



EXAMINING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Examining Circular

Subject: Guidelines for Capitalization of Interest
on Loans

The guidelines in EC 229 also apply to federal savings associations; refer to the policy statement attached to OCC Bulletin 2023-23.

TO: Deputy Comptrollers; District Administrators; Division Directors; and Examining Personnel

PURPOSE

This issuance describes OCC policies governing the accounting treatment for capitalization of interest on loans.

POLICY

Capitalization of interest should be based upon the borrower's ability to discharge the indebtedness in the normal course of business.

BACKGROUND

Capitalized interest on loans is generally defined as uncollected interest which is added to unpaid principal in accordance with the contractual loan agreement. Although there are several ways this can occur, two methods predominate.

One arises when the cash interest payment required from the borrower at the regular interest payment date is less than the actual rate of interest charged. The loan contract usually provides for any difference to be added to the principal amount of the loan and repaid at a later date. Examples include "negative amortization" home mortgage loans, equipment installment loans with skip payment provisions and loans having maximum payment provisions in the initial term offset by larger payments in the latter term ("capped loans").

The second method involves loans which are renewed at maturity with the uncollected interest included in the new loan. Such arrangements occur in connection with real estate construction financing and agricultural credits.

Although interest is capitalized under the terms of the loan contract and is added to the note, capitalization of interest for reporting purposes is appropriate only when the borrower has the ability to repay the debt in the normal course of business. However, present regulatory and generally accepted accounting principles do not provide specific guidance as to when interest



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capitalization is appropriate. The prevailing practice has generally relied upon safe and sound lending policies consistent with prudent credit judgement. The lack of specific guidance and increased frequency of the practice make the issuance of formal guidance appropriate.

Loan agreements with borrowers are not affected by these guidelines and will continue to be based upon the bank's established lending policy. However, since capitalization of interest may reduce the normal discipline imposed by payment of full interest charges, it is important that banks maintain adequate procedures for monitoring and controlling such loans.

PROCEDURES

The appropriateness of interest capitalization for accounting purposes is based primarily upon the creditworthiness of the borrower. The evaluation of the creditworthiness of a borrower should be based upon credit quality factors consistent with those employed in the classification of credits as identified in Section 215.1 of the Comptroller's Handbook for National Bank Examiners. In evaluating these credits, the following questions should be considered in determining whether credit quality is such that capitalization of interest is appropriate.

- Was interest capitalization anticipated upon approval of the initial loan based upon a planned temporary lack of borrower cash flow?
- Is the loan well secured either by (a) collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including capitalized and accrued interest) in full, or (b) by the guaranty of a financially responsible party?
- Is repayment of the loan, including capitalized interest, based upon a reasonably ascertainable event in the future?
- Can the borrower obtain funds from sources other than the existing creditor at similar rates and terms?
- Is there little or no doubt as to the ultimate collection of all principal and interest?

If the answers to the above questions are predominantly affirmative, then interest capitalization may be acceptable. However, the above questions are not intended to be the only factors considered in such an analysis. As mentioned, the key to this determination is credit quality.



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Reporting of capitalized interest may be acceptable for credits of sound quality even though the answers to some of the above questions are negative. Since the evaluation of credit quality necessarily involves the exercise of prudent judgment, the examiner should exercise caution in determining whether reporting of capitalized interest as current income is appropriate. For example, there is a presumption against capitalization of interest for loans classified substandard. It is recognized though, that circumstances may exist whereby such capitalization is appropriate. In no case, however, should interest capitalization be permitted if the analysis results in the loan being classified (by the examiner or through a similar internal bank classification system) as: (1) loss; (2) doubtful; (3) value impaired; or (4) nonaccrual.

If it is clear upon applying this analysis that interest has been inappropriately capitalized, the amount should be reversed or charged off in accordance with the methods permitted in the Instructions - Consolidated Reports of Condition and Income. Although it may be difficult to determine when capitalization of interest should cease, it should not be permitted after it is no longer prudent based upon the criteria described above.

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