Troubled Debt Restructuring / Nonaccrual Loans

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Troubled Debt Restructuring (TDR) Reporting Considerations

Step One:
Determine whether the borrower is experiencing financial difficulties

(generally more than one of these)

- Default on any debts
- Headed toward or is in bankruptcy
- Questionable ability to remain an ongoing concern
- Unable to service debt based on reasonable terms
- Inability to obtain takeout financing (as planned)
- Inability to obtain funds from another bank at a rate granted to non-troubled borrowers
- Borrower's securities have been delisted
- Debt specific weakness (e.g., inability to maintain tenants/rents or loss of key leadership)

Step Two:
Determine whether a concession has been granted

- Forgive principal or interest
- Lower the interest rate to a below market rate
- Defer principal payments (e.g., I/O)
- Extend the repayment period

"Concession"
Frequently Asked Questions

- What is market rate of interest?

- What would be an appropriate use of interest-only terms?

Red flag: Loan with Concession but Borrower not "Experiencing Financial Difficulties"

- Generally not a TDR <u>if</u> the borrower can obtain funds from sources other than the lender at market rates and terms and can afford those payments
- Declaring a borrower is not "experiencing financial difficulties" is sometimes misused
- If there is a concession, what is the underlying rationale?
  - Debt forgiveness, reduction in the rate (relative to prime rate), or protracted terms **AND**
  - Borrower is not being sought as a new customer by other banks

Regulatory Reporting / Accounting Considerations

Implications for Interest Accrual

- Bank should not materially overstate income.
- Decision to return a loan to accrual status should be based on a sustained period of performance at the revised terms (e.g., six months).

TDR Treatment

- Banks need to assess whether (a) the borrower is ***experiencing financial difficulties***, <u>and</u> (b) the lender has granted a ***concession***.

Call Report (Schedule RC-C Part I memoranda item 1b)

- Restructured loans are reported as restructured until paid in full.
- However, a restructured loan that is in compliance with its modified terms and yields a market rate need not continue to be reported as a troubled debt restructuring after the year in which the restructuring took place.

Allowance for Loan and Lease Losses (ALLL)

- Loans that are reported as TDRs are deemed to be impaired and are generally evaluated on an individual loan basis, based on the present value of expected cash flows.
- Loans with smaller balances and/or common risk characteristics may be pooled; when ASC 310-30 applies, modifications do not result in removal from the pool.

SR 09-7 Prudent Commercial Real Estate Loan Workouts

Selected Examples

Attachment One

Income Producing Property
Office Building

(pages 14-16)

BASE CASE:

- Lender originates $15 million loan for purchase of office building
- Monthly payments based on 20-year amortization and $13.6 million balloon payment at end of year three
- At origination, loan had a:
  - 75 percent loan-to-value (LTV) based on an appraisal reflecting a $20 million market value on an "as stabilized" basis
  - debt service coverage ratio of 1.35x
  - market interest rate
- Lender expected to renew loan when balloon payment became due at end of year three
- Project cash flow has declined. Borrower granted rental concessions to existing tenants to retain them and compete with other landlords in a weak economy

Income Producing Property
Office Building (Cont'd)

(pages 14-16)

SCENARIO 1:

- At maturity, lender:
  - renewed $13.6 million loan at a market rate of interest that provides for the incremental credit risk
  - amortized the principal over the remaining 17 years
- Borrower had not been delinquent on prior payments
- Borrower has sufficient cash flow to service the market rate terms at a debt service coverage ratio of 1.12x
- Majority of tenants are now stable occupants with long-term leases

Income Producing Property
Office Building (Cont'd)

(pages 14-16)

SCENARIO 1: NONACCRUAL TREATMENT

Lender should maintain loan on accrual status

- Borrower has demonstrated ability to make regularly scheduled payments
- Despite decline in the borrower's creditworthiness, cash flow appears sufficient to make payments
- Full repayment of principal and interest is expected

SCENARIO 1: TDR TREATMENT

Renewed loan is not considered a TDR

- Although experiencing some financial deterioration, borrower has:
  - sufficient cash flow to service debt
  - no record of payment default
- Therefore, borrower is not ***experiencing financial difficulties***

Income Producing Property
Office Building (Cont'd)

(pages 14-16)

SCENARIO 2:

- At maturity, lender:
  - renewed $13.6 million loan at a market rate of interest that provides for the incremental credit risk
  - amortized the principal over the remaining 17 years
- Borrower had not been delinquent on prior payments
- Building's net operating income has decreased; current cash flow to service the new loan has declined, resulting in a debt service coverage ratio of 1.12x
- Some of the leases are coming up for renewal; additional rental concessions may be necessary to keep existing tenants in a weak economy
- Project debt service coverage not expected to drop below 1.05x
- Current valuation has not been ordered. Lender estimates the property's current "as stabilized" market value at $14.5 million or a 94 percent LTV
- Lender has not asked borrower to provide current financial statements to assess borrower's ability to service the debt with cash from other sources

Income Producing Property
Office Building (Cont'd)

(pages 14-16)

SCENARIO 2: NONACCRUAL TREATMENT

Lender should maintain loan on accrual status

- Borrower has demonstrated ability to make regularly scheduled payments
- Despite decline in the borrower's creditworthiness, cash flow appears sufficient at this time to make payments
- Full repayment of principal and interest is expected

SCENARIO 2: TDR TREATMENT

Renewed loan is not considered a TDR

- Although experiencing some financial deterioration, borrower is not ***experiencing financial difficulties*** given:
  - sufficient cash flow to service debt
  - no history of payment default

Income Producing Property
Office Building (Cont'd)

(pages 14-16)

SCENARIO 3:

- At maturity, lender restructured $13.6 million loan at:
  - 12-month, interest-only basis
  - below-market interest rate
- Borrower had been sporadically delinquent on prior payments
- Project debt service coverage is expected at 1.12x based on the preferential terms
- At time of restructuring, majority of tenants had short-term leases; some were behind on rental payments to borrower
- Tenant situation has not improved since restructuring
- Recent appraisal reported a $14.5 million "as stabilized" market value for the property or a 94 percent LTV

Income Producing Property
Office Building (Cont'd)

(pages 14-16)

SCENARIO 3: NONACCRUAL TREATMENT

Lender should not maintain loan on accrual status

- Loan was not restructured with reasonable repayment terms
- Borrower has limited capacity to service a below-market rate loan on an interest-only basis
- Reduced estimate of cash flow from the property indicates full repayment of principal and interest is not reasonably assured

SCENARIO 3: TDR TREATMENT

Renewed loan is a TDR

- Borrower is ***experiencing financial difficulties*:**
  - cash flow is questionable, lease income is declining, loan payments have been sporadic, and collateral values have declined
- Borrower granted a concession:
  - Below-market interest rate; deferred principal payments

Construction Loan
Single-Family Residence

(pages 20-22)

BASE CASE:

- Lender originated a $400,000 construction loan on single-family “spec” residence with a 15-month maturity
- Loan required monthly interest only payments at a market rate
- Loan was based on a 70 percent LTV at origination
- During original loan construction phase, borrower made all interest payments from personal funds
- At maturity, house had not sold
- Borrower unable to find another lender willing to finance property under similar terms

Construction Loan
Single-Family Residence (Cont'd)

(pages 20-22)

SCENARIO 1:

- At maturity, lender restructured loan for one year on an interest only basis at a below-market rate
- LTV at restructure date was 90 percent
- Borrower has limited ability to continue to pay interest from personal funds
- If house does not sell by revised maturity date, borrower plans to rent it out
- In this event, lender will consider modifying debt into amortizing loan with a 20-year maturity, which is consistent with this type of income-producing investment property
- Any shortfall between the net rental income and loan payments would be paid by the borrower

Construction Loan
Single-Family Residence (Cont'd)

(pages 20-22)

SCENARIO 1: NONACCRUAL TREATMENT

Lender should not maintain loan on accrual

- Loan was not restructured on reasonable repayment terms
- Borrower has limited capacity to service a below-market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is questionable

SCENARIO 1: TDR TREATMENT

Lender should report the restructured loan as a TDR

- Borrower is ***experiencing financial difficulties***
  - Depleted cash reserves; inability to refinance this debt at similar terms with other sources; inability to repay loan at maturity consistent with the original exit strategy
- Concession was provided. Loan renewed with:
  - Principal payments deferred
  - A below-market interest rate for an additional year when loan was no longer in construction phase

Construction Loan
Single-Family Residence (Cont'd)

(pages 20-22)

SCENARIO 2:

- At maturity, lender restructured the original debt for one year at interest-only with a below-market rate to allow borrower more time to sell the house
- Eight months later, the borrower rented out the property
- At that time, borrower and lender agreed to restructure the loan again
- Terms call for monthly payments that amortize the debt over 20 years at a market rate for a residential investment property
- Since the date of the second restructuring, borrower has made all payments for over six consecutive months

Construction Loan
Single-Family Residence (Cont'd)

(pages 20-22)

SCENARIO 2: NONACCRUAL TREATMENT

Lender should maintain loan on nonaccrual after first restructure

- Loan was not restructured on reasonable repayment terms

Lender may return loan to accrual after second restructure

- Sustained performance demonstrated under reasonable repayment terms
- Lender expects full repayment of principal and interest from rental income

SCENARIO 2: TDR TREATMENT

Lender should report the first restructuring as a TDR

- Borrower is ***experiencing financial difficulties*** given depleted cash resources and weak financial condition; interest-only terms granted

Second restructuring is not considered a TDR

- No concession was granted given the loan is at market rate and terms

Commercial Operating Line of Credit in Connection with Owner-Occupied Real Estate

(pages 25-26)

BASE CASE:

- Two years ago, lender originated CRE loan at a market rate to a borrower whose business occupies the property
- Loan was based on a 20-year amortization with balloon payment due in 3 years
- LTV equaled 70 percent at origination
- One year ago, lender financed a $5 million interest-only operating line of credit (LOC) for seasonal business operations at a market rate
- LOC has a 1-year maturity; secured with blanket lien on all business assets
- To better monitor ongoing overall collateral position, lender established a borrowing base reporting system, which includes monthly accounts receivable aging reports
- At maturity of the operating LOC, borrower’s A/R aging report reflects growing delinquencies, which are causing the borrower some temporary cash flow difficulties
- Borrower has recently initiated more aggressive collection efforts

Commercial Operating Line of Credit in Connection with Owner-Occupied Real Estate

(pages 25-26)

SCENARIO 1:

- Lender renewed the $5 million operating LOC for one year
- LOC requires monthly interest payments at a market rate
- Borrower's liquidity position has tightened but remains satisfactory
- Borrower's cash flow to service all debt is 1.2x; both loans have been paid according to the contractual terms
- Primary repayment source is from business operations, which remain satisfactory
- An updated appraisal is not considered necessary

Commercial Operating Line of Credit in Connection with Owner-Occupied Real Estate

(pages 25-26)

SCENARIO 1: NONACCRUAL TREATMENT

Lender should maintain CRE loan and renewed operating LOC on accrual

- Borrower has demonstrated ongoing ability to perform
- Borrower has financial capacity to pay at market rate of interest
- Full repayment of principal and interest is reasonably assured

SCENARIO 1: TDR TREATMENT

Lender does not need to report the renewed operating LOC as a TDR

- Borrower has been affected by declining economic conditions
- However, borrower is not ***experiencing financial difficulties***:
  - Borrower has ability to repay both loans, which represent most of its obligations, at a market rate of interest
  - Lender expects full collection of principal and interest from borrower's operating income

Sources of Relevant Supervisory and Accounting Guidance

(pages 29-30)

Attachment 2
Sources of Relevant Supervisory and Accounting Guidance

Supervisory Guidance

- Federal regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: FDIC: 12 CFR part 365 and appendix A; FRB: 12 CFR part 208 subpart E and appendix C; OCC: 12 CFR part 34, subpart D and appendix A: and OTS: 12 CFR Parts 545 and 563. For NCUA, refer to 12 CFR part 723 for member business loan regulation which addresses commercial real estate lending.
- Federal appraisal regulations: FDIC: 12 CFR part 323; FRB: 12 CFR part 208 subpart E and 12 CFR part 225 subpart G; OCC: 12 CFR part 34, subpart C; OTS: 12 CFR Part 564; and NCUA: 12 CFR part 722.
- *FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income* (FFIEC 031 and FFIEC 041 Instructions); *Thrift Financial Report (TFR) Instruction Manual*; and *NCUA 5300 Call Report Instructions*.
- FRB, FDIC, and OCC joint guidance and the OTS guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, issued December 2006.
- *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, issued December 2006.
- *Interagency FAQs on Residential Tract Development Lending*, issued September 2005.
- *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*, issued July 2001.[26]
- *Interagency Appraisal and Evaluation Guidelines*, issued October 1994.[27]

[26] The guidance in the July 2001 Policy Statement was substantially adopted by the NCUA through its Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions*, in May 2002.

[27] The October 1994 guidance was issued by NCUA through its Letter to Credit Unions No. 03-CU-17, *Independent Appraisal and Evaluation Functions for Real Estate-Related Transactions*, in November 2003.

Authoritative Accounting Guidance

New Accounting Standards Codification (ASC) References	Former References
FASB ASC 450-20, *Contingencies - Loss Contingencies*	FASB Statement No. 5, *Accounting for Contingencies*
FASB ASC 310-10-35-2 through 30, *Receivables – Overall - Subsequent Measurement – Impairment*	FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*
FASB ASC 310-20-35, *Receivables – Nonrefundable Fees and Other Costs – Subsequent Measurement*	FASB Emerging Issues Task Force (EITF) No. 01-7, *Creditor's Accounting for a Modification or Exchange of Debt Instruments*
FASB ASC 310-40, *Receivables - Troubled Debt Restructurings by Creditors*	FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring*; and FASB Technical Bulletin No. 80-2 *Classification of Debt Restructurings by Debtors and Creditors*
FASB ASC 470-60, *Debt – Troubled Debt Restructurings by Debtors*	FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*; and FASB EITF No. 02-4, *Determining Whether a Debtor's Modification or Exchange of Debt Instrument is within the Scope of FASB Statement No. 15*
FASB ASC 820, *Fair Value Measurements and Disclosures*	FASB Statement No. 157, *Fair Value Measurements*
FASB ASC 825-10-35-1 through 3, *Financial Instruments – Overall - Subsequent Measurement - Credit Losses on Financial Instruments with Off-Balance-Sheet Credit Risk*	American Institute of Certified Public Accountants (AICPA) Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*

Non-authoritative Accounting Guidance

- In December 2008, the Center for Audit Quality, an affiliate of the AICPA, issued *Application of Statement 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructurings*