

**DEPARTMENT OF THE TREASURY**  
**Office of the Comptroller of the Currency**  
**[Docket No. 05-08]**

**FEDERAL RESERVE SYSTEM**  
**[Docket No. OP-1227]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**DEPARTMENT OF THE TREASURY**  
**Office of Thrift Supervision**  
**[No. 2005-14]**

**Interagency Proposal on the Classification of Commercial Credit Exposures**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury, (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision, Treasury, (OTS).

**ACTION:** Joint notice and request for comment.

**SUMMARY:** The OCC, Board, FDIC, and OTS (the agencies) request comment on their proposal to revise the classification system for commercial credit exposures.

The proposal will replace the current commercial loan classification system categories “special mention,” “substandard,” and “doubtful” with a two-dimensional based framework. The proposed framework would be used by institutions and supervisors for the uniform classification of commercial and industrial loans; leases; receivables; mortgages; and other extensions of credit made for business purposes by federally insured depository institutions and their subsidiaries (institutions), based on an assessment of borrower creditworthiness and estimated loss severity. The proposed framework would not modify the interagency classification of retail credit as stated in the “Uniform Retail Credit Classification and Account Management Policy Statement,” issued in February 2000. However, by creating a new treatment for commercial loan exposures, the proposed framework would modify Part I of the “Revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts” issued in June 2004.

This proposal is intended to enhance the methodology used to systematically assess the level of credit risk posed by individual commercial extensions of credit and the level of an institution’s aggregate commercial credit risk.

**DATES:** Comments must be received by June 30, 2005.

**ADDRESSES:** Interested parties are invited to submit written comments to any or all of the agencies. All comments will be shared among the agencies.

**ADDRESS:** Comments should be directed to:

**OCC:** You should include OCC and Docket Number 05-08 in your comment. You may submit comments by any of the following methods:

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.
- **OCC Web Site:** <http://www.occ.treas.gov>. Click on "Contact the OCC," scroll down and click on "Comments on Proposed Regulations."
- **E-mail address:** [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- **Fax:** (202) 874-4448.
- **Mail:** Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219.
- **Hand Delivery/Courier:** 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

*Instructions:* All submissions received must include the agency name (OCC) and docket number or Regulatory Information Number (RIN) for this notice of proposed rulemaking. In general, OCC will enter all comments received into the docket without change, including any business or personal information that you provide. You may review comments and other related materials by any of the following methods:

- **Viewing Comments Personally:** You may personally inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.
- **Viewing Comments Electronically:** You may request e-mail or CD-ROM copies of comments that the OCC has received by contacting the OCC's Public Information Room at [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- **Docket:** You may also request available background documents and project summaries using the methods described above.

**Board:** You may submit comments, identified by Docket Number OP-1227, by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments on the <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include docket number in the subject line of the message.
- FAX: 202-452-3819 or 202-452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, N.W., Washington, DC 20551.

All public comments are available from the Board's web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, except as necessary for technical reasons. Accordingly, your comments will not be edited to

remove any identifying or contact information. Public comments may also be viewed electronically or in paper in Room MP-500 of the Board's Martin Building (20<sup>th</sup> and C Streets, N.W.) between 9:00 a.m. and 5:00 p.m. on weekdays.

**FDIC:** You may submit comments by any of the following methods:

- Agency Web Site: <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow instructions for submitting comments on the Agency web site.
- E-mail: Comments@FDIC.gov.
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17<sup>th</sup> Street, N.W., Washington, D.C. 20429.
- Hand Delivery/Courier: Guard station at the rear of the 550 17<sup>th</sup> Street Building (located on F Street) on business days between 7:00 a.m. and 5:00 p.m. Instructions: All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html> including any personal information provided.

**OTS:** You may submit comments, identified by No. 2005-14, by any of the following methods:

- **Federal eRulemaking Portal:** <http://www.regulations.gov>. Follow the instructions for submitting comments.
- **E-mail:** regs.comments@ots.treas.gov. Please include No. 2005-14 in the subject line of the message, and include your name and telephone number in the message.
- **Fax:** (202) 906-6518.
- **Mail:** Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2005-14.
- **Hand Delivery/Courier:** Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9:00 a.m. to 4:00 p.m. on business days, Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2005-14.

**Instructions:** All submissions received must include the agency name and document number or Regulatory Information Number (RIN) for this notice. All comments received will be posted without change to <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>, including any personal information provided.

**Docket:** For access to the docket to read background documents or comments received, go to <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>. In addition, you may inspect comments at the Public Reading Room, 1700 G Street, NW, by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to

[public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10:00 a.m. and 4:00 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

#### **FOR FURTHER INFORMATION CONTACT:**

OCC: Daniel Bailey, National Bank Examiner, Credit Risk Division, (202) 874-5170, Office of the Comptroller of the Currency, 250 E Street SW, Washington, DC 20219.

Board: Robert Walker, Senior Supervisory Financial Analyst, Credit Risk, (202) 452-3429, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System. For the hearing impaired only, Telecommunication Device for the Deaf (TDD), (202) 263-4869, Board of Governors of the Federal Reserve System, 20th and C Streets NW, Washington, DC 20551.

FDIC: Kenyon Kilber, Senior Examination Specialist, (202) 898-8935, Division of Supervision and Consumer Protection, Federal Deposit Insurance Corporation, 550 17th Street NW, Washington, DC 20429.

OTS: William J. Magrini, Senior Project Manager, (202) 906-5744, Supervision Policy, Office of Thrift Supervision, 1700 G Street, NW, Washington, DC 20552.

#### **SUPPLEMENTARY INFORMATION:**

##### **Background Information**

The Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (current classification system<sup>1</sup>) was originally issued in 1938. The current classification system was revised in 1949, again in 1979,<sup>2</sup> and most recently in 2004. Separately in 1993, the agencies adopted a common definition of the special mention rating. The current classification system is used by both regulators and institutions to measure the level of credit risk in commercial loan portfolios, benchmark

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<sup>1</sup>The supervisory categories currently used by the agencies are:

Special Mention: A “special mention” asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Substandard: A “substandard” asset is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful: An asset classified “doubtful” has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable.

Loss: An asset classified “loss” is considered uncollectible, and of such little value that its continuance on the books is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future.

<sup>2</sup> The Federal Home Loan Bank Board, the predecessor of the OTS, adopted the Uniform Agreement in 1987.

credit risk across institutions, assess the adequacy of an institution's capital and allowance for loan and lease losses (ALLL), and evaluate an institution's ability to accurately identify and evaluate the level of credit risk posed by commercial exposures.

The current classification system focuses primarily on borrower weaknesses and the possibility of loss without specifying how factors that mitigate the loss, such as collateral and guarantees, should be considered in the rating assignment. This has led to differing applications of the current classification system by institutions and the agencies.

Under the current classification system, rating differences between an institution and its supervisor commonly arise when, despite a borrower's well-defined credit weaknesses, risk mitigants such as collateral and the facility's structure reduce the institution's risk of incurring a loss. The current classification system does not adequately address how, when rating an asset, to reconcile the risk of the borrower's default with the estimated loss severity of the particular facility. As a result, the system dictates that transactions with significantly different levels of expected loss receive the same rating. This limits the effectiveness of the current classification system in measuring an institution's credit risk exposure.

To address these limitations, the agencies are proposing a two-dimensional rating framework (proposed framework) that considers a borrower's capacity to meet its debt obligations separately from the facility characteristics that influence loss severity. By differentiating between these two factors, a more precise measure of an institution's level of credit risk is achieved.

The proposal includes three borrower rating categories, "marginal," "weak" and "default." Facility ratings would be required only for those borrowers rated default (i.e. borrowers with a facility placed on nonaccrual or fully or partially charged off). Typically, this is a very small proportion of all commercial exposures. For borrowers not rated default, institutions would have the option of assigning the facility ratings as discussed in the proposed framework.

The agencies believe that this flexibility will allow institutions with both one-dimensional and two-dimensional internal risk rating systems to adopt the proposed framework. Under the current classification system, institutions with two-dimensional internal credit rating systems have encountered problems translating their internal ratings into the supervisory categories.

The agencies also propose to adopt common definitions for the "criticized" and "classified" asset quality benchmarks.

In this proposed framework, the agencies have sought to minimize complexity and supervisory burden. The agencies believe that the proposed framework attains these goals and that institutions of all sizes will be able to apply the approach.

The proposed framework aligns the determination of a facility's accrual status, partial charge-off and ALLL treatment with the rating assignment process. The current framework does not provide a link between these important determinations and a facility's assignment to a supervisory category. The proposed framework leverages off many determinations and estimates management must already make to comply with generally accepted accounting principles (GAAP). As a result, financial institutions should benefit from a more efficient assessment process and improved clarity.

This proposed framework, if adopted, would apply to all regulated financial institutions and their operating subsidiaries supervised by the agencies. Institutions will

be provided transition time to become familiar with the proposal and to implement the framework for their commercial loan portfolios. In addition, the agencies will need to review the existing classification guidance for specialized lending activities, such as commercial real estate lending, to reflect the proposed rating framework. The text of the proposed framework statement follows below.

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## **UNIFORM AGREEMENT ON THE CLASSIFICATION OF COMMERCIAL CREDIT EXPOSURES**

This agreement applies to the assessment of all commercial credit exposures both on and off an institution's balance sheet. An institution's management is encouraged to differentiate borrowers and facilities beyond the requirements of this framework by developing its own risk rating system. Institutions may incorporate this framework into their internal risk rating systems or, alternatively, they may map their internal rating system into the supervisory framework. Note that this framework does not apply to commercial credit exposures in the form of securities.

The framework is built upon two distinct ratings:

- Borrower<sup>3</sup> rating – rates the borrower's capacity to meet financial obligations.
- Facility rating – rates a facility's estimated loss severity.

When combined, these two ratings determine whether the exposure will be a "criticized" or "classified" asset, as those asset quality benchmarks are defined.

### **BORROWER RATINGS: MARGINAL**

A "marginal" borrower exhibits material negative financial trends due to company-specific or systemic conditions. If these potential weaknesses are not mitigated, they threaten the borrower's capacity to meet its debt obligations. Marginal borrowers still demonstrate sufficient financial flexibility to react to and positively address the root cause of the adverse financial trends without significant deviations from their current business strategy. Their potential weaknesses deserve institution management's close attention and warrant enhanced monitoring.

A marginal borrower exhibits potential weaknesses, which may, if not checked or corrected, negatively affect the borrower's financial capacity and threaten its ability to fulfill its debt obligations.

The existence of adverse economic or market conditions that are likely to affect the borrower's future financial capacity may support a "marginal" borrower rating. An adverse trend in the borrower's operations or balance sheet, which has not reached a point where default is likely, may warrant a "marginal" borrower rating. The rating should also be used for borrowers that have made significant progress in resolving their financial weaknesses but still exhibit characteristics inconsistent with a "pass" rating.

### **WEAK**

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<sup>3</sup> Borrower means any obligor or counterparty in a credit exposure, both on and off the balance sheet.

A “weak” borrower does not possess the current sound worth and payment capacity of a creditworthy borrower. Borrowers rated weak exhibit well-defined credit weaknesses that jeopardize their continued performance. The weaknesses are of a severity that the distinct possibility of the borrower defaulting exists.

Borrowers included in this category are those with weaknesses that are beyond the requirements of routine lender oversight. These weaknesses affect the ability of the borrower to fulfill its obligations. Weak borrowers exhibit adverse trends in their operations or balance sheets of a severity that makes it questionable that they will be able to fulfill their obligations, thus making default likely. Illustrative adverse conditions that may warrant a borrower rating of “weak” include an insufficient level of cash flow compared to debt service needs; a highly leveraged balance sheet; a loss of access to the capital markets; adverse industry and/or economic conditions that the borrower is poorly positioned to withstand; or a substantial deterioration in the borrower’s operating margins. A “weak” rating is inappropriate for any borrower that meets the conditions described in the definition of a “default” rating.

## **DEFAULT**

A borrower is rated “default” when one or more of the institution’s material<sup>4</sup> credit exposures to the borrower satisfies one of the following conditions:

- (1) the supervisory reporting definition of non-accrual,<sup>5</sup> or
- (2) the institution has made a full or partial charge-off or write-down for credit-related reasons or determined that an exposure is impaired for credit-related reasons.

Borrowers rated “default” may be upgraded if they have met their contractual debt service requirements for six consecutive months and their financial condition supports management’s assessment that they will recover their recorded book value(s) in full.

## **FACILITY RATINGS:**

Facilities to borrowers with a rating of default must be further differentiated based upon their estimated loss severity. The framework contains additional applications of facility ratings; however, institutions may choose not to utilize them. An institution can estimate how severe losses may be for either individual loans or pooled loans (provided the pooled transactions have similar risk characteristics), mirroring the institution’s allowance for loan and lease losses (ALLL) methodologies. Institutions may use their ALLL impairment analysis as a basis for their loss severity estimates.

The four facility ratings are:

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<sup>4</sup> The materiality of credit exposures is measured relative to the institution’s overall exposure to the borrower. Charge-offs and write-downs on material credit exposures include credit-related write-downs on securities of distressed borrowers for other than temporary impairment, as well as material write-downs on exposures to distressed borrowers that are sold or transferred to held-for-sale, the trading account, or other reporting categories.

<sup>5</sup> An asset should be reported as being in nonaccrual status if (1) it is being maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) payment in full of principal and interest is not expected, or (3) principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection.

<b>Loss Severity Category</b>	<b>Loss Severity Estimate</b>
Remote Risk of Loss	0%
Low	<=5% of recorded investment <sup>6</sup>
Moderate	>5% and <=30% of recorded investment
High	> 30% of recorded investment

## **REMOTE RISK OF LOSS**

Management has the option to expand the use of the “remote risk of loss” facility rating to borrowers rated “marginal” and “weak.” Facilities or portions of facilities that represent a remote risk of loss include those secured by cash, marketable securities, commodities, or livestock. In the event of the borrower’s contractual default, management must be capable of liquidating the collateral and applying the funds against the facility’s balance. The balance reflected in this category should be adequately margined to reflect fluctuations in the collateral’s market price.

Loans for the purpose of financing production expenses associated with agricultural crops may be rated “remote risk of loss” if management can demonstrate that the loan will be self-liquidating at the end of the production cycle. That is, based upon current estimates of yields and market prices for the crops securing the loan, the borrower should be expected to yield sufficient cash from the sale to repay the loan in full.

Facilities guaranteed by the U.S. government or a government-sponsored entity (GSE) that have a high investment grade external rating might be included in this category. If the guaranty is conditional, the “remote risk of loss” rating should be used only when the institution can satisfy the conditions and qualify for payment under the terms of the guaranty.

Asset-based lending facilities may be rated “remote risk of loss” only if certain criteria are met, as described below (see “Treatment of Asset-Based Lending Activities.”)

## **LOW LOSS SEVERITY**

The “low loss severity” rating applies to exposures to borrowers rated default. Loss severity is estimated to be 5 percent or less of the institution’s recorded investment. Asset-based lending facilities to Weak borrowers may be rated “low loss severity” only if certain criteria are met, as described below (see “Treatment of Asset-Based Lending Activities.”)

<sup>6</sup> Recorded investment means the exposure amount reported on the financial institution’s balance sheet per the Call Report or Thrift Financial Report instructions.



## **MODERATE LOSS SEVERITY**

The “moderate loss severity” rating only applies to exposures to borrowers rated default. Loss severity is estimated to be greater than 5 percent and at most 30 percent of the institution’s recorded investment. Recovery in full is not likely.

## **HIGH LOSS SEVERITY**

The “high loss severity” rating only applies to exposures to borrowers rated default. Loss severity is estimated to be greater than 30 percent of the institution’s recorded investment. Recovery in full is not likely.

## **LOSS**

Assets rated “loss” are considered uncollectible and of such little value that their continuance on the institution’s balance sheet is not warranted. This rating does not mean that the asset has absolutely no recovery or salvage value (it may indeed have some fractional future value), but rather that it is not practical or desirable to defer writing off this basically worthless asset.

Portions of facilities rated “low loss severity” and “moderate loss severity” must be rated loss when they satisfy this definition. Entire facilities or portions thereof rated “high loss severity” must be rated loss if they satisfy the definition. Balances rated loss are charged off and netted from the facility’s balance and the institution’s loss severity estimate must be updated to reflect the uncertainty in collecting the remaining recorded investment.

A loss rating for an exposure does not imply that the institution has no prospects to recover the amount charged off. However, institutions should not maintain an asset or a portion thereof on their balance sheet if realizing its value would require long-term litigation or other lengthy recovery efforts. A facility should be partially rated “loss” if there is a remote prospect of collecting a portion of the facility’s balance. When the collectibility of the loan becomes highly questionable, it should be charged off or written down to a balance equal to a conservative estimate of its net realizable value under a realistic workout strategy. When access to the collateral is impeded, regardless of the collateral’s value, the institution’s management should carefully consider whether the facility should remain a bankable asset. Furthermore, institutions need to recognize losses in the period in which the asset is identified as uncollectible.

## **TREATMENT OF ASSET-BASED LENDING FACILITIES**

Institutions with asset-based lending (ABL) activities can utilize the following facility ratings for qualifying exposures; however, this treatment is not required. Some ABL facilities, including some debtor-in-possession (DIP) loans, may be included in the “remote risk of loss” category if they are well-secured by highly liquid collateral and the institution exercises strong controls over the collateral and the facility. ABL facilities secured by accounts receivable or other collateral that readily generates sufficient cash to repay the loan may be included in this category. In addition, the institution must have dominion over the cash generated from the conversion of collateral, prudent advance rates, strong monitoring controls, such as frequent borrowing base audits, and the expertise to liquidate sufficient collateral to repay the loan. Facilities that do not possess these characteristics are excluded from the category.

ABL facilities and the lending institution must meet certain characteristics for the exposure to be rated “remote risk of loss.”

- Convertibility
  - Institution is able to liquidate the collateral within 90 days of the borrower’s contractual default.
  - Collateral is readily convertible to cash.
- Coverage
  - Loan is substantially over-collateralized such that full recovery of the exposure is expected.
  - Collateral has been valued within 60 days.
- Control
  - Collateral is under the institution’s control.
  - Active lender management and credit administration can mitigate all loss through disbursement practices and collateral controls.

For ABL facilities whose borrower is rated weak, management may assign the “low loss severity” rating if the conditions set forth below are satisfied:

- Convertibility
  - Institution is able to liquidate collateral within 180 days of the borrower’s contractual default.
  - Substantial amount of the collateral is self-liquidating or marketable.
- Coverage
  - Loss severity is estimated to be 5 percent or less.
  - Collateral has been valued within 60 days.
- Control
  - Collateral is under the institution’s control.
  - Active lender management and credit administration can minimize loss through disbursement practices and collateral controls.

The institution’s ABL controls and capabilities are the same as those described in the “remote risk of loss” description above. This category simply lengthens the period it would likely take the institution to liquidate the collateral from 90 days to 180 days and increases the loss severity estimate from full recovery of the exposure to 5 percent or less.

**COMMERCIAL CREDIT RISK BENCHMARKS:**

Criticized Assets = All loans to borrowers rated marginal, excluding those facilities, or portions thereof, rated “remote risk of loss”

plus  
ABL transactions to borrowers rated weak, if they satisfy the “low loss severity” definition.

Classified Assets = All loans to borrowers rated default, excluding those facilities, or portions thereof, rated “remote risk of loss”  
plus  
All loans to borrowers rated weak, excluding those facilities, or portions thereof, rated “remote risk of loss” and ABL transactions rated “low loss severity.”

When calculating a financial institution’s criticized and classified assets, the institution’s recorded investment plus any undrawn commitment that is reported on the institution’s Call Report or Thrift Financial Report is included in the total, excluding any balances rated “remote risk of loss.” In the cases of lines of credit with borrowing bases or any other contractual restrictions that prevent the borrower from drawing on the entire committed amount, only the amount outstanding and available under the facility is included — not the full amount of the commitment. However, the lower amount should be used only if it is management’s intent and practice to exert the institution’s contractual rights to limit its exposure.

## **FRAMEWORK PRINCIPLES**

The borrower ratings should be utilized for both improving and deteriorating borrowers. Management should refresh ratings with adequate frequency to avoid significant jumps across their internal rating scale.

When a facility is unconditionally guaranteed, the guarantor’s rating can be substituted for that of the borrower to determine whether a facility should be criticized or classified. If the guarantor does not perform its obligations under the guarantee, the guarantor is rated default and the facility is included in the institution’s classified assets.

Loss severity estimates must relate to the institution’s recorded investment, net of prior charge-offs, borrower payments, application of collateral proceeds, or any other funds attributable to the facility.

Each loss severity estimate for borrowers rated default must reflect the institution’s estimate of the asset’s net realizable value or its estimate of projected future cash flows and the uncertainty of their timing and amount. For this purpose, financial institutions may use their impairment analysis for determining the adequacy of their ALLL. Facilities may be analyzed individually or in a pool with similar facilities.

The “default” borrower rating in no way implies that the borrower has triggered an event of default as specified in the loan agreement(s). The rating indicates only that management has placed one or more of the borrower’s facilities on non-accrual or recognized a full or partial charge-off. Legal determinations and collection strategies are the responsibility of management. If a borrower is rated default, it does not imply that the lender must take any particular action to collect from the borrower.

When management recognizes a partial charge-off, the loss severity estimate and facility rating should be updated. For example, after a facility is partly charged off, its loss severity may improve and warrant a better rating.

Estimating loss severity for many exposures to defaulted borrowers is difficult. If borrowers have filed for bankruptcy protection, there is normally significant uncertainty regarding their intent and ability to reorganize, to sell assets, to sell divisions, or, if it comes to that, to liquidate the firm. In addition, there is considerable uncertainty regarding the timing and amount of cash flows that these various strategies will produce for creditors. As a result, the loss severity estimates for facilities to borrowers rated default should be conservative and based upon the most probable outcome given current circumstances and the institution's loss experience on similar assets. The financial institution should be able to credibly support recovery rates on facilities in excess of the underlying collateral's net realizable value. Supervisors will focus on estimates where institution management has estimated recovery rates in excess of a loan's collateral value. Market prices for a borrower's similar exposures are one indication of a claim's intrinsic value. However, distressed debt prices may not be a realistic indication of value if trading volume is low compared to the magnitude of the institution's exposure.

Split facility ratings should be used only when part of the facility meets the criteria for the "remote risk of loss" category. When a portion of a facility is rated "remote risk of loss," management's loss severity estimate should only reflect the risk associated with the remaining portion of the facility.

To eliminate the need for split facility ratings and further simplify the framework, institutions have the option to disregard the "remote risk of loss" category for loans partially secured by collateral that qualify for the treatment. In that case, the institution would reflect the loss characteristics of the loan in its entirety when estimating the loan's loss severity and slot the loan in one of the three remaining facility ratings.

Because individually rating every borrower would be labor-intensive and costly, institutions may use an alternative rating approach for borrowers with an aggregate exposure below a specified threshold. Examiners will evaluate the appropriateness of the alternative rating approach and aggregate exposure threshold by considering factors such as the size of the institution, the risk profile of the subject exposures, and management's portfolio management capabilities.

The following chart summarizes the structure of the proposed framework:

**Chart 1 – Framework Overview**

← Borrower Dimension →				
Pass	Marginal	Weak	Default	
<b>Pass</b>	Remote Risk of Loss and Facility Loss Estimate = 0% Pass			↑ Facility Dimension ↓
	<b>Criticized Assets</b>	Low Loss Severity (qualifying ABL transactions) Criticized	Low Loss Severity <=5% Classified	
		<b>Classified Assets</b>	Moderate Loss Severity >5 & <=30% Classified	
			High Loss Severity >30% Classified	

**APPENDIX A. APPLICATION OF FRAMEWORK**

The following examples highlight how certain loan facilities should be rated under the “Uniform Agreement on the Assessment of Commercial Credit Risk.”

**Example 1. Marginal Borrower Rating**

Credit Facility: \$100 line of credit for working capital, \$50 outstanding

Source of Repayment:

- Primary: Cash flow from conversion of assets
- Secondary: Security interest in all corporate assets

Collateral: Accounts receivable with a net book value of \$70 from large hospitals, nursing care facilities, and other health care providers. Receivables turn slowly, 120-150 days, but with a low level of uncollectible accounts. No customer concentrations

exceed 5 percent of sales. Modest inventory levels consist of products to fill specific orders.

**Situation:**

The borrower is a distributor of health care products. Consolidation of health care providers in the firm's market area has had a negative effect on its revenues, profitability, and cash flow. The borrower's balance sheet exhibits moderate leverage and liquidity. The firm is currently operating at break-even. The firm has developed a new relationship with a hospital chain that operates in adjacent markets to the firm's traditional trade area. The new client is expected to increase sales by 10 percent in the coming fiscal year. If this expectation materializes, the borrower should return to profitability. Line utilization has increased over the last fiscal year; however, the remaining availability should provide sufficient liquidity during this slow period.

**Borrower Rating:**

The borrower has shown material negative financial trends; however, it appears that there is sufficient financial flexibility to positively address the cause of the concerns without significant deviation from its original business plan. Accordingly, the borrower is rated marginal.

The loan is included in criticized assets.

**Example 2. Weak Borrower Rating**

**Credit Facility:**

\$100 line of credit for working capital purposes, \$100 outstanding. Borrowing base equal to 70 percent of eligible accounts receivable.

**Sources of Repayment:**

Primary: Cash flow from conversion of assets

Secondary: Security interest in all unencumbered corporate assets

**Situation:**

The borrower is a regional truck transportation firm. A sustained increase in fuel prices over the last six months led to operating losses. The borrower has been unable to increase prices to offset the higher fuel prices.

The borrower's interest payments have been running 15 to 30 days late over the last several months. Net cash flow from operations is breakeven, but sufficient to meet lease payments on its truck fleet. The borrower leases all of its trucks from the manufacturer's leasing company. The line was recently fully drawn to pay registration fees and insurance premiums for the fleet. The borrower is moderately leveraged and has minimal levels of liquid assets. Borrower continues to maintain its

customer base and generate new business, but pricing pressures are forcing it to run unprofitably.

The most recent borrowing base certificate indicates the borrower is in compliance with the advance rate.

Borrower and  
Facility rating:

The borrower's unprofitable operations and lack of liquidity constitute well-defined credit weaknesses. As a result, the borrower is rated weak.

The loan is included in classified assets.

### **Example 3. Remote Risk of Loss Facility Rating**

Credit Facilities:       \$100 line of credit to fund seasonal fluctuations in cash flow  
                              \$100 mortgage for the acquisition of farmland

Sources of Repayment:

Primary:   Cash flow from operations  
Secondary: Security interest in collateral

Collateral:               The line of credit is secured by livestock and crops with a market value of \$110. The mortgage is secured by a lien on acreage valued at \$75. A U.S. government agency guarantee was obtained on the mortgage loan. The guarantee covers 75% of any principal deficiency the institution suffers on the mortgage.

Situation:                Borrower's financial information reflects the negative effect of low commodity prices and a reduction in the value of the livestock. The borrower does not have adequate sources of liquidity to remain operating. Both loans have been placed on nonaccrual since they are delinquent in excess of 90 days. Institution management has completed a recent inspection of the livestock and crops securing their loan. The borrower has placed its operations up for sale, including all of the collateral securing both loans. The farmland is under contract with a purchase price of \$75. Management expects to realize after selling expenses \$100 from the sale of livestock and crops and \$70 from the sale of the farmland. As a result, management expects to collect approximately \$20 (75% of \$30) under the government guarantee. Management estimates that the mortgage has impairment of \$10 based on the fair value of the collateral and the guarantee.

Borrower and  
Facility rating:

The borrower is rated default because the loans are on nonaccrual.

Because the line of credit is adequately collateralized by marketable collateral, the facility is rated “remote risk of loss.” The portion of the mortgage supported by the sale of the property and proceeds from the government guarantee, \$90, is also considered “remote risk of loss.” The remaining \$10 balance is rated loss due to the collateral shortfall and the unlikely prospects of collecting additional amounts.

The line of credit and the portion of the mortgage supported by the government guarantee are included in pass assets.

#### **Example 4. Rating Assignments for Multiple Loans to a Single Borrower**

Credit Facilities:        \$100 mortgage for permanent financing of an office building located at One Main Street.  
                                  \$100 mortgage for permanent financing of an office building located at One Central Avenue.

Sources of Repayment:

Primary:            Rental income  
Secondary:        Sale of real estate

Collateral:                Each loan is secured by a perfected first mortgage on the financed property. The values of the Main Street and Central Avenue properties are \$85 and \$110, respectively.

Situation:                The borrower is a real estate holding company for the two commercial office buildings. The Main Street building is not performing well and is generating insufficient cash flow to maintain the building, renovate vacant space for new tenants, and service the debt. The borrower is more than 90 days delinquent on the building’s mortgage. Because the building’s rents have declined and its vacancy rate has increased, the fair market value of the troubled property has declined to \$85 from \$120 at the time of loan origination. Market conditions do not favor better performance of the Main Street property in the short run. As a result, management has placed the loan on nonaccrual.

The Central Avenue property is performing adequately, but is not generating sufficient excess cash flow to meet the debt service requirements of the first loan. The property is currently estimated to be worth \$110. Since the loan’s primary source of repayment remains adequate to service the debt, the credit remains on accrual basis.

According to institution management’s estimates, foreclosing on the troubled Main Street building and selling it would realize \$75, net of brokerage fees and other selling



expenses. However, the institution is exploring other workout strategies exclusive of foreclosure. These strategies may mitigate the amount of loss to the institution. To be conservative, the institution bases its loss severity estimate on the foreclosure scenario. If the Central Avenue building continues to generate sufficient cash flow to service the loan and maintains its fair market value, the institution does not expect to incur any loss on the second loan. Therefore, management assigns a 5 percent loss severity estimate to the facility, which is equal to its impairment estimate for a pool of similar facilities and borrowers.

Borrower and  
Facility Ratings:

The borrower is rated default because the one mortgage is on non-accrual.

The mortgage on the Main Street property is rated “moderate loss severity” (>5% and <=30%) because management’s estimate is a 25 percent loss severity. The mortgage on the Central Avenue property is rated “low loss severity” (<=5%) because management’s estimate is a 5 percent loss severity.

Both facilities are included in classified assets.

### **Example 5. Loss Recognition**

Credit Facility: \$100 term loan

Source of Repayment:

Primary: Cash flow from business  
Secondary: Security interest in collateral

Collateral: The institution has a blanket lien on all business assets with an estimated value of \$60.

Situation: The borrower is seriously delinquent on its loan payments and has filed for bankruptcy protection. Because the borrower’s business prospects are poor, liquidation of collateral is the only means by which the institution will receive repayment. Management estimates net realizable value ranges between \$50 and \$60. As a result, management charges off \$40 and places the loan on nonaccrual. Management also assigns a 10 percent loss severity estimate to the remaining balance, which is equal to its impairment estimate for a pool of similar facilities and borrowers.

Borrower and

Facility Rating: Since the borrower's facility was placed on nonaccrual and partially charged off, the borrower is rated default.

After recognizing a loss in the amount of \$40, the facility's remaining balance is rated "moderate loss severity" (>5% and <30%) because management's analysis indicates impairment of 10 percent of the loan balance.

The loan is included in classified assets.

### **Example 6. Asset-backed Loan**

Credit Facility: \$100 revolving credit facility, \$50 outstanding with \$20 available under the borrowing base

Sources of Repayment:

Primary: Conversion of accounts receivable

Secondary: Liquidation of collateral

Collateral: Accounts receivable from companies with investment grade external ratings.

Situation: The borrower manufactures patio furniture. Because the prices of aluminum and other raw materials have increased, the borrower's profit margin has compressed significantly. As a result, the borrower's financial condition exhibits well-defined credit weaknesses.

Despite the borrower's financial weakness, the financial institution is well-positioned to recover its loan balance and interest. The institution controls all cash receipts of the company through a lock-box and applies excess funds daily against the loan balance. The institution also controls the borrower's cash disbursements. The facility has a borrowing base that allows the borrower to draw 70 percent of eligible receivables. Eligibility is based on restrictive requirements designed to exclude low-quality or disputed receivables. Management monitors adherence to the requirements by conducting periodic on-site audits of the borrower's accounts receivable. Management estimates that the facility is not impaired because the collateral is liquid and has ample coverage, the account receivables counterparties are highly creditworthy, and the institution's management not only has tight controls on the loan but also has a favorable track record of managing similar loans. In the event of the borrower's contractual default, the institution's management believes that it would recover sufficient cash to repay the loan within 60 days.

Borrower and  
Facility Rating:

The borrower is rated weak due to its well-defined credit weaknesses.

The facility is rated “remote risk of loss” because of institutional management’s expertise; the facility’s strong controls and high quality; and the collateral’s liquidity and ample coverage.

The facility is included in pass assets.

### **Example 7. Debtor-in-Possession**

Credit Facility: \$100 debtor-in-possession (DIP) facility, \$70 outstanding with \$10 available  
\$100 term loan

Sources of Repayment:

Primary: Cash flow from operations

Secondary: Liquidation of collateral

Collateral:

The DIP facility is secured by receivables from several investment grade companies and underwritten with a conservative advance rate to protect against dilution risk.

The term loan is secured by equipment.

Situation:

The borrower has filed for Chapter 11 bankruptcy protection because the recall of one of the company’s products has precipitated a substantial decline in sales. The product liability litigation resulted in substantial legal expenses and settlements. Because collecting the term loan in full is very unlikely, the financial institution’s management placed the term loan on nonaccrual prior to the borrower’s bankruptcy filing. Management estimates the institution will collect 70 percent to 80 percent on their secured claim under the borrower’s bankruptcy reorganization plan. Based on this estimate, management charges off \$20 and estimates impairment of \$10 for the remaining balance. The DIP facility repaid the pre-petition asset-based line of credit. Management has expertise in asset-based lending and strong controls over the activity.

Borrower and  
Facility Rating:

The borrower is rated default since one of its facilities was placed on nonaccrual.

The DIP facility is rated “remote risk of loss” not only because it is secured by high-quality receivables with ample coverage, but also because the financial institution’s management has performed frequent borrowing-base audits and has strong

controls over cash disbursements and collections. The term loan is rated “moderate loss severity” (>5% and <=30%) because management’s impairment estimate for the remaining loan balance falls within this range.

The DIP facility is included in pass assets.  
The term loan is included in classified assets.

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### **Request for Comment**

The agencies request comments on all aspects of the proposed policy statement. In addition, the agencies also are asking for comment on a number of issues affecting the policy and will consider the answers before developing the final policy statement. In particular, your comments are needed on the following issues:

1. The agencies intend to implement this framework for all sizes of institutions. Could your institution implement the approach?
2. If not, please provide the reasons.
3. What types of implementation expenses would financial institutions likely incur? The agencies welcome financial data supporting the estimated cost of implementing the framework.
4. Which provisions of this proposal, if any, are likely to generate significant training and systems programming costs?
5. Are the examples clear and the resultant ratings reasonable?
6. Would additional parts of the framework benefit from illustrative examples?
7. Is the proposed treatment of guarantors reasonable?

Please provide any other information that the agencies should consider in determining the final policy statement, including the optimal implementation date for the proposed changes.

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT NOTICE AND REQUEST  
FOR COMMENT, “INTERAGENCY PROPOSAL ON THE CLASSIFICATION OF  
COMMERCIAL CREDIT EXPOSURES”]

Dated: March 17, 2005

Julie L. Williams (signed)

**Julie L. Williams,**  
*Acting Comptroller of the Currency*

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT NOTICE AND REQUEST  
FOR COMMENT, “INTERAGENCY PROPOSAL ON THE CLASSIFICATION OF  
COMMERCIAL CREDIT EXPOSURES”]

Board of Governors of the Federal Reserve System, March 21, 2005

Jennifer J. Johnson (signed)  
**Jennifer J. Johnson,**  
Secretary of the Board.

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT NOTICE AND REQUEST  
FOR COMMENT, “INTERAGENCY PROPOSAL ON THE CLASSIFICATION OF  
COMMERCIAL CREDIT EXPOSURES”]

Dated at Washington, D.C., this 18<sup>th</sup> day of March, 2005.

FEDERAL DEPOSIT INSURANCE CORPORATION

Robert E. Feldman (signed)

**Robert E. Feldman,**  
Executive Secretary.

[THIS SIGNATURE PAGE PERTAINS TO THE JOINT NOTICE AND REQUEST FOR COMMENT, "INTERAGENCY PROPOSAL ON THE CLASSIFICATION OF COMMERCIAL CREDIT EXPOSURES"]

Dated: March 18, 2005

By the Office of Thrift Supervision,

James E. Gilleran (signed)  
**James E. Gilleran,**  
*Director.*