of such situations are: the loan is well-secured by collateral and is in the process of collection; the loan is supported by a valid guarantee or insurance; or it is a loan where claims have been filed against a solvent estate. "Well-secured" implies collateralization by liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt in full, or collateralization by the guarantee of a financially responsible party. "In the process of collection" infers collection is proceeding in due course either through legal action or, in appropriate circumstances, through collection efforts not involving legal action that are reasonably expected to result in repayment of the debt or its restoration to a current status. For the purpose of computing delinquency, a payment of 90% or more of the contractual payment will be considered a full payment.

OTS regulations at 12 CFR §§ 561.13 and 561.47 do not preclude the adverse classification of consumer credit delinquent for a lesser period, or not delinquent, when such classification is warranted.

Investment Securities

Classification of investment securities is based on credit risk, not interest-rate risk. A decline in the market value of a security simply due to interest-rate fluctuations is not a basis for adverse classification. Classification should be based on the credit risk and collectibility of interest and principal that the association has booked as an asset.

In assessing the credit quality of securities, associations and regulators will find the qualitative ratings

[2] When computing whether a modified or refinanced loan is Slow, "(t)he date on which the association obligates itself is the date on which the modification or refinancing becomes effective. Such a transaction becomes effective when all conditions precedent have been met by the borrower, thereby binding the association. For example, in states having an escrow procedure, a modification or refinancing would become effective when all conditions of the escrow had been met." (Based on an internal interpretation of the General Counsel issued January 4, 1966; formerly issued as FHLBB Memorandum T 16-1.)

lack of credible support for full repayment from reliable sources.

These principles hold for individual loans, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each loan should be based on the fundamental characteristics that affect the collectibility of the particular loan. The problems broadly associated with certain segments of an industry should not lead to overly pessimistic assessments of individual loans that are not affected by the problems of the troubled sectors.

Valuation and Classification of Troubled, Collateral-Dependent Loans[1]

Effective ***March 31, 1995,*** OTS's policy for troubled, collateral-dependent loans (where proceeds for repayment can be expected to come only from the operation and sale of the collateral) is as follows:

For a troubled, collateral-dependent loan where, based on current information and events, it is probable that the lender will be unable to collect all amounts due (both principal and interest), ***the amount classified Loss should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard.***

For a troubled, collateral-dependent loan, it is probable that the lender will be unable to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are less than the principal and interest payments due according to the contractual terms of the loan agreement. The term "all amounts due" is based on the original contractual terms, except as discussed below.

For a troubled, collateral-dependent loan (whether or not restructured) where, based on current information it is probable, but not reasonably assured, that the lender will be able to collect all amounts due (both principal and interest), ***the amount classified Doubtful should be no less than any excess of the recorded investment in the loan over the fair value of the collateral, and the remainder should generally be classified Substandard.***

For a troubled, collateral-dependent loan, it will be deemed probable, but not reasonably assured, that the lender will be able to collect all amounts due when the expected future cash flows, on an undiscounted basis, from the operation and sale of the collateral over a period of time not to exceed the intermediate term (e.g., five years) are equal to or greater than the principal and interest payments due according to the contractual terms of the loan agreement.

An exception to this policy is for a loan that was restructured in a troubled debt restructuring involving a modification of terms prior to September 30, 1993. For loans restructured before September 30, 1993, the evaluation for probability of collection may be based on the collectibility of principal and interest under the restructured contractual terms. For all restructured loans, including loans modified before and after September 30, 1993, that become impaired after modification, ***the loan should be measured at the fair value of the collateral as discussed above.***

OTS does not allow savings associations to use general valuation allowances to cover any amount considered to be a Loss under the above policy; however, Specific Valuation Allowances (SVAs) may be used in lieu of charge-offs.

Mortgage Loans (One- to Four-Family, Owner-Occupied Dwellings)

The primary indicator for classifying owner-occupied home loans is the past payment history. As such, slow loans (§ 561.48) provide a good starting point to determine the mortgage loans to be adversely classified. Due to the volume of such loans in the thrift industry, a regulator's time should not be invested in individual review of all slow mortgage loans to determine if adverse classification is

[1]The policy described in this Section does not apply to smaller-balance homogeneous loans (such as one- to four-family owner-occupied home mortgage loans) that are generally classified on the basis of delinquency status.