FEDERAL RESERVE BANK OF DALLAS

ROBERT D. McTEER, JR.
PRESIDENT
AND CHIEF EXECUTIVE OFFICER

April 9, 1991

DALLAS, TEXAS 75222

Notice 91-25

TO: The Chief Executive Officer of each member bank and others concerned in the Eleventh Federal Reserve District

SUBJECT

Joint Supervisory Policy Guidelines on Lending Practices of Banks and Thrifts

DETAILS

The Federal Reserve Board, Comptroller of the Currency, Office of Thrift Supervision, and the Federal Deposit Insurance Corporation have issued a joint statement clarifying supervisory policies on lending practices of banks and thrifts. The guidelines are intended to clarify regulatory policies and reduce concerns about extensions of credit to sound borrowers.

Specifically, the joint statement: (1) encourages disclosure of additional information about nonaccrual loans; (2) encourages the extension of sound loans to credit-worthy borrowers and the workout of problem loans to sound borrowers who are experiencing temporary difficulties; (3) discusses the supervisory technique for evaluating real estate loans; (4) addresses questions regarding the recognition of income on partially charged-off credits; and (5) clarifies other issues which may have been perceived as impediments to lending to credit-worthy customers.

ATTACHMENTS

A copy of the general statement and the joint policy guidelines are attached.

MORE INFORMATION

For more information, please contact Robert Hankins at (214) 744-7477. For additional copies of this notice, please contact the Public Affairs Department at (214) 651-6289.

Sincerely yours,

Robert D. McTeer, Jr.

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

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Joint News Release

Federal Reserve Board

Comptroller of the Currency

Office of Thrift Supervision

Federal Deposit Insurance Corporation

GENERAL STATEMENT

Recent credit problems have underscored the importance of prudent lending practices to the overall safety and soundness of the nation's financial system. The emergence of credit problems in a number of sectors of the economy has prompted many depository institutions to review their lending practices as well as their capacity to meet credit demands. Many institutions have wisely tightened credit standards where such standards had become too loose. Others have reduced the pace of lending in response to the need to shore up their capital positions and strengthen their balance sheets.

It is possible, however, that some depository institutions may have become overly cautious in their lending practices. In some instances this caution has been attributed to concerns on the part of lenders that the regulators of depository institutions are applying excessively rigorous examination standards.

The Federal banking and thrift regulators do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them. As a result, the agencies today are issuing a series of guidelines and statements that are intended to clarify regulatory policies in a number of areas and reduce concerns depository institutions may have about extensions of credit to sound borrowers. Specifically, the guidelines and statements released today: (1) encourage enhanced disclosure to

the public, (2) facilitate extensions of credit to sound borrowers and the workout of problem loans, and (3) better assure sound assessments of the value of real estate by depository institutions and Federal examiners.

Recent concerns related to a tightening of credit have focused the agencies' attention on regulatory policies and their effects on institutions' willingness to extend new credit and to work with troubled borrowers. The guidelines and statements released today, which have been under development for some time, are not intended, nor are they expected, to "solve" all credit availability problems. When combined with other steps that have been taken (such as lower money market interest rates and changes in reserve requirements), these initiatives should help facilitate prudent credit extensions to sound borrowers.

Enhanced disclosure will help to ensure that the public is better informed about the nature of institutions' portfolios. The new guidance recently issued by the Office of the Comptroller of the Currency (OCC) on suggested disclosures of more detailed information about nonaccrual loans in public financial statements, and recent banking agency guidelines on Highly Leveraged Transactions, should help by differentiating among broad groups of assets with varying degrees of risk.

Depository institutions have traditionally worked with their borrowers who are experiencing problems. In the current economic environment, it is especially important for institutions to avoid shutting off credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems.

Consistent with sound banking practices, depository institutions, including those with low capital positions, should work in an appropriate and constructive fashion with borrowers

who may be experiencing temporary difficulties. Such efforts may include reasonable workout arrangements or prudent steps to restructure extensions of credit. Institutions that have in place effective internal controls to manage and reduce excessive concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers because of the borrower's particular industry or geographic location.

The documents released today by the Federal bank and thrift regulatory agencies aim to facilitate the workout of problem loans by addressing the income accrual treatment of formally restructured debt and acquired nonaccrual loans consistent with generally accepted accounting principles. Further, there is a clarification of the accounting treatment of multiple loans to a single borrower when some, but not all, of the loans to the borrower are troubled.

The agencies have also clarified when payments may be recognized as income on a cash basis for loans that have been partially charged-off. In addition, the agencies are developing guidelines that address how institutions can accrue income on loans that have been partially charged-off.

Finally, the agencies are also clarifying their policies on the supervisory valuation of real estate. The policies provide that the evaluation of loan loss reserves or net carrying values for real estate loans should reflect a realistic market analysis and not be based solely on liquidation values.

1. <u>Enhanced Disclosure to the Public</u>

<u>A. Disclosure of Nonaccrual Loans</u> Nonaccrual loans vary widely with respect to their quality and cash generating capacity. Consequently, the simple total of such

loans on an institution's books may not be a good indicator of the institution's financial position. One method to address this is to provide more information to the public on these assets. For example, useful supplemental disclosures might include information on the amount of charge-offs taken on nonaccrual loans, the amount of cash payments received on these assets, and the portion of these loans that generate substantial cash flow.

OCC recently issued a Banking Bulletin that contains suggestions for the voluntary disclosure of additional information on nonaccrual loans. The Federal regulatory agencies fully support the voluntary disclosures of the type suggested by the OCC and described in the attached statement.

B. Disclosure of Highly Leveraged Transactions (HLTs)
The Federal banking agencies have previously developed a uniform supervisory definition for HLTs. The purpose of the definition is to provide a consistent means to monitor loans to HLT borrowers. The agencies have recently provided the attached additional guidance to examiners and bankers on the application of this definition. This guidance stresses that the HLT designation does not imply a supervisory criticism of the credit.

The guidance also makes clear that certain extensions of credit, such as loans to debtors-in-possession (DIPs), do not fit the definition of HLT loans and should not be so reported. The criteria for the removal of a loan from HLT status have been expanded in the attached document. The agencies will continue to review these criteria to determine if other steps are warranted in view of the characteristics and performance of HLT credits, including the quality and

reliability of the borrower's cash flow.

2. Other Lending Issues

There appears to be some concern that any new lending by institutions that fail to meet minimum capital requirements will result in supervisory criticism. While it is essential that depository institutions that fail to meet minimum capital standards take effective and timely steps to address this deficiency, such institutions are not necessarily required to cease prudent, low-risk lending activities. Institutions should attain capital compliance in a prudent manner that strengthens their financial conditions. Institutions that seek to improve their capital-to-assets ratios through shrinking their balance sheets should avoid actions that raise their risk exposure, such as the sale of all high-quality assets or of core deposits. Such actions by themselves, or the refusal to lend to sound borrowers, fail to achieve the important objective of improving the quality of under-capitalized institutions' portfolios.

The agencies share common procedures to address capital deficiencies at depository institutions. In general, each agency requires such institutions to prepare a plan that details the steps they will take to attain the minimum capital levels. Approved plans generally do not preclude a continuation of sound lending activities, including prudent steps to work with borrowers encountering financial difficulties.

Similarly, there appears to be some concern that institutions with loan concentrations are automatically turning down good loans. The benefits of adequate portfolio

diversification are well recognized by depository institutions and their regulators. Although the regulatory agencies have not established rigid rules on asset concentrations, they are in agreement that, as a matter of sound operating policy, depository institutions should establish and adhere to policies that control "concentration risk."

Institutions that have in place effective internal controls to manage and reduce undue concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers. The purpose of institutions' policies should be to improve the overall quality of their portfolios. The replacement of unsound loans with sound loans can enhance the quality of a depository institution's portfolio, even when concentration levels are not reduced.

3. Recognition of Income on Certain Nonperforming Loans

Questions have been raised regarding the recognition of income on loans that have been partially charged-off. This subject is not explicitly addressed in the agencies' regulatory reporting requirements. The agencies wish to clarify that payments can be recognized as income on a cash basis for loans that have been partially charged-off, without requiring that the prior charge-off first be recovered, so long as the remaining book balance is deemed fully collectible.

The agencies, along with the Securities and Exchange Commission (SEC), each plan to solicit public comment on proposed guidelines which would allow certain nonperforming loans to be placed back on accrual status once the loans are reduced to an appropriate level through charge-offs. Any

formal guidance issued will be based on the comments received from the public and on-going discussions between the agencies and the SEC.

The agencies have released today supervisory guidance on a variety of other issues related to nonaccrual assets and formally restructured debt. These guidelines include a discussion of regulatory requirements related to cash basis income recognition, multiple loans to one borrower, and the acquisition of nonaccrual assets.

4. Valuation of Real Estate Loans

In recent months, there have been significant declines in real estate values in certain markets. In response to these declines, examiners have reviewed the adequacy of institutions' loan loss reserves and, where they believed it appropriate, have required additional reserves based on, in part, their estimates of real estate values.

These actions have focused attention on the techniques used to assess the value of real estate, especially commercial real estate. It is important that valuation techniques reflect not only existing market conditions, but also reasonable expectations of the property's performance in the market over time. The Federal regulatory agencies are reiterating their policy on the assessment of real estate values and the establishment of loan loss reserves.

The basic thrust of this guidance is to ensure that income property loans not be assessed solely on the basis of liquidation values but also on the income-producing capacity of the properties over time. Supervisory evaluations should take into account the lack of liquidity and cyclical nature

of real estate markets and the temporary imbalances in the supply and demand for real estate that may occur.

5. Review of Supervisory Findings

The agencies want to make clear their policy that any institution may request a review of any major decision reached as part of the supervisory process, including those related to asset classification and required reserve levels.

DISCLOSURE OF NONACCRUAL ASSETS

The purpose of the attached schedule is to provide a suggested format to banking and thrift organizations for reporting more information in public disclosures about nonaccrual assets, including loans, leases, and securities. The additional disclosures presented in this guidance are not required. However, financial institutions are encouraged to disclose publicly this type of information or other information deemed useful or relevant, in order to improve understanding of the impact of nonaccrual assets on the institution's financial condition and results of operations. Such disclosures may utilize whatever format is considered appropriate by the financial institution.

In recent months, the financial institutions industry and their analysts have placed increasing emphasis on the amount of nonaccrual assets at banking and thrift organizations. Current public disclosures about these assets have generally been limited to the total amount of nonaccrual assets, interest income, and interest foregone. Such information may not be sufficient to fully explain the impact of nonaccrual assets on the earnings and financial condition of financial institutions. As a result, some financial institutions have said they want to make additional disclosures about nonaccrual assets in their annual reports.

Attached is an example of a format that could be used to provide additional information on the characteristics of nonaccrual assets and their contribution to net income. This information may prove useful in assessing the prospects for the orderly workout and ultimate repayment of assets placed in nonaccrual status. Nonaccrual loans to developing countries are

not intended to be included in the attached example, because these are generally disclosed separately.

The detail provided in the example may not be considered appropriate or necessary for all banks. Some banks may elect to disclose more specific categories of nonaccrual assets or only part of the data in the example. Others may wish to disclose principal payments on nonaccrual assets, associated collateral values, or other significant facts. Financial institutions may also consider providing appropriate similar disclosures related to other real estate owned, including net cash inflows from the properties, and a segregation of properties with significant net cash inflows.

Attachment

SAMPLE DISCLOSURE

Generally, the accrual of income is discontinued when the full collection of principal or interest is in doubt, or when the payment of principal or interest has become contractually 90 days past due unless the obligation is both well secured and in the process of collection. Nonaccrual loans amounted to $___ at December 31, 1990. This amount is net of aggregate charge-offs on these loans of $____.

Further information regarding the balance of nonaccrual loans at December 31, 1990, and related interest payment information, is as follows:

	Book balance at December 31, 1990 (5)	Contractual balance at December 31, 1990	Cash interest payments applied as (6)(7)		
			interest income	recovery of prior partial charge-offs	reduction of principal
Contractually past due with:					
o substantial performance (1)	$	$	$	$	$
o limited performance (2)	$	$	$	$	$
o no performance	$	$	$	$	$
Contractually current, however,:					
o payment in full of principal or interest in doubt (3)	$	$	$	$	$
o other (4)	$	$	$	$	$
Total	$	$	$	$	$

EXPLANATIONS REGARDING SAMPLE NONACCRUAL DISCLOSURE FORMAT

(1) While unable to cure contractual delinquency, the borrower in this category would be consistently making substantial periodic payments relative to the required periodic payments due. If substantial performance is disclosed, management should be able to identify a threshold of performance which it considers to be substantial. While there is not a specified minimum, the threshold should be sufficient to provide a meaningful distinction within the information disclosed. This threshold or definition used should also be disclosed.

The determination of substantial performance will differ depending upon the loan repayment terms. For amortizing loans, both principal and interest payments would likely be considered. For loans with contractual interest-only payments and then a single principal payment at a specified time, interest performance only might be considered. However, if a significant principal payment were missed, then performance would likely be considered something less than substantial. In any event, management should disclose its definition of "substantial" performance.

(2) Borrower is demonstrating less than substantial performance, as defined, but is making some periodic payment.

(3) While not contractually past due, the loan has been placed on nonaccrual status due to doubt as to the full collection of principal or interest. Interest payments on such loans are being applied to reduce principal to the extent necessary to eliminate doubt as to full collectibility of the book balance.

(4) There is no longer doubt as to full collectibility of principal or interest. However, for other reasons, the loan is reported as nonaccrual. For example, interest income is being

recorded on a cash basis, while the borrower demonstrates a period of performance or interest payments are recorded as loan loss recoveries.

(5) Net of charge-offs to-date and interest payments applied to principal. The book balance should not include any reductions for any allocations of the allowance for loan and lease losses, if such allocations are made.

(6) Represents the application of cash interest payments during 1990, on the loans in nonaccrual status at December 31, 1990, from the time those loans were placed on nonaccrual status. The amount should not include the cash interest payments during the year from any of these loans prior to their placement on nonaccrual status.

It will be likely that some loans will move between categories between reporting dates. In such cases, year-to-date cash interest payment data would be reclassified to the same category where the period-end balance is reported.

(7) Additionally, management may consider it useful to disclose the yield provided from cash payments of interest on nonaccrual loans. A simple rate might be disclosed or data provided to allow the reader to determine the yield, as follows:

(a) As the cash interest data in the table relates to year-end balances only, the disclosure might provide a weighted average book balance of loans on nonaccrual status at December 31, 1990, for the period they were in nonaccrual status during the year then ended. The average balances would be properly weighted when aggregated, to reflect the relative amount of time within the year that individual loans were in nonaccrual status.

(b) It may prove difficult to monitor and report weighted average balances suggested in (a), above, because they relate to period-end balances. Alternatively, management might supplement the suggested tabular disclosure with the following two disclosures related to nonaccrual activity for the entire reporting period:

-- Cash interest payments on all nonaccrual loans while in nonaccrual status during the period (including loans no longer in nonaccrual status at period end). The amount of payments applied to principal should generally be distinguished from those which contributed directly to income to facilitate the determination of yields.

-- Average balance of all nonaccrual loans during the period.

SUPERVISORY GUIDANCE REGARDING THE
DEFINITION OF HIGHLY-LEVERAGED TRANSACTIONS (HLTs)

The guidelines below are intended to supplement the uniform interagency definition of HLTs and the existing procedures for applying this definition.

Overview. A highly-leveraged transaction is a type of financing which involves the restructuring of an ongoing business concern financed primarily with debt. The purpose of an individual credit is most important when initially determining HLT status. Once an individual credit is designated as an HLT, all currently outstanding and future obligations of the same borrower are also included in HLT totals until such time as the borrower is removed from HLT status.

The regulatory purpose of the HLT definition is to provide a consistent means of aggregating and monitoring this type of financing transaction. The HLT designation does not imply a supervisory criticism of a credit. Before any HLT or any other credit is criticized, an examiner reviews a whole range of factors on a credit-by-credit basis. These factors include cash flow, general ability to pay interest and principal on outstanding debt, economic conditions and trends, the borrower's future prospects, the quality and continuity of the borrower's management, and the lender's collateral position. Participation of banking organizations in highly-leveraged transactions is not considered inappropriate so long as it is conducted in a sound and prudent manner, including the maintenance of adequate capital and loan loss reserves to support the risks associated with these transactions.

Treatment of Debtor-In-Possession (DIP) Financings. The agencies have further considered the question of whether some DIP loans should be included in the HLT portfolio. One important consideration in this regard is that the bankruptcy estate is considered a legally separate and distinct borrower from the pre-bankruptcy borrower. In addition, loans to DIPs generally do not meet the HLT purpose test. Further, the Chapter 11 bankruptcy code is designed to promote DIP lending and, thereby, affords significant protection to DIP lenders in order to preserve the value of the bankruptcy estate and to promote rehabilitation of the debtor. Therefore, court-approved debtor-in-possession (or trustee-in-possession) financing for a business concern in Chapter 11 reorganization proceedings will generally be exempt from HLT designation. All pre-petition debt of an HLT borrower and any post-reorganization debt (after a company emerges from Chapter 11 bankruptcy) will continue to be included in HLT exposure until delisting occurs.

Guidance on Delisting Credits from HLT Status. Options are being added to the specific HLT delisting criteria that make borrowers eligible for delisting from HLT status when all direct buyout, acquisition, or recapitalization debt satisfying the HLT purpose test has been paid and when companies perform well for an extended period of time, despite operating with high leverage. Further, the wording of the specific delisting criteria pertaining to exposures designated as HLTs because of the 75 percent leverage test is being made consistent with these new options. The general delisting criteria are reiterated below along with the four specific ways to become eligible for delisting from HLT status.

(a) General Criteria -- For credits to become eligible for removal from HLT status, a company must demonstrate an ability to operate successfully as a highly-leveraged

company over a period of time. Under normal circumstances, two years should be sufficient for the credit to show performance and to validate the appropriateness of projections. The banking organization should conduct a thorough review of the obligor to include, at a minimum, overall management performance against the business plan, cash flow coverages, operating margins, status of asset sales, if applicable, reduction in leverage, and industry risk.

(b) Specific Criteria -- In addition to these general criteria, at least one of the following specific criteria must be met to become eligible for delisting:

(1) For exposures that were included because of the 75 percent leverage test, exposures are eligible for delisting from HLT status when leverage is reduced below 75 percent, and the company has demonstrated an ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

(2) If two years have passed since a company's most recent acquisition, buyout, or recapitalization satisfying the HLT purpose test, then the borrower's credits are eligible for delisting from HLT status if **all** debt satisfying the HLT purpose test is repaid in full, even if the borrower's total liabilities to total assets leverage ratio continues to exceed 75 percent. The refinancing of HLT purpose-related debt through additional borrowings does not constitute a repayment of HLT debt. Rather, the repayment of debt must occur from cash generated from operations, planned sales of assets, or a capital injection.

(3) For exposures that were included because of the 75 percent leverage test, a borrower's credits are eligible for delisting when the borrower satisfies the general performance criteria for delisting for at least 4 (four) consecutive years since its last buyout, acquisition, or recapitalization involving financing; the company has a positive net worth; and the company's leverage ratio does not significantly exceed its industry norm. Although this criteria does not require leverage to be reduced to less than 75 percent, the borrower must demonstrate an ability to continue servicing debt satisfactorily without undue reliance on unplanned asset sales.

(4) For those exposures that arose under the "doubling of liabilities to greater than 50 percent" leverage criteria, delisting is acceptable based upon the general criteria in (a) above and a demonstrated ability to satisfactorily continue to service the debt.

As was stated in previous guidance, any significant changes in the borrower's financial condition after delisting should cause the exposure to be reviewed for relisting.

SUPERVISORY GUIDANCE ON CERTAIN ISSUES
RELATING TO NONACCRUAL ASSETS
AND FORMALLY RESTRUCTURED DEBT

Cash basis income recognition. Current regulatory reporting requirements do not preclude the cash basis recognition of income on nonaccrual assets (including loans that have been partially charged off), provided that the remaining book balance of the loan is deemed fully collectible. Recognition of interest income on a cash basis should be limited to that which would have been accrued on the recorded balance at the contractual rate. Any cash interest received in excess of this limit should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered.

Multiple loans to one borrower. As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectibility and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a depository institution does not automatically have to place all other extensions of credit to that borrower in nonaccrual status. When a depository institution has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets criteria for nonaccrual status, the depository institution should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

Acquisition of nonaccrual assets. A depository institution (or the receiver of a failed institution) may sell loans or debt securities that the institution had maintained in nonaccrual

status. Such loans or debt securities that have been acquired from an unaffiliated third party by a depository institution should be reported by the purchaser in accordance with AICPA Practice Bulletin No. 6. When the criteria specified in this Bulletin are met, these assets may be placed in accrual status.[1]

Treatment of formally restructured debt. A loan or other debt instrument that has been formally restructured in accordance with FASB Statement No. 15 so as to be reasonably assured of repayment and of performance according to a reasonable repayment schedule need not be maintained in a nonaccrual status.[2] In returning the loan to accrual status, sustained historical payment performance for a reasonable time prior to the restructuring may be taken into account.

A FASB 15 restructuring may result in a market yield on the recorded investment in the loan, i.e., an effective interest rate that is equal to the rate that the depository institution is willing to accept for a new loan with comparable risk. While a loan or other debt instrument that qualifies as a FASB Statement No. 15 restructuring must be disclosed as such in the year that the restructuring took place, restructured assets that yield market rates of interest need not continue to be reported as FASB 15 troubled debt restructurings in subsequent years.

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[1] Practice Bulletin No. 6, Amortization of Discounts on Certain Acquired Loans. American Institute of Certified Public Accountants, August 1989.

[2] Statement of Financial Accounting Standards No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, Financial Accounting Standards Board, June 1977.

Other issues. Because an analysis of the Allowance for Loan and Lease Losses (ALLL) requires an assessment of the relative credit risks in the portfolio, many depository institutions attribute for analytical purposes portions of the ALLL to loans and other assets classified "substandard" by management or a supervisory agency. Management may do this because it believes, based on past history or other factors, that there may be unidentified losses associated with loans classified in this category in the aggregate.

Furthermore, management may use this analytical approach in estimating the total amount necessary for the ALLL and in comparing the ALLL to various categories of loans over time. As a general rule, an individual loan classified substandard may remain in accrual status as long as the regulatory reporting requirements for accrual treatment are met, even when an attribution of the ALLL has been made.