The Board has a long-standing policy on real estate appraisals, which emphasizes the importance of sound appraisal policies and procedures in a banking organization's real estate lending activity. In December 1987, the Board and the other bank regulatory agencies jointly adopted guidelines for real estate appraisal policies and review procedures. With the passage of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Board, in August 1990, as well as the other federal financial institutions regulatory agencies, adopted regulations to implement the statute's title XI provisions (12 U.S.C. 3310, 3331–3351, and 1844(b)) relating to the performance and use of appraisals by federally regulated financial institutions. On June 7, 1994, the Board and the federal financial institutions regulatory agencies adopted several amendments to their appraisal regulations to clarify the agencies' appraisal requirements.[1] Additionally, the Board revised its guidelines for real estate appraisal and evaluation programs in September 1992 and October 1994. (See SR-94-50, SR-94-55, SR-95-16, SR-95-27, and SR-95-31 (SUP).)

The intent of title XI of FIRREA and subpart G of the Board's Regulation Y (12 CFR 225) is to protect federal financial and public policy interests in real estate–related financial transactions requiring the services of an appraiser. The statute requires that real estate appraisals be prepared in writing, in accordance with uniform standards, and by individuals with demonstrated competency and whose professional conduct is subject to effective supervision.

Title XI permitted each state to establish a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with *federally related transactions*.[2] Additionally, title XI designated the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. The states were authorized by title XI to establish qualification standards for licensing. It established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council to monitor the requirements established to meet the intent of title XI.

The Board's appraisal regulation requires appraisals performed in connection with federally related transactions entered into after August 9, 1990, to comply with the regulation. Real estate–related financial transactions entered into before August 9, 1990, would have had to comply with the Board's supervisory guidelines, issued in 1987, as well as with safe and sound banking practices. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform before the effective date. The requirement to use a state-certified or -licensed appraiser has a separate effective date, December 31, 1992.[3]

2231.0.1 APPRAISAL AND EVALUATION POLICY

A banking organization's board of directors is responsible for adopting policies and procedures that establish effective real estate appraisal and evaluation programs. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan-approval process, undue reliance should not be placed on the collateral value in lieu of an

1. The appraisal standards for federally related transactions are found in sections 225.61 to 225.67 of subpart G of Regulation Y. Section 225.63 was amended, effective December 28, 1998, to exclude from the Board's appraisal requirements transactions that involve underwriting or dealing in mortgage-backed securities. The amendment permits bank holding company subsidiaries engaged in underwriting and dealing in securities to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements. See 1999 FRB 50.

2. *Federally related transaction* refers to any real estate–related financial transaction entered into on or after August 9, 1990, that (1) the Board or any regulated institution engages in or contracts for and (2) requires the services of an appraiser. A *real estate–related financial transaction* is any transaction involving (1) the sale, lease, purchase, investment in, or exchange of real property, including interests in property, or the financing thereof; (2) the refinancing of real property or interests in real property; or (3) the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

3. States have the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within his or her state. Financial institutions doing business in a state that has an earlier effective date for mandatory use of a certified or licensed appraiser than the federally mandated effective date will have to abide by any state laws.

adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important to have sound appraisal policies and procedures.

2231.0.1.1 Appraisal and Evaluation Programs

The appraisal and evaluation programs should be tailored to the lender's size, its location, and the nature of its real estate market and attendant real estate–related activity. These programs should establish prudent standards and procedures which ensure that written appraisals or evaluations are obtained and analyzed for real estate–related financial transactions before a final credit decision is made.

Appraisal and evaluation programs should also establish the manner in which the institution selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. Key elements of the programs should ensure that individuals are fairly considered for the assignment, possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license if applicable, and are capable of rendering a high-quality, written appraisal or evaluation.

2231.0.1.2 Real Estate Appraisal Compliance Procedures

To ensure compliance with the Board's real estate appraisal regulation and supervisory guidelines, the banking organization should have established regulatory compliance procedures for all appraisals and evaluations. The compliance review may be part of a loan officer's overall credit analysis and may take the form of a narrative or checklist. The individual who prepared the appraisal or evaluation should take corrective action for noted deficiencies. Unreliable appraisals or evaluations should be replaced before the final credit decision. Formal documentation or evidence of the review should be maintained.

Additionally, a banking organization should have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential construction loans, or out-of-area real estate loans. The banking organization should establish criteria for identifying which appraisals should be considered for more comprehensive analytical procedures. These comprehensive analytical procedures should be designed to verify the appropriateness of the methods and approaches used in the appraisal and assess the reasonableness of the appraiser's analysis, opinions, and conclusions.

Formal documentation to support the comprehensive analytical procedures should be maintained. An individual performing this analysis, either an employee of the banking organization or an outside consultant, should have real estate–related training or experience and be independent of the transaction. The individual may not change the appraisal's or evaluation's estimate of value as a result of the review—unless that person is appropriately licensed or certified and performs the review according to procedures in the Uniform Standards of Professional Appraisal Practice (USPAP), standard 3.

2231.0.1.3 Reappraisals and Reevaluations

A program should be developed for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples include large-credit exposures and out-of-area loans. The decision to reappraise or reevaluate the real estate collateral for a subsequent transaction should be guided by the appraisal exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption, however, depends upon the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A loan may be renewed or refinanced based on a valid appraisal or evaluation if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. However, if the property has reportedly appreciated because of a planned change in use, such as rezoning, an appraisal would be required for a federally related transaction—unless another exemption applied (for example, if the amount financed is below the appraisal threshold).

While the Board's appraisal regulation generally allows appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds in excess of reasonable closing costs are advanced, a new appraisal for the renewal of an existing transaction should be obtained when there is a material change in market conditions that threatens the banking organization's real estate collateral protection.

For loan workouts, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification. If there is an expected delay in obtaining the appraisal or evaluation, the banking organization should first protect its interest to facilitate the orderly collection of the loan or to reduce the risk of loss. In a troubled-loan situation, a reappraisal would not be required when a banking organization advances funds to protect its interest in a property, such as to repair damaged property, because these funds are being used to restore the damaged property to its original condition.

Real estate posted as collateral that has been acquired by a banking organization through foreclosure or deed in lieu of qualifies for the appraisal exemption for subsequent transactions. Therefore, the banking organization is only required to have an evaluation but may first initiate the foreclosure proceedings to protect its collateral interests before obtaining the evaluation. Because the sale or disposal and the financing of the sale of other real estate owned (OREO) do not arise from an existing extension of credit, these OREO transactions do not qualify for the appraisal exemption. Thus, a banking organization is required to have a valid appraisal to support the sale of OREO unless the transaction qualifies for another appraisal exemption. If the banking organization already has a valid appraisal (or an evaluation) of the real estate, it need not obtain a new appraisal.

2231.0.2 TRANSACTIONS NOT REQUIRING THE SERVICES OF A LICENSED OR CERTIFIED APPRAISER

The Board has determined that certain categories of real estate–related financial transactions do not require the services of a certified or licensed appraiser and, as such, are not considered federally related transactions.

Transactions not requiring the services of a certified or licensed appraiser include transactions in which—

1. the transaction value[4] is $250,000 or less;
2. a lien on real property has been taken as collateral in an abundance of caution;
3. the transaction is not secured by real estate;
4. a lien on real estate has been taken for purposes other than the real estate's value;
5. the transaction is a business loan that has a transaction value of $1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
6. a lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
7. the transaction involves an existing extension of credit at the lending institution, provided that there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or there is no advancement of new monies, other than funds necessary to cover reasonable closing costs;
8. the transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
9. the transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government–sponsored agency;
10. the transaction either qualifies for sale to a U.S. government agency or U.S. government–sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

4. *Transaction value* is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered one transaction if it appears that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

11. the regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under any other law;
12. the transaction involves underwriting or dealing in mortgage-backed securities;[5] or
13. the Board determines that the services of an appraiser are not necessary to protect federal financial and public policy interests in real estate–related financial transactions or to protect the safety and soundness of the institution.

For transactions below the appraisal threshold, qualifying for the $1 million or less business-loan exemption, or qualifying for the existing extension-of-credit exemption, the Board still requires an appropriate evaluation of the real property collateral that is consistent with safe and sound banking practices.

The Board reserves the right to require an appraisal on an exempt transaction whenever it is necessary to address safety-and-soundness concerns. Whether a banking organization will be required to obtain an appraisal for a particular transaction or an entire group of credits will depend on its condition. For example, if a banking organization is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the banking organization to obtain an appraisal for all new transactions below the threshold. However, regardless of a banking organization's condition, an examiner may require an appraisal for a particular real estate–related transaction to address safety-and-soundness concerns.

2231.0.3 OBTAINING AN APPRAISAL

The banking organization or its agent is responsible for engaging the appraiser and must have sufficient time to analyze the appraisal as part of its decision process to enter into the transaction. A banking organization may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. An appraisal obtained by a financial services institution may be used by a federally regulated institution so long as procedures have been established for reviewing appraisals, the review indicates that the appraisal meets the regulation's requirements, and the review is documented in writing.

5. This Regulation Y exemption from the Board's appraisal standards was effective on December 28, 1998.

For a multiphased development or construction loan, the appraisal of an earlier phase cannot be used for a new phase due to the change in risk. However, if the original appraisal was prepared for all phases of the project, the project appraisal may be used if the appraisal's value for the new phase is still valid at the time additional credit is extended.

2231.0.4 USEFUL LIFE OF AN APPRAISAL

Since a banking organization may wish to use an existing appraisal or evaluation for a subsequent loan or investment, its appraisal and evaluation program should include criteria to determine the validity of an existing appraisal or evaluation. The useful life of an appraisal will vary, depending on the circumstances surrounding the property and the marketplace. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a banking organization should determine if any material changes to the underlying assumptions have occurred that would affect the original estimate of value.

Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; a change in zoning; or environmental contamination. The banking organization should document its information sources and analyses used to determine if an existing appraisal or evaluation remains valid. It should also document whether the banking organization will be using that appraisal or evaluation in a subsequent transaction.

2231.0.5 APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions logically so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation and to those established in USPAP as promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms com-

pleted in compliance with the regulation and USPAP are also acceptable.

2231.0.5.1 Appraisal Standards

The minimum standards for appraisals performed in connection with federally related transactions are those set forth in USPAP, as well as any other standards that the Board deems necessary. In summary, an appraisal must—

1. conform to the generally accepted appraisal standards as evidenced by USPAP, unless principles of safe and sound banking require compliance with stricter standards;
2. be written and contain sufficient information and analysis to support the banking organization's decision to engage in the transaction;
3. analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
4. be based on the definition of market value as set forth in the regulation; and
5. be performed by state-licensed or -certified appraisers in accordance with the requirements in the regulation.

The Board's appraisal regulation also permits banking organizations to use appraisals prepared according to the USPAP Departure Provision, which permits limited exceptions to ''specific guidelines'' in USPAP. Appraisers using the Departure Provision still must comply with all ''binding requirements'' of USPAP and must be sure that the resulting appraisal will not be misleading.

2231.0.5.2 Appraisal Assignment

A banking organization may engage an appraiser to perform an appraisal assignment, either a complete or a limited appraisal. In a complete appraisal assignment, an appraiser must meet all USPAP standards and guidelines in estimating market value. In a limited appraisal assignment, the appraiser elects to depart from certain specific guidelines by invoking the Departure Provision. Before beginning the appraisal, the appraiser must obtain the banking organization's concurrence that the use of the Departure Provision is appropriate for the transaction. The appraiser must ensure that the resulting appraisal report will not mislead the banking organization or other intended users of the appraisal report. The banking organization should realize that as the degree of departure increases, the extent of reliability of the limited appraisal decreases, resulting in a higher level of risk.

2231.0.5.3 Appraisal Reports

The appraisal report usually includes a disclosure of sales history and an opinion as to the highest value and best use of the property. After preparing a report, appraisers must certify that—

1. statements of fact are true and correct,
2. limiting conditions have been disclosed,
3. they have no interest (present or future) in the transaction or property,
4. compensation is not contingent on rendering a specified value,
5. they have complied with USPAP,
6. an inspection of the property was or was not performed, and
7. assistance was or was not received in the preparation of the appraisal.

Three different report formats can be used for either the complete or the limited appraisal assignment: a self-contained report, a summary report, and a restricted report. Since USPAP requires all appraisal reports to encompass all aspects of the assignment, reports will differ based on the degree of detail presented. The self-contained appraisal report provides the most detail; the summary appraisal report condenses the information; and the restricted appraisal report presents minimal information, with supporting details maintained in the appraiser's work files.

The restricted report is not appropriate for a significant number of federally related transactions because the minimal amount of information limits the usefulness of the document for underwriting, compliance, and other decision-making purposes. However, a restricted report might be used when providing ongoing collateral monitoring of a banking organization's real estate transactions and under other circumstances when a banking organization's program requires an evaluation.

2231.0.5.4 Appraisal Content

The appraisal must reflect a market value of the real estate. The regulation defines market value

as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby—

1. the buyer and seller are typically motivated,
2. both parties are well informed or well advised and acting in what they consider their own best interests,
3. a reasonable time is allowed for exposure in the open market,
4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto, and
5. the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

To properly underwrite a construction loan, a banking organization may need to know the prospective value of a property and its market value as of the appraisal date. Prospective value is based on events yet to occur, such as completion of construction or renovation, reaching stabilized occupancy, or some other event yet to be determined. Thus, more than one value may be reported in an appraisal as long as all values are clearly described and reflect the projected dates when future events could occur. Assumptions and projections used to develop prospective value estimates must be fully supported and reasonable in light of current market conditions.

2231.0.6 APPRAISAL VALUATION APPROACHES

The appraiser typically uses three market-value approaches to analyze the value of property:

1. cost approach
2. comparable-sales approach
3. capitalization-of-income approach

All three approaches have particular merits depending on the type of real estate being appraised. For single-family residential property, the cost and comparable-sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach as well as the cost and comparable-sales approaches. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approach. If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this had an impact on the value estimate.

2231.0.6.1 Value Correlation

The three value estimates—cost, market, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. When these value estimates are relatively close together, correlating them and setting the final market-value estimate presents no special problem. However, if widely divergent values are obtained by using the three appraisal approaches, the appraiser must exercise judgment in analyzing the results and determining the estimate of market value.

2231.0.6.1.1 Cost Approach

In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any depreciation, that is, disadvantages or deficiencies, of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction-cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

2231.0.6.1.2 Comparable-Sales Approach

The focus of this approach is to determine the recent sales price of similar properties. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. To determine the extent of comparability of two or more properties, the appraiser must judge their similarity with respect to age, location, condition, construction, layout, and equipment. The sales or list price of those properties that the appraiser determines to be most comparable will tend to set the range for the value of the subject property.

2231.0.6.1.3 Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach typically is used to determine the market value of income-producing properties such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted-cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual technique. The use of a particular technique will depend on whether there is project financing, there are long-term leases with fixed-level payments, and the value is being rendered for a component of the project such as land or buildings.

The accuracy of the income approach depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and method. The following data are assembled and analyzed to determine potential net income and value:

1. Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This information provides gross rental data and the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.
2. Expense data such as taxes, insurance, and operating costs being paid from revenues derived from the subject property and comparable properties. Historical trends in these expense items are also determined.
3. Timeframe for achieving "stabilized" or normal occupancy and rent levels (also referred to as holding period).
4. An appropriate capitalization rate and valuation technique, selected and applied to net income to establish a value estimate.

Basically, the income approach converts all expected future net operating income into a value estimate. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct-capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a "cap" rate. Stabilized 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.

The use of this technique assumes that either the stabilized 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, explicit discounting and direct capitalization will yield the same results.

For special-use properties, new projects, or troubled properties, the discounted-cash-flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a timeframe for achieving a stabilized or normal occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the stabilization period (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be

based on the ability of the project to generate income over time based on reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions.

2231.0.7 OTHER DEFINITIONS OF VALUE

The Board's appraisal regulation requires that the appraisal contain a market value of the real estate collateral. Some other definitions of value that are encountered when appraising and evaluating real estate transactions are described below.

1. *Fair value* is an accounting term that is generally defined as the amount in cash or cash-equivalent value or other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (selling price), other than a forced or liquidation sale.[6] According to accounting literature, fair value is generally used in valuing assets in nonmonetary transactions, troubled-debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.
2. *Investment value* is based on the data and assumptions that meet a particular investor's criteria and objectives for a specific property or project. The investor's criteria and objectives are often substantially different than those of participants in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit-analysis decisions.
3. *Liquidation value* assumes that there is little or no current demand for the property and that the property needs to be disposed of quickly. In this situation, the owner may have to sacrifice property appreciation for an immediate sale.
4. *Going-concern value* is based on the value of the business entity, rather than the value of the real estate. The valuation is based on the existing operations of a business that has a proven operating record, with the assumption that the business will continue to operate.
5. *Assessed value* represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.
6. *Net realizable value (NRV)* is recognized under generally accepted accounting principles[7] as "the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal." The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price is generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

The appraiser should state the definition of value reported in the appraisal, and, for federally related transactions, the value must meet the definition of market value in the regulation. This is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably, and the price is not affected by undue stimulus. Other presentations of value, in addition to market value, are allowed and may be included in the appraisal at the request of the banking organization.

2231.0.8 EVALUATION REQUIREMENTS

The Board's appraisal regulation requires an evaluation for certain real estate–related financial transactions that are exempt from the title XI appraisal requirement. These transactions include—

6. FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Appendix A—Glossary.

7. FASB Statement No. 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects," Appendix A—Glossary.

1. transactions below the $250,000 threshold;
2. transactions qualifying for the exemption for business loans of $1 million or less, when rental income or sales proceeds from real estate is not the primary source of repayment; and
3. subsequent transactions resulting from an existing extension of credit (for example, renewals and refinancings).

An evaluation should provide a general estimate of the value of the real estate and need not meet the detailed requirements of a title XI appraisal.[8] An evaluation must provide appropriate information to enable the banking organization to make a prudent decision regarding the transaction. Moreover, a banking organization is not precluded from obtaining an appraisal that conforms to the regulation for any exempt transaction. At a minimum, an evaluation should—

1. be written;
2. include the preparer's name, address, and signature, and the effective date of the evaluation;
3. describe the real estate collateral, its condition, and its current and projected use;
4. describe the sources of information used in the analysis;
5. describe the analysis and supporting information; and
6. provide an estimate of the real estate's market value, with any limiting conditions.

2231.0.8.1 Form and Content of Evaluations

The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the evaluator's analysis, assumptions, and conclusions. The evaluator is not required to use a particular form or valuation approach, but the analysis should apply to the type of property and fully explain the value rendered.

An individual who conducts an evaluation should have real estate–related training or experience relevant to the type of property. However, the individual does not have to be a state-licensed or -certified appraiser. Prudent practices require that a more detailed evaluation be performed as the banking organization engages in more complex real estate–related financial transactions or as its overall exposure in a real estate–related financial transaction increases.

An evaluation for a transaction that needs a more detailed analysis should describe the property; give its location; and discuss its use, especially for nonresidential property. An evaluation for a transaction that requires a less detailed analysis may be based on information such as comparable property sales information from sales-data services (for example, the multiple-listing service or current tax-assessed value in appropriate situations).[9] Further, an evaluation may be based on the banking organization's own real estate loan portfolio experience and on value estimates prepared for recent loans on comparable properties, when appraisals meeting the regulatory requirements were obtained. Regardless of the method, the banking organization must document its analysis and findings in the loan file.

2231.0.9 SELECTION AND QUALIFICATIONS CRITERIA FOR APPRAISERS AND EVALUATORS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the individual performing the appraisal or evaluation, as well as on that person's expertise at developing and interpreting pertinent data for the subject property. Appraisers and evaluators should have adequate training, experience, and knowledge of the local real estate market to make sound judgments concerning the value of a particular property. Their level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, appraisers and evaluators should be independent of the credit decision, have no interest in the property being appraised, and have no affiliations or associations with the potential borrower. Absent absolute lines of independence, a banking organization must be able to demonstrate that it has prudent safeguards in place to isolate its collateral-evaluation process from influence or interference from the loan-production process.

8. An appraisal means the kind of specialized opinion on the value of real estate that contains certain formal elements recognized by appraisal industry practices and standards.

9. Assessed values for tax purposes may be a specified fraction of market value, as determined by the tax assessor. Therefore, tax-assessed values should be adjusted to a market-value equivalent. In cases where the assessed value does not have a reliable correlation to current value, the use of assessed value would be inappropriate as the basis for an evaluation.

2231.0.9.1 Appraiser Qualifications

Title XI of FIRREA identified two classifications of appraisers to be used in federally related transactions: state-certified appraisers and state-licensed appraisers. For a state-certified appraiser, title XI anticipated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. The Appraisal Foundation standards set forth minimum educational, testing, experience, and continuing-education requirements. For a licensed appraiser, the states have some latitude to establish qualification standards, provided criteria are adequate to protect federal financial and public policy interest.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring state compliance with title XI. The Board also has the authority to impose additional certification and licensing requirements on those adopted by a given state.

2231.0.9.2 Selection of an Appraiser

An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property. In certain instances involving small banking organizations, officers and directors who perform appraisals must take appropriate steps to ensure that they are independent from the transaction under consideration.

When selecting an appraiser for an appraisal assignment, a banking organization is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a particular designation from an appraisal association, organization, or society.

In that regard, banking organizations are expected to treat all appraisers fairly and equitably in determining whether to use the services of a particular appraiser. Generally, banking organizations have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of pre-approving appraisers for ongoing appraisal work and maintaining an approved appraiser list is acceptable so long as all appraisers are required to follow the same approval process. However, a banking organization that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of other appraisal organizations—would be viewed as having a discriminatory selection process.

2231.0.9.3 Appraisals Performed by Certified or Licensed Appraisers

In summary, a banking organization is required to use a certified appraiser for (1) all federally related transactions over $1 million, (2) nonresidential federally related transactions of more than $250,000, and (3) complex residential federally related transactions of more than $250,000.[10] A banking organization may use either a state-certified or a state-licensed appraiser for noncomplex residential federally related transactions that are under $1 million.

2231.0.9.4 Other Appraiser Designations

Some states have adopted other appraiser designations that may cause confusion about whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states use designations such as ‘‘certified residential’’ appraiser and ‘‘certified general’’ appraiser, which leads to further confusion. Other states have no specified license designation but have used the term ‘‘certified residential’’ based on the standards for licensing. For this reason, a banking organization needs to understand the qualification criteria set forth by the state appraiser regulatory body and whether these standards are equivalent to the federal designations accepted by the Appraisal Subcommittee.

The Appraisal Subcommittee has recognized two other appraiser designations: certified residential appraiser and transitional licensed appraiser. For the certified residential appraiser, the minimum qualification standards are those

10. Complex one- to four-family residential property appraisal means one in which the property to be appraised, the form of ownership, or the market conditions are atypical.

established by the Appraiser Qualifications Board for "certified residential real estate appraiser." Under the Board's regulation, a certified residential appraiser would be permitted to appraise real estate in connection with a federally related transaction designated for a "certified" appraiser, provided the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the Board are also willing to recognize a transitional license that would allow a state to issue a license to an appraiser, provided the individual has passed an examination and has satisfied either the education or experience requirement. A transitional licensed appraiser is permitted to appraise real estate collateral in connection with a federally related transaction as if licensed. The transitional licensed appraiser is expected to complete the missing requirement within a set timeframe or the license expires. Recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from a new regulatory program. The Appraisal Subcommittee has advised the states that the use of the transitional licenses should be phased out once the appraiser regulatory program is fully established. As a result, the use of a transitional license and the applicable timeframe will vary from state to state.

2231.0.9.5 Qualifications of Individuals Who Can Perform Evaluations

Evaluations can be performed by a competent person who has experience in real estate–related activities, including, but not limited to, appraisals, real estate lending, real estate consulting, and real estate sales. A banking organization may also augment in-house expertise by hiring an outside consultant familiar with a certain market or a particular type of real estate. The evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and for confirming their qualifications and independence to evaluate a particular transaction. An individual performing an evaluation need not be licensed or certified. However, if a banking organization desires, it may use state-licensed or -certified appraisers to prepare evaluations.

2231.0.10 EXAMINER REVIEW OF APPRAISAL AND EVALUATION POLICIES

A banking organization's appraisal and evaluation policies and procedures will be reviewed as part of the inspection of the organization's overall activities. This includes a review of the procedures for selecting an appraiser for a particular appraisal or evaluation assignment and for confirming that the appraiser is qualified, independent, and if applicable, licensed or certified to undertake the assignment. If an institution maintains a listing of qualified real estate appraisers acceptable for the banking organization's use, the examiner should ascertain whether the board of directors or senior management has reviewed and approved the list.

If a banking organization is in troubled condition that is attributable to underwriting problems in its real estate loan portfolio, the Board may require the banking organization to obtain appraisals for all new real estate–related financial transactions below the threshold that are not subject to another exemption. The Reserve Bank will determine if a particular banking organization will have to obtain appraisals below the threshold.

When analyzing individual credits, examiners will analyze appraisals or evaluations to determine that the methods, assumptions, findings, and conclusions are reasonable and comply with the Board's rule, policies, and supervisory guidelines. Examiners should not challenge the underlying assumptions, including the discount and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Furthermore, an examiner is not bound to accept the appraisal or evaluation results, regardless of whether a new appraisal or evaluation was requested during the examination. An examiner who concludes that an appraisal or evaluation is deficient for any reason will take that fact into account when judging the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, he or she may adjust the estimated value of the property for credit-analysis purposes. It is important to emphasize that an examiner's overall analysis and classification of a credit may be based on other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation.

Significant failures to meet standards and procedures as outlined above will be criticized and corrective action will be required. Furthermore, banking organizations that fail to maintain a

sound appraisal or evaluation program or that fail to comply with the agencies' appraisal regulations and policies, or to the Board's supervisory guidelines, will be cited in inspection reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

The appraisal regulation and guidelines require that banking organizations use the services of qualified, independent, and certified or licensed appraisers to perform appraisals. Furthermore, a banking organization that knowingly uses the services of an individual who is not properly certified or licensed to perform an appraisal in connection with a federally related transaction is violating the Board's Regulation Y. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of title XI should be reported to the Federal Reserve Bank for referral to the appropriate state appraiser regulatory agency for investigation.

2231.0.11 INSPECTION OBJECTIVES

1. To determine whether policies, practices, procedures, and internal controls regarding real estate appraisals and evaluations for real estate–related financial transactions are adequate.
2. To determine whether the banking organization's officers and employees are conforming with the board of directors' appraisal policies.
3. To determine whether appraisals performed in connection with federally related transactions comply with the minimum standards of the Board's appraisal regulation and the Uniform Standards of Professional Appraisal Practice.
4. To determine if appraisers used in connection with federally related transactions are certified or licensed as appropriate.
5. To determine whether appraisers are competent to render appraisals in federally related transactions and whether they are independent of the specific transaction or other lending, investment, or collection functions as appropriate.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations or noncompliance with provisions of supervisory guidelines have been noted.

2231.0.12 INSPECTION PROCEDURES

1. Test real estate–related financial transactions for compliance with approved real estate appraisal policies and established practices, procedures, and internal controls. Also, obtain a listing of any deficiencies noted in the latest review performed by internal and/or external auditors and determine if appropriate corrections have been made. Based on these results, determine the scope of the inspection for appraisals.
   a. Provide copies of the banking organization's appraisal and evaluation policies and procedures to examiners assigned to functional areas when real estate–related transactions may require the services of an appraiser or evaluator.
   b. Review appraisals and evaluations of individual real estate–related transactions during the inspection of loans, BHC premises, DPC assets, or OREO transactions. Review the appraisals and evaluations for compliance with the Board's appraisal regulation and appraisal guidelines and with the banking organization's appraisal and evaluation programs.
   c. When real estate–related transactions are examined on a portfolio basis, review the appraisal and evaluation processes. Determine whether the processes ensure that appraisals and evaluations comply with the Federal Reserve Board's appraisal regulation, the interagency appraisal guidelines, and the banking organization's appraisal and evaluation programs.
2. When performing the above procedures, determine whether—
   a. the board of directors approves and periodically reviews the appraisal policies and procedures that establish the appraisal and evaluation programs for real estate lending, as required by the Board's real estate lending regulation;
   b. the appraisal and evaluation programs include comprehensive analytical procedures;
   c. the banking organization engages competent individuals who are independent of the transaction to perform appraisals and evaluations, and whether the appraisal and evaluation programs establish the manner in which it selects, evaluates, and monitors those individuals;
   d. the appraisal program ensures that appraisals conform to the Board's appraisal regulation;
   e. the evaluation program ensures that eval-

uations conform to the Board's guidance on evaluations (SR-94-55 and SR-94-50);
f. the appraisal and evaluation programs appropriately reflect the banking organization's size, its location, and the nature and complexity of its real estate–related activities;
g. policies and procedures require appraisals and evaluations to be written;
h. criteria have been established for determining when to obtain reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring; and
i. the banking organization has appropriate procedures to assess the validity of appraisals and evaluations for certain subsequent transactions that are exempt from the Board's appraisal requirements, or whether new appraisals or evaluations were obtained.

3. Review and assess the banking organization's compliance procedures to ensure that the appraisal and evaluation programs are effective and in compliance with regulatory requirements and that they review the appropriateness of appraisals and evaluations before final credit decisions. Determine if—
   a. The monitoring procedures demonstrate that appraisals and evaluations comply with the Board's appraisal regulation and the Board's appraisal and evaluation guidelines.
   b. The program provides that appraisals and evaluations are obtained before the final credit or other decision. However, for transactions involving loan workouts or restructurings to facilitate the orderly collection of the credit or to reduce the risk of loss, appraisals or evaluations were obtained in a reasonable time after the transaction occurs.
   c. The programs have review procedures to verify that the methods, assumptions, and conclusions in the appraisals or evaluations are reasonable and appropriate for the transaction and the property.
   d. Criteria are established to identify which transactions should have their appraisal or evaluation considered for more comprehensive analytical procedures. For example, certain types of transactions, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential real estate construction loans, or out-of-area real estate, should ensure that the appraisal or evaluation provides adequate support for the particular transaction.
   e. The banking organization ensures that individuals who perform these reviews have appropriate training and experience and are independent of the transaction.
   f. There is adequate documentation to demonstrate that the review has occurred. While a checklist may serve this purpose for many of these transactions, a more comprehensive review would require a more detailed written analysis.
   g. Appropriate procedures exist for any deficiencies noted in the review, thus requiring (1) the individual who prepared the appraisal or evaluation to correct the deficiencies or (2) a new appraisal or evaluation to be obtained before the final credit or other decision.
   h. The program ensures that changes of an appraisal's estimate of value were made in accordance with standard 3 of the Uniform Standards of Professional Appraisal Practice (USPAP), and whether the changes were made by an appropriately qualified licensed or certified appraiser.
   i. Appropriate procedures exist for referring potential cases of misconduct by licensed and certified appraisers to the appropriate state appraiser regulatory authority.

4. Assess the procedures for determining whether a real estate–related transaction requires an appraisal or evaluation, or is otherwise exempt from the Board's appraisal regulation.
   a. For appraisals required under the appraisal program, determine that—
      - the banking organization engaged the appraiser or, if the appraiser was engaged directly by another financial services entity, the banking organization determined that the appraisal complies with its own program and the Board's appraisal regulation. (The banking organization may *not* accept an appraisal prepared for the borrower.);
      - the appraisal was obtained in sufficient time to be analyzed before the final credit or other decision;
      - the appraisal conforms to the generally accepted appraisal standards as evidenced by USPAP, for example—
        — the appraiser uses the three market-value approaches—cost, comparable sales, and income—and corre-

    lates the results into a final value estimate;
  - if the above-mentioned approaches were not used, the appraiser discloses the reason and whether this affected the value estimate;
  - the appropriate type of appraisal was obtained (complete or limited), and the appropriate report format (self-contained, summary, or restricted) was used for the particular transaction; and
  - if a limited appraisal was used (that is, the appraiser invoked the Departure Provision), the appraisal fully discloses the limiting conditions;
- the appraisal is written and contains sufficient information and analysis to support the banking organization's decision to enter into the transaction;
- if the appraisal is for proposed construction or renovation, partially leased buildings, nonmarket lease terms, or tract developments with unsold units, the appraisal includes an appropriate analysis and disclosure of deductions and discounts for holding costs, marketing costs, leasing commissions, rent losses, tenant improvements, and entrepreneurial profits;
- the appraisal contains an estimate of the current market value of the property in its actual physical condition and current zoning, as defined by the Board's appraisal regulation;
- the appraisal contains an estimate of the property's prospective market value based on the completion of improvements or stabilized occupancy, if the appraisal is for a property where improvements or renovations are to be made;
- the appraisal clearly identifies each value estimate and, for the prospective value, gives the projected dates when future events are expected to occur when more than one estimate of value is reported;
- the individual who performed the appraisal was independent of the transaction and appropriately licensed and certified for the assignment:
  - A certified appraiser must perform the appraisal for a transaction of $1,000,000 or more, a nonresidential transaction of $250,000 or more, or a complex residential transaction of $250,000 or more.
  - A licensed or certified appraiser must perform the appraisal for any other type of federally related transaction.
- the individual who performed the appraisal had appropriate training and experience demonstrating expertise in appraising similar types of properties and knowledge of the property's market; and
- incidents of possible appraiser misconduct are documented for possible referral by the Reserve Bank to the state appraiser regulatory agency.

b. For exempt transactions requiring an evaluation, such as transactions below the $250,000 threshold, business loans less than $1 million, and subsequent transactions, including renewals and refinancings, determine that—
- the evaluation at a minimum—
  - is written;
  - includes the preparer's name, address, and signature and the effective date;
  - describes the real estate collateral, its condition, and its current and projected use;
  - describes the source of information used in the analysis;
  - describes the analysis and supporting information; and
  - gives an estimate of the real estate's value with limiting conditions;
- the evaluation provides sufficient detail to support the estimate of collateral value in more complex real estate–related transactions, or when the overall exposure is high;
- the individual who performed the evaluation had the appropriate real estate training and sufficient experience and knowledge of the market to prepare the evaluation; and
- the individual who performed the evaluation, regardless of whether the banking organization's staff performed the evaluation, was independent of the transaction, credit decision, or function.

5. Assess management's compliance with its policies and procedures and with the Board's appraisal regulation and guidance by reviewing appraisals and evaluations.
6. If the review of appraisals or evaluations on one- to four-family residential loans or multi-

family loans indicates that the appraisals or evaluations do not meet the Board's requirements, or that the loan-to-value ratio at origination was higher than 80 percent for fixed-rate loans or 75 percent for floating-rate loans, then these loans may not be eligible for the 50 percent risk weight permitted under the Board's risk-based capital rule.

7. Evaluate the banking organization with respect to—
   a. the adequacy of written appraisal and evaluation programs;
   b. the methods used by the banking organization's officers to conform with established policy;
   c. internal control deficiencies or exceptions;
   d. the integrity of the appraisal and evaluation process, including appraisal and evaluation compliance procedures;
   e. the integrity of individual appraisals and evaluations for their adequacy, their reasonableness, and the appropriateness of the methods, assumptions, and techniques used, and for their compliance with the Board's appraisal regulation and real estate appraisal and evaluation guidelines;
   f. recommended corrective action when policies, practices, or procedures are deficient;
   g. the degree of any violations of the Board's appraisal regulation, and the extent of noncompliance with interagency appraisal guidelines, if noted; and
   h. the existence of other matters of significance, for example—
      - misrepresentation of data such as the omission of information on favorable financing, seller concessions, sales history, feasibility, zoning, easements, or deed restrictions;
      - inadequate techniques of analysis, that is, failure to use the cost, comparable sales, or income approach in the appraisal, when the approach is appropriate for the type of property;
      - use of dissimilar comparables in the comparable-sales approach to valuation (for example, the age, size, quality, or location of the comparable is significantly different from the subject property, making reconciliation of value difficult);
      - underestimating of factors such as construction cost, construction period, lease-up period, and rent concessions;
      - use of best-case assumptions for the income approach to valuation without performing a sensitivity analysis on the factors which would identify the lender's downside risk;
      - overly optimistic assumptions, such as a high absorption rate in an overbuilt market; and
      - demographic factors, such as existing housing inventory, projected completions, and expected market share, that are not reconciled to the value rendered, but are only discussed as background information.
8. Report any instances of questionable conduct by appraisers along with supporting documentation to the Reserve Bank for possible referral to the appropriate state appraisal authorities.
9. Update workpapers with any information that will facilitate future inspections.

2231.0.13 INTERNAL CONTROL QUESTIONNAIRE

Review the internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The appraisal and evaluation system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. *The items marked with an asterisk (*) require substantiation by observation or testing.*

2231.0.13.1 Appraisal and Evaluation Policies

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define—
   a. management's responsibility for selecting, evaluating, and monitoring the individual who is performing the appraisal or evaluation?
   b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment? (This ensures that the individual is independent of the transaction, possesses the requisite expertise, and holds the proper state certification or license, if applicable.)
   c. the procedures as to when appraisals and evaluations should be obtained?

d. the procedures for when to obtain a reappraisal or reevaluation, including frequency and scope?
e. appraisal and evaluation compliance and review procedures? Will those procedures ascertain that the bank holding company's appraisals and evaluations are consistent with USPAP and the Board's regulations, policies, and guidelines?

2. Does the board of directors periodically review its appraisal, evaluation, and review policies and procedures to ensure that they meet the needs of the bank holding company's real estate lending activity?

2231.0.13.2 Appraisals

*1. Are appraisals in writing, dated, and signed?

*2. Does the appraisal meet the minimum standards of the Board's regulation and USPAP, including—
a. purpose;
b. market value;
c. effective date;
d. marketing period;
e. sales history of subject property;
f. reflection of the valuation using the cost, income, and comparable-sales approaches;
g. evaluation and correlation of the three approaches into a final value estimate based on the appraiser's judgment;
h. explanation of why an approach is inappropriate if not used in the appraisal; and
i. full support for the assumptions and the value rendered through adequate documentation?

*3. Are appraisals received before making the final credit or other decision? (For example, is the date of the loan commitment letter later than the date of the appraisal—unless the loan commitment letter is conditioned on receipt of the appraisal?)

*4. If the bank holding company is depending on an appraisal obtained for another financial services institution as support for its transaction, does the bank holding company have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation? These types of transactions would include loan participations and mortgage-backed securities.

*5. If an appraisal for one transaction is used for a subsequent transaction, are the determinations that the appraisals are still valid sufficiently documented?

2231.0.13.3 Appraisers

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Do appraisers have requisite knowledge and experience to complete the appraisal before taking the assignment?
3. Do appraisers who discover deficiencies in their expertise before taking the assignment or while performing the appraisal—
   a. disclose their lack of knowledge and/or experience to the client before accepting the assignment or when the deficiencies become readily apparent?
   b. describe in the appraisal their lack of knowledge and/or experience and the steps taken to competently complete the assignment?
4. Are appraisers independent of the transaction?
   a. Are staff appraisers independent of the lending, investment, and collection functions, and are they uninvolved, except as an appraiser, in the federally related transaction, with no direct or indirect interest, financial or otherwise, in the property?
   b. Are fee appraisers engaged directly by the banking organization or its agents, and are written assurances obtained that those appraisers have no direct or indirect interest, financial or otherwise, in the property or transaction?
5. If staff appraisers are used, does the bank holding company periodically have test appraisals performed by independent appraisers to check the organization's knowledge of trends, values, and markets?
6. If fee appraisers are used, are investigations performed to determine their qualifications and reputation?
7. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
8. Are fee appraisers paid the same fee whether or not the loan is granted?
9. If the transaction is outside the local geographic market, does the bank holding company engage appraisers or consultants with knowledge of the market where the real estate collateral is located?

2231.0.13.4 Evaluations

1. Are individuals performing evaluations independent of the transaction?
*2. Are evaluations required to be in writing, dated, and signed?
*3. Does the bank holding company require sufficient information and documentation to support the estimate of value and the evaluator's analysis?
*4. If an evaluation obtained for one transaction is used for a subsequent transaction, is the determination that the evaluation is still valid sufficiently documented?
*5. Are evaluations received before making the final credit decision?
*6. If the bank holding company is depending on an evaluation obtained for another financial services institution as support for its transaction, does the holding company have evaluation review procedures to ensure that the evaluation meets the Board's regulation and guidance?

2231.0.13.5 Evaluators

1. Are individuals who perform evaluations competent to complete the assignment?
2. Are evaluations prepared by individuals who are independent of the transaction?

2231.0.13.6 Reappraisals and Reevaluations

1. Is a formal reappraisal and reevaluation program followed?
2. Does the bank holding company sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

2231.0.14 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Appraisal standards for federally related transactions	3310, 3331, 3351	Subpart G, 225.61–67	4-053– 4-054.4	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference

2231.0.15 APPENDIX A—GUIDELINES FOR REAL ESTATE APPRAISAL AND EVALUATION PROGRAMS

INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES
October 27, 1994

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are jointly issuing these guidelines, which supersede each of the agencies' appraisal and evaluation guidelines issued in 1992.[a] These guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate–related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions.[b] Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective state supervision.

Common agency regulations[c] issued pursuant to section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) also require each regulated institution to adopt and maintain written real estate lending policies that are consistent with safe and sound banking practices and that reflect consideration of the real estate lending guidelines attached to the regulation. The real estate lending guidelines state that a real estate lending program should include an appropriate real estate appraisal and evaluation program.

Supervisory Policy

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate–related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate–related activities when assessing the appropriateness of its program.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies,[d] supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should—

a. FRB: "Guidelines for Real Estate Appraisal and Evaluation Programs," September 28, 1992; OCC: BC-225, "Real Estate Appraisal and Evaluation Guidelines," September 28, 1992; FDIC: FIL-69-92, "Guidelines for Real Estate Appraisal and Evaluation Programs," September 30, 1992; OTS: Thrift Bulletin 55, "Real Estate Appraisal and Evaluation Guidelines," October 13, 1992.

b. OCC: 12 CFR 34, subpart C; FRB: 12 CFR 208.18 and 12 CFR 225, subpart G; FDIC: 12 CFR 323; and OTS: 12 CFR 564.

c. OCC: 12 CFR 34, subpart D; FRB: 12 CFR 208, subpart C; FDIC: 12 CFR 365; and OTS: 12 CFR 545 and 563.

d. The appraisal guidance contained in the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," November 7, 1991, generally applies to all transactions.

- establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations,
- provide for the independence of the person performing appraisals or evaluations,
- identify the appropriate appraisal for various lending transactions,
- establish criteria for contents of an evaluation,
- provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision,
- assess the validity of existing appraisals or evaluations to support subsequent transactions,
- establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations, and
- establish internal controls that promote compliance with these program standards.

Selection of Individuals Who May Perform Appraisals and Evaluations

An institution's program should establish criteria to select, evaluate, and monitor the performance of the individuals who perform a real estate appraisal or evaluation. The criteria should ensure that—

- the institution's selection process is nonpreferential and unbiased;
- the individual selected possesses the requisite education, expertise, and competence to complete the assignment;
- the individual selected is capable of rendering an unbiased opinion; and
- the individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal and Evaluation Function

Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals

Although the agencies' appraisal regulations exempt certain categories of real estate–related financial transactions from the appraisal requirements, most real estate transactions over $250,000 are considered federally related transactions and thus require appraisals.[e] A "federally related transaction" means any real estate–related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.[f]

e. To facilitate recovery in designated major disaster areas, subject to safety-and-soundness considerations, section 2 of the Depository Institutions Disaster Relief Act of 1992 authorized the agencies to waive certain appraisal requirements for up to three years after a presidential declaration of a natural disaster.

f. As a matter of policy, OTS requires problem associations and associations in troubled condition to obtain appraisals for all real estate–related transactions over $100,000 (unless the transaction is otherwise exempt).

Minimum Appraisal Standards

The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must—

- conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards;

  Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise.

- be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

  As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.

- analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;

  This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.

- be based upon the definition of market value set forth in the regulation; and

  Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.

- be performed by state-licensed or -certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options

An appraiser typically uses three market value approaches to analyze the value of a property—cost, income, and comparable sales—and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he or she has complied with USPAP and is independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal.[g] When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision, which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches

g. USPAP Statement on Appraisal Standards No. 7 (SMT-7)—Permitted Departure from Specific Guidelines for Real Property Appraisal, issued March 30, 1994, effective July 1, 1994.

to value. Departure from standards designated as binding requirements is not permitted. An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.

The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations

A formal opinion of market value prepared by a state-licensed or -certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate rather than an appraisal when the transaction—

- has a value of $250,000 or less;
- is a business loan of $1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
- involves an existing extension of credit at the lending institution, provided that (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies, or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

Institutions should also establish criteria for obtaining appraisals or evaluations for safety-and-soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content

An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should—

- be written;
- include the preparer's name, address, and signature, and the effective date of the evaluation;
- describe the real estate collateral, its condition, its current and projected use;
- describe the source(s) of information used in the analysis;
- describe the analysis and supporting information; and
- provide an estimate of the real estate's market value, with any limiting conditions.

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to

understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate–related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations

Individuals who prepare evaluations should have real estate–related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or salespersons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use state-licensed or -certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate–related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations

The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction, if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions

While the agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, an institution would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral, and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit,

including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance

An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, nonresidential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified state-licensed or -certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring

The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques—even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals

Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a state-licensed or -certified appraiser violates USPAP or applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

These guidelines are designed to in ensure that troubled real estate loans receive consistent treatment nationwide. The guidelines are not intended to be a substitute for the examiner's judgment or for careful analysis of applicable credit and collateral factors. Use of the word "institution" in these guidelines refers to any lending source within the bank holding company organization, whether the lender is the parent company, a bank, thrift, or nonbanking subsidiary.

2240.0.1 EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

2240.0.1.1 Loan Policy and Administration Review

As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

2240.0.1.2 Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness

In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

There are several warning signs that real estate markets or projects are experiencing problems that may result in real estate values decreasing from original appraisals or projections. Adverse economic developments and/or an overbuilt market can affect a project's economic feasibility and may cause a real estate project and the loan to become troubled. Available indicators, such as permits for—and the value of—new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash flow problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.
- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.
- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
- Rent concessions or sales discounts resulting in cash flow below the level projected in the original feasibility study or appraisal.
- Concessions on finishing tenant space, moving expenses, and lease buyouts.
- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- Delinquent lease payments from major tenants.
- Land values that assume future rezoning.
- Tax arrearages.

As the problems associated with a commer-

cial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.
- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.
- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.
- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.
- Loans to borrowers with no development plans or noncurrent development plans.
- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.[1]

2240.0.1.3 Examiner Review of Individual Loans, Including the Analysis of Collateral Value

The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[2] However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.[3] Management is responsible for reviewing each appraisal's 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.[4] Management should adjust any assumptions used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.[5] This analysis should not be based solely on the current performance of the collateral or similar

1. As discussed more fully in Manual section 2240.0.2, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

2. The treatment of guarantees in the classification process is discussed in subsection 2240.0.3.

3. Department of the Treasury, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90–16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R–0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064–AB05); Department of the Treasury; Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90–1495).

4. Stabilized 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.

5. The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization (“cap”) rates.

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today’s market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and “cap” rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, “cap” rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and “cap” rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property 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 and can support alternative assumptions.

2240.0.2 CLASSIFICATION GUIDELINES

As with other types of loans, commercial real estate 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 classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions. In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower’s creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan’s record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be

classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.

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 fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

2240.0.2.1 Classification of Troubled Project-Dependent Commercial Real Estate Loans[6]

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. The guidelines are not intended to address loans that must be treated as "Other Real Estate Owned" for bank and BHC reporting purposes.

As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss."[7] 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 amount of the loan balance in excess of the value of the collateral, or portions thereof, should be 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, this would occur infrequently.

2240.0.2.2 Guidelines for Classifying Partially Charged-off Loans

Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

2240.0.2.3 Guidelines for Classifying Formally Restructured Loans

The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally 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

6. The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

7. For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

terms.[8] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

2240.0.3 TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.[9] The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have both the financial capacity and willingness to provide support for the credit;
- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and[10]
- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

2240.0.3.1 Considerations Relating to a Guarantor's Financial Capacity

The lending institution must have sufficient information on the guarantor's 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. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

2240.0.3.2 Considerations Relating to a Guarantor's Willingness to Repay

Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. 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. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;
- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

2240.0.3.3 Other Considerations as to the Treatment of Guarantees in the Classification Process

In general, only guarantees that are legally

8. An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a "cash flow" mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

9. Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

10. Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

During the early 1980s, open-end credit primarily consisted of credit card accounts with small lines of credit to the most creditworthy borrowers. Currently, open-end credit consists of much larger lines of credit that have been extended to diverse borrowers with a variety of risk profiles. In 1980, the Federal Financial Institutions Examination Council (FFIEC) (the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and, in 1987, the Federal Home Loan Bank Board (now the Office of Thrift Supervision)) adopted a uniform policy for the classification of installment credit based on delinquency status. The 1980 policy also provided for different charge-off time frames for open-end and closed-end credit.

Because open-ended borrowing practices had changed and institutional practices for charging off open-end accounts based on their past-due status were inconsistent, the agencies (the FRB, FDIC, OTS, and OCC) undertook a review of the 1980 FFIEC classification policy in concert with a review of all written policies, as mandated by section 303(a) of the Riegle Community Development and Regulatory Improvement Act of 1994 (RCDRIA). In February 1999, an updated policy was issued, effective for use on FFIEC bank call reports beginning December 31, 2000. This new policy was revised again and reissued in June 2000, with the same effective date. (The June 2000 policy supersedes both the 1980 policy and the updated February 1999 policy.) The June policy provides supervisory guidance for residential and home equity loans; fraudulent loans; loans to deceased persons; loans to borrowers in bankruptcy; treatment of partial payments involving past-due loans; and re-aging, deferrals, renewals, or rewrites of open-end and closed-end credit. The agencies are to use this expanded supervisory guidance when applying the uniform classifications to retail-credit loans extended by depository institutions. See SR-00-8.

While the terms of the revised policy apply only to federally insured depository institutions, the Federal Reserve believes the guidance is broadly applicable to bank holding companies (BHCs) and their nonbank lending subsidiaries. Accordingly, examiners should apply the revised policy, as appropriate, in the inspection of consumer finance subsidiaries of BHCs.

When reviewing consumer finance subsidiaries of banking organizations, examiners should consider the methodology used for aging retail loans. In accordance with the FFIEC bank call report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments. BHCs, in preparing their financial statements, are permitted to use the range of options available under GAAP. This, in effect, allows uninsured, nonbank consumer finance subsidiaries of BHCs to employ the recency method, which ages loans according to the date of the most recent payment, regardless of the contractual terms of the loan.

In general, the contractual method provides a more accurate reflection of loan performance and, therefore, is the *preferred* methodology, especially from the standpoint of financial-statement transparency and public disclosure. Examiners should encourage BHCs and their consumer finance subsidiaries to use the contractual method. However, BHCs should not change their aging methodology from contractual to recency without the prior concurrence of the Federal Reserve. A BHC subsidiary may not change its methodology if the intent or effect of such a change is to mask asset quality or financial weaknesses. Moreover, in the event that consumer receivables are transferred from a bank to its BHC or the BHC's nonbanking subsidiaries, the BHC or the nonbanking subsidiaries should continue to age the receivables according to the contractual method.

When a BHC uses the recency method, it should have adequate controls in place to accurately track the performance of loans within the retail portfolio and to demonstrate sound and compelling business reasons for the use of the recency method. Examiners should see section 3100.0 for further guidance on the review of consumer finance operations.

2241.0.1 UNIFORM RETAIL-CREDIT CLASSIFICATION AND ACCOUNT-MANAGEMENT POLICY

The uniform retail-credit classification and account-management policy issued by the FFIEC (and approved by the Federal Reserve Board) is reproduced below. The Board has clarified certain provisions of this policy. In this text, the Board's revisions are in brackets. Section numbers have also been added to the subtitles of the text.

The Uniform Retail-Credit Classification and Account-Management Policy[1] establishes standards for the classification and treatment of retail credit in financial institutions. Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

1. Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.
2. Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified loss and charged off.[2] In lieu of charging off the entire loan balance, loans with non–real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.
3. One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios greater than 60 percent should be classified substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.

   For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
4. Loans in bankruptcy should be classified loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
5. Fraudulent loans should be classified loss and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
6. Loans of deceased persons should be classified loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

1. [For the Federal Reserve's depository institution classification guidelines, see section 2060.1, "Classification of Credits," in the *Commercial Bank Examination Manual.]*

2. For operational purposes, whenever a charge-off is necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate.

OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified loss in lieu of charge-offs.

Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

2241.0.1.1 Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. "In the process of collection" means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

2241.0.1.2 Partial Payments on Open- and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, [the institution could aggregate the payments received ($150 × six payments, or $900). It could then give credit for three full months ($300 x three payments) and thus treat the loan as] three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

2241.0.1.3 Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans[3] can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

2241.0.1.4 Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

1. The borrower has demonstrated a renewed willingness and ability to repay the loan.

3. These terms are defined as follows. *Re-age:* Returning a delinquent, open-end account to current status without collecting (at the time of aging) the total amount of principal, interest, and fees that are contractually due. *Extension:* Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. *Deferral:* Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, (or the due date for subsequently scheduled payments,) of the loan. The account is shown current upon granting the deferral. *Renewal:* Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. *Rewrite:* Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

2. The account has existed for at least nine months.
3. The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once-in-twelve-months/twice-in-five-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

2241.0.1.5 Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

1. The borrower should show a renewed willingness and ability to repay the loan.
2. The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
3. Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

2241.0.1.6 Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail-Credit Classification and Account-Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account-management practices that are deficient.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

Issued by the Federal Financial Institutions Examination Council on June 6, 2000.

In carrying out its regulatory and supervisory responsibilities, the Board requires the submission of various reports from bank holding companies. These reports are an integral part of the Board's supervision, monitoring, and surveillance functions. Information from these reports is used to evaluate the performance of bank holding companies, appraise their financial condition, and determine their compliance with applicable laws and regulations. The examiner must review the reports (submitted to the Federal Reserve System) for accuracy and timeliness and insist on their being amended if material errors are found. If inaccurate data are submitted, the resulting ratios could conceal deteriorating trends in the company's financial condition and performance. Bank holding companies should maintain sufficient internal systems and procedures to ensure that reporting is accomplished according to appropriate regulatory requirements. Clear, concise, and orderly workpapers should support the data presented and provide a logical tie between report data and the financial records. For detailed current information on who must submit reports and what the reporting requirements are, see the Board's public site on the Internet at the following address: www.federalreserve.gov/boarddocs/reportforms.

2250.0.1 PENALTIES FOR ERRORS IN REPORTS

Section 8 of the Bank Holding Company Act (the act) was amended to provide for the assessment of civil money penalties for the submission of late, false, or misleading reports filed by bank holding companies that are required by the act and Regulation Y and for the failure to file the required regulatory reports. Financial institutions that have adequate procedures to avoid any inadvertent errors but that unintentionally submit incorrect information or are minimally late in publishing or transmitting the reports can be fined up to $2,000 per day. The financial institution has the burden of proving that the error was inadvertent. If the error was not inadvertent, a penalty of up to $20,000 per day can be assessed. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1 million or 1 percent of the institution's assets can be assessed for each day of the violation. Institution-affiliated parties who participate in any manner in the filing of an institution's false or misleading required regulatory report, or who cause the failure to file or a late filing of a required regulatory report, may be assessed a civil money penalty of up to $25,000 per day.

2250.0.2 APPROVAL OF DIRECTORS AND SENIOR OFFICERS OF DEPOSITORY INSTITUTIONS

The Federal Deposit Insurance Act (12 U.S.C. 1811) was amended to require each insured depository institution and depository institution holding company to give 30 days' prior notification to the federal banking authority of (1) the proposed addition of any individual to its board of directors or (2) the employment of any individual as a senior executive officer. This requirement applies to the following institutions:

1. institutions that have been chartered less than two years
2. institutions that have undergone a change in control within the preceding two years
3. institutions that are in a troubled condition or whose capital is below minimum standards

The agencies have the authority to issue a notice of disapproval to stop the appointment or employment of an individual if they feel that appointing or employing the person would not be in the interests of the public, taking into account that individual's competence, experience, character, and integrity.

2250.0.3 INSPECTION OBJECTIVES

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate and complete.
3. To recommend corrective and, if needed, formal enforcement action when official reporting practices, policies, or procedures are deficient.

2250.0.4 INSPECTION PROCEDURES

1. A bank holding company's historical record concerning the timely submission of reports should be ascertained by reviewing relevant

Reserve Bank files. The examiner should determine, from documentation in the files, which reports should have been filed because of the passage of time or the occurrence of an event. If a report is delinquent, the bank holding company should be instructed to prepare and submit the report expeditiously.

2. Copies of regulatory reports filed since the prior inspection should be reviewed and compared with company records on a random, line-by-line basis, using a significance test. In some cases, the review will necessarily extend to supporting schedules and workpapers that substantiate the data reflected in the reports. If the initial reports reviewed are found to be substantially correct, then the scope of subsequent reviews may be curtailed. If the reports are found to be incorrect, the overall review procedures should be intensified. When an error or misstatement is considered significant, the matter should be brought to management's attention and the bank holding company should be required to submit adjusted data. Improper methods used in preparing reports should be called to management's attention. The examiner should explain all changes carefully and assist bank holding company personnel in whatever way possible to ensure proper reporting in future reports.
3. At the conclusion of the review process, the examiner should discuss the following with management, when applicable:
   a. inaccuracies found in reports and the need for submission of amended pages or reports
   b. violations of law, rulings, or regulations
   c. recommended corrective action when policies or procedures have contributed to deficiencies noted in the reports or the untimely submission of report(s)
4. Details concerning the late or inaccurate preparation of reports should be listed in the inspection report on the Other Supervisory Issues report page. If the matter is considered significant, it should be noted on the Examiner's Comments and Matters Requiring Special Board Attention report page, as well. When the exceptions are considered minor and have been discussed with management and corrected, it will suffice to state this on the Other Supervisory Issues workpaper supporting page.
5. When it is determined that false, misleading, or inaccurate information is contained in financial statements or reports, consider whether formal enforcement action is needed to ensure that the offending bank holding company, financial institution, or other entity under the holding company structure will correct the statements and reports.

2250.0.5 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws* [1]	*Regulations* [2]	*Interpretations* [3]	*Orders*
Submission of reports concerning compliance with the act, or regulations or orders under it	1844(c)			
Annual reports	1844(c)	225.5(b)		
Report on intercompany transactions	1844(c)	225.5(b)		
Reports emanating from inspection report recommendations	1844(c)	225.5(b)		
Reports emanating from cease-and-desist orders	1818(b), (c)			
Civil money penalties for errors on bank call and BHC Reports	324 1847			

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. *Federal Reserve Regulatory Service* reference.

2260.0.1 INTRODUCTION

Venture capital activities are usually conducted through one or more of the following types of entities: Small Business Investment Companies (SBIC); Minority Enterprise Small Business Investment Companies (MESBIC); Non-licensed Venture Capital Companies; and Partnerships or Venture Capital Funds. SBIC's and MESBIC's are licensed and regulated by the Small Business Administration (SBA); the other types are not. Both SBIC's and MESBIC's are limited by regulation to investing in and lending to small businesses; whereas, non-licensed venture capital companies and partnerships have greater latitude. The activities of MESBIC's (section 103d companies) are specifically limited to small firms owned by socially or economically disadvantaged persons. Most banks and bank holding companies engage in venture capital activities through an SBIC because of its broad ability to take equity positions in other companies. SBIC's are permitted to own up to 49.9 percent of the voting shares of a company. By contrast, a non-licensed venture capital company that is a subsidiary of a bank holding company may not own more than 4.9 percent of the voting shares of a business. To escape from this limitation some bank holding companies have formed partnerships or venture capital funds. However, a bank holding company can only participate as a limited partner with an ownership interest not to exceed 24.9 percent. Limited partnerships are preferred by those bank holding companies who do not possess the expertise for this type of activity but seek the potential opportunity for high returns.

Through the use of private capital and, in some cases, borrowed money, venture capital companies invest in and lend to new and growing business enterprises. They prefer to invest in and lend to companies that exhibit strong management talent and clearly defined strategies. Many of the companies are yet unknown to the public. Their products either have been introduced to the market or are due to arrive in the next few years. Venture capital companies do not favor pioneering research. Instead, they are interested in financing innovative products, i.e., those next in generation to existing ones, that have a wide market appeal and the potential for strong growth. Such products are preferred because of their shorter development time and possible faster realization of profits. One of the ways a venture capital company makes money is by purchasing the common stock of an emerging company and selling it when the company has grown and the stock has appreciated in value. It also generates earnings by making convertible preferred stock investments and by lending money in the form of subordinated debentures and term loans. Usually lending agreements contain provisions which enable a venture capital company to acquire shares or increase existing holdings through the exercise of warrants or stock options at a later date. Although in most cases some equity interest is taken, venture capital companies, generally, do not acquire a controlling interest in a business they finance.

Once financing commences, venture capital companies typically take an active role in the management of the companies. They usually receive representation on the company's board of directors, which enables them to review budgets and assist in structuring the company's long-range strategic plan. Guiding a company through its developing stages is considered essential for the achievement of equity appreciation and realization of the high returns sought by venture capital companies.

2260.0.2 LOANS AND INVESTMENTS

Investments and lending philosophy may differ among venture capital companies. Some choose to be equity-oriented; that is, they look for higher returns on investments through capital appreciation, while others favor lending in the form of loans or convertible debt securities which provide cash flow to fund operations and service debt. However, most companies will strive for a diversified portfolio in terms of the type of investment and industry mix. The range of financing possibilities associated with lending and/or investing is as follows:

First Step Financing	Funds needed for seed capital to help develop an idea.
Start-up Financing	Funds needed to cover the cost of preparing a business plan, conducting market studies and opening a business.
First Stage Financing	Funds needed to start manufacturing and selling the product(s).
Second Stage Financing	Funds needed for working capital to expand production and build inventories. Company is operating but not yet profitable.
Third Stage Financing	Funds needed to improve the product, build working capital and expand marketing and production facilities. At this point, the company should be generating a profit.
Fourth Stage Financing	Additional working capital funds needed prior to initial public offering which may be as much as a year later.

In addition to the above, venture capital companies will consider financing leveraged buyouts and turnaround situations.

The degree of risk assumed varies according to the stage of financing, i.e., lower stages contain greater risk because of the requirement for longer-term investment discipline than higher stages. Investments in start-up companies typically take five to seven years or more to mature. Because of the high risk involved, most bank-affiliated venture capital companies will avoid the earlier or lower stages of financing. Newly established venture capital companies and especially those that use leverage tend to focus on the intermediate and latter stages of financing. These stages are represented primarily by debenture financing, preferred stock investments, and straight term loans. In structuring a portfolio, a venture capitalist should consider both liquidity and capital protection. The ideal financing mix might entail a limited amount of money invested in common stock with the remainder distributed between debentures, loans, and preferred stock. These instruments will provide income to cover operating expenses and service debt as well as give some protection should the business start to decline. Limited holdings of common stock give the company the opportunity to enhance earnings through capital gains without adversely effecting cash flow. Regardless of the type of financing offered, the ability to exist from an investment or loan through either the issuance of public stock or a cash buyout by a larger company is the goal of a venture capital company.

2260.0.3 FUNDING

A venture capital company may use private capital, leverage, or a combination of both to fund its portfolio of loans and investments. Venture capital companies obtain private capital from their parent organization, either banks or bank holding companies. Generally, private capital is used to fund high-risk, lower-stage investments, although some companies may diversify their portfolio and deploy a portion of capital in loans, debentures and preferred stock. Leverage may be derived from internal and external borrowings. SBIC's that are banking subsidiaries may receive funding in the form of loans from their parent bank. For those companies that are a subsidiary of a bank holding company, internal funding may be provided by the bank holding company from internal cash flow or its external borrowing sources. A bank holding company might borrow from its available bank lines or other borrowing sources to fund venture capital operations. There is, however, one exception; that is, the use of commercial paper proceeds to fund venture capital investments and loans does not appear to qualify under the exemptive provisions of section 3(a)(3) of the Securities Act of 1933. SBIC's and MESBIC's can obtain external financing from the U.S. government and the private sector, while, non-licensed venture capital companies are limited to only private sources for their external financing. Under current SBA regulations, an SBIC can borrow up to $35 million from the federal financing bank with no limit as to the aggregate amount of private debt. Because of the investment restrictions on MESBIC's, the SBA allows them to incur higher leverage. MESBIC's are permitted to

borrow up to four times their capital base and issue preferred stock to the SBA up to two times their capital base. MESBIC's also have no limit on the aggregate amount of private debt. All government borrowings ings are through the federal financing bank and carry the guarantee of the SBA. Such borrowings are classified as senior debt.

2260.0.4 PROFITABILITY

Earnings of venture capital companies can fluctuate widely depending on the nature of their activities. Those companies that blend their portfolios with loans, debentures and preferred stock investments tend to be more predictable and less erratic in earnings performance than companies that are strictly equity-oriented. The difference being that loans, debentures and preferred stock provide income to cover operating expenses and debt service requirements, while common stock investments may not yield positive returns for several years. Portfolio diversification tends to smooth out earnings, although the potential for major fluctuations in earnings exists in the future should capital gains be realized on equity investments. In measuring earnings performance, one should consider the combination of net realized earnings (net investment income plus net realized gains (losses) on sale of investments) and net unrealized appreciation or depreciation on investment holdings found in the capital structure of the balance sheet. It is not uncommon to see aggregate returns on capital reach 50

or more. Typically, returns of this magnitude are influenced by either large gains realized on the sale of investments or a substantial amount of unrealized appreciation on investments held or a combination of both. Appreciation or depreciation in portfolio investments represents potential realized gains or losses and, therefore, should be considered in evaluating the company's earnings performance. Specifically, the change in year-to-year net unrealized appreciation or depreciation is a factor that should be considered in analyzing results. When measuring the company's contribution to consolidated earnings, net unrealized appreciation or depreciation should be ignored.

2260.0.5 CAPITALIZATION

In addition to the usual equity components of capital stock, surplus and retained earnings, the capital structure of a venture capital company includes a separate category for net unrealized appreciation (depreciation) on equity interests. Net unrealized appreciation (depreciation) on equity interests represents the gross amount reported under loans and investments less an appropriate provision for taxes. Since unrealized appreciation (depreciation) on equity interests represents future profits (losses) they are measured separately in the equity account rather than in earnings.

There are no industry norms with which to measure capital adequacy. What is known, however, is that the SBA requires a minimum capital investment of $1,000,000 to establish an SBIC. Moreover, regulations governing SBIC's limit the dollar amount of investments and/or loans to a single customer to 20 percent of an SBIC's capital base. Although banks are limited by statute to a maximum capital investment in an SBIC of 4.9 percent of their primary capital, statistics show that SBIC's have substantially less than this limit. By contrast, there are no restrictions as to the amount of capital that a bank holding company may invest in a nonbank affiliated venture capital company. Dependence on capital to fund portfolio loans and investments seems to be preferred as the cost of leverage, at present, cannot provide meaningful spreads. It can be assumed that the larger the capital position the higher the dollar amount available for investing and/or lending to a single customer.

Sustained profitability and satisfactory asset quality are required to maintain financial soundness and capital adequacy. The SBA will consider an SBIC's capital as impaired if net unrealized depreciation and/or operating losses equal 50 percent or more of its capital base. It would seem appropriate to use this guideline for measuring the adequacy of capital of non-licensed venture capital companies that are affiliated with a bank holding company.

2260.0.6 INSPECTION OBJECTIVES

1. To determine whether the company is operating within the scope of its approved activities and within the provisions of the Act and Regulation Y.
2. To determine whether transactions with affiliates, especially banks, are in accordance with applicable statutes and regulations.
3. To determine the quality of the asset portfolios and whether the allowance for losses is

adequate in relation to portfolio risk and whether the nonaccrual policy is appropriate.

4. To determine the viability of the company as a going concern, and whether its affiliate status represents a potential or actual adverse influence upon the parent holding company and its affiliated bank and nonbank subsidiaries and the condition of the consolidated corporation.

5. To determine whether the company has formal written policies and procedures relating to lending and investing.

6. To determine if such policies and procedures are adequate and that management is operating in conformance with the established policies.

7. To assess management's ability to operate the company in a safe and sound manner.

8. To suggest corrective action when policies, practices or procedures are deficient, or when asset quality is weak, or when violations of laws or regulations have been noted.

2260.0.7 INSPECTION PROCEDURES

2260.0.7.1 Pre-Inspection

All SBIC's and MESBIC's are subject to comprehensive regulations and annual examinations administered by the SBA. Therefore, it is not necessary to conduct a full scope inspection of these subsidiaries. The bank holding company inspection should focus on the quality of assets, as disclosed in the annual director's valuation and financial statements submitted to the SBA on an annual basis, transactions with affiliates and an overall financial evaluation.

The decision whether the operations of a non-licensed venture capital company will be inspected "on-site" is based on the availability and adequacy of data from either the parent holding company or that which is obtained upon request from the subsidiary. The following information should be obtained and thoroughly reviewed prior to making a decision to go "on-site":

1. Minutes of the board and executive committee meetings since inception of company or the date of the previous inspection;

2. Comparative interim and fiscal financial statements containing value accounting adjustments, including the year-end filing with the SBA;

3. Listing of contingent liabilities, including any pending material litigation;

4. Latest director's valuation of loans and investments and results of latest internal loan or credit review;

5. Copies of the most recent internal and external audit reports;

6. Trial balance of all loans and investments, indicating the percent ownership of a company involving an equity interest;

7. Listing of loans, debentures and preferred stock on which scheduled payments are in arrears 30 days or more or on which payments are otherwise not being made according to original terms;

8. Details of internal and external borrowing arrangements; and

9. Any agreements, guarantees or pledges between the subsidiary and its parent holding company or affiliates.

After reviewing the above information, a decision whether or not to conduct an on-site inspection must be made. Some of the determinants of this decision would include: relative size; current level and trend of earnings; asset quality as indicated in the director's valuation of loans and investments; and the condition of the company when last inspected. From the information provided, it might be determined that the company is operating properly and is in sound condition. In such a case, an on-site inspection may not be warranted. Conversely, a deteriorating condition might be detected which would warrant a visit even though a satisfactory condition had been determined during the previous inspection. All non-licensed venture capital companies should be inspected on-site at least once every three years.

2260.0.7.2 On-Site Inspection

If the decision was made to conduct an "on-site" inspection of the subsidiary, the examiner should expand the scope of the review to include these additional procedures:

1. Hold a brief meeting with the chief executive officer of the company to establish contact and present a brief indication of the scope of the inspection;

2. Review the company's policy statements for loans, investments, nonaccruals, and charge-offs;

3. Review the latest internal review by the company's directors or the loan review department of the bank affiliate or bank holding company;

4. Conduct an independent review of the portfolio;

a. Establish the minimum dollar of loans

and investments to be reviewed to achieve at least 70 percent coverage of the portfolio;

b. Review loans and investments in sample, giving consideration to the following:

- Latest balance sheet and income data;
- Profitability projections;
- Product(s) being produced by customer and their market acceptance;
- Business plan;
- Extent of relationship with customer;
- Funding sources; and
- Ultimate source of repayment.

c. Discuss the more serious problem loans and investments with management;

d. Classify, if necessary, those loans and investments that exhibit serious weaknesses where collectibility is problematical or worse. Lower classification criteria must accompany these assets, which possess a higher degree of credit risk than found in other types of nonbank lending;

e. Determine the diversification of risk within the portfolio, i.e., the mix of loans and investments and the type of industries financed;

f. Review the adequacy of the allowance for loan losses and determine the reasonableness of the amount of unrealized appreciation or depreciation reported on the balance sheet in conjunction with the asset evaluation; and

g. Determine whether the board of directors or parent holding company has established credit limits for the maximum amount of loans and investments to be extended to a single customer. Verify adherence to the limits.

5. Review equity investments for compliance with the 4.9 percent maximum limitation to any one customer;
6. Verify office locations and activities with system approvals;
7. Compare company's general ledger with statements prepared for the latest FR Y–6;
8. Review the quality and liquidity of other investment holdings;
9. Review and classify, if necessary, assets acquired in liquidation of a customer's business due to default. Determine compliance of divestiture period with section 4(c)(2) of The Bank Holding Company Act;
10. Review the manner and frequency in which subsidiary management reports to the parent holding company;
11. Follow-up on matters criticized in the most recent audit reports and the previous inspection report on the subsidiary; and
12. Assess the expertise of subsidiary management and awareness of subsidiary directors.

2260.0.7.3 Matters Warranting Recommendation in Inspection Report

Deficiencies or concerns that warrant citation in the inspection report for the attention of management are:

1. Lack of policies and/or controls in the lending and investing functions;
2. Improper diversification of risk in the loan and investment portfolio;
3. Adverse tie-in arrangements with the affiliate bank(s):
4. Lack of management expertise;
5. Impairment of capital as a result of operating losses or high unrealized depreciation on equity interests or a combination of both; and
6. Lack of adequate reporting procedures to parent holding company management.

2260.0.8 LAWS, REGULATIONS, INTERPRETATIONS AND ORDERS

Subject	*Laws* [1]	*Regulations* [1]	*Interpretations* [3]	*Orders*
Acquisition of SBIC by a bank holding company	1843(c)(8) 1843(c)(5)	225.111	4–173 4–175 4–174	
Limitations of an SBIC's control over business enterprises		13 C.F.R. 107.901(a)		
Criteria for various types of business investments of an SBIC		13 C.F.R. 121.3–10 13 C.F.R. 121.3–11		
Acquisition of a non-licensed venture capital company by a bank holding company	1843(c)(8)	225.112		
Formation of joint ventures (limited partnerships) for purpose of conducting venture capital activities	1843(c)(6)			
Limitation on equity interests of a non-licensed venture capital company affiliated with a bank holding company	1843(c)(6)			
Loans to affiliates—Section 23A of FR Act	371c			
Restrictions on transactions with affiliates	371c			
Acquisition of shares acquired DPC	1843(c)(2)			
Acquisition of assets acquired DPC	1843(c)(2)	225.132	4–175.1	

1. 12 U.S.C., unless specifically stated otherwise.
2. 12 C.F.R., unless specifically stated otherwise.
3. Federal Reserve Regulatory Service reference.

2260.0.9 APPENDIX 1—VENTURE CAPITAL COMPANY SAMPLE BALANCE SHEET

	December 31, 19XX
ASSETS	
Cash	XXXX
Money Market investments	XXXX
Loans and investments	XXXX
Loans	XXXX
Debt securities	XXXX
Equity interests	XXXX
Total loans and investments	XXXX
Less: Allowance for losses on loans and investments	XXXX
Plus: Unrealized appreciation (depreciation) on equity interests	XXXX
Net loans and investments	XXXX
Interest and dividends receivable	XXXX
Assets acquired in liquidation of loans and investments	XXXX
Other assets	XXXX
Total assets	XXXX
LIABILITIES	
Notes payable—affiliates	XXXX
Notes payable—others	XXXX
Accrued taxes payable	XXXX
Deferred tax credits	XXXX
Other liabilities	XXXX
Total liabilities	XXXX
STOCKHOLDER'S EQUITY	
Common stock (par value XXX)	XXXX
Surplus	XXXX
Retained earnings	XXXX
Net unrealized appreciation (depreciation) of equity interests	XXXX
Total stockholder's equity	XXXX
Total liabilities and stockholder's equity	XXXX

2260.0.10 APPENDIX 2—VENTURE CAPITAL COMPANY—SAMPLE INCOME STATEMENT

	For Fiscal Year Ended December 31, 19XX
INTEREST INCOME	
Interest on loans and debt securities	XXX
Dividends on equity interests	XXX
Interest on money market investments	XXX
Total interest income	XXX
INTEREST EXPENSE	
Interest on notes payable to affiliates	XXX
Interest on notes payable to others	XXX
Total interest expense	XXX
NET INTEREST INCOME	XXX
PROVISION FOR LOAN LOSSES	XXX
Net interest after provision for loan losses	XXX
OTHER REVENUE	
Income from assets acquired in liquidation of loans and investments	XXX
Management Fees	XXX
Total other revenue	XXX
Net interest and other revenue	XXX
NONINTEREST EXPENSE	
Salaries and benefits	XXX
Management and service fees	XXX
Other expenses	XXX
Total noninterest expense	XXX
Income before taxes	XXX
Applicable taxes	XXX
Net investment income	XXX
Realized gain (loss) on sale of securities, net of tax	XXX
Net income	XXX