Credit Risk Management

Debunking Myths and Misinformation

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Key Topics

- **Impairment vs. Nonaccrual**
- **Collateral Dependent Loans**
- **Troubled Debt Restructures**
  - Concession Criteria
  - Classification, Nonaccrual
- **Quick Hits**

Myth #1

If a loan is considered impaired, it must be on non-accrual status

Impaired versus Nonaccrual

Impaired Loans

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due **according to the contractual terms of the loan agreement**. "All amounts due according to the contractual terms" means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

(ASC 310-10-35-16)

Nonaccrual Loans

Banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset (1) which is maintained on a cash basis because of deterioration in the financial condition of the borrower, (2) for which payment in full of principal or interest is not expected, or (3) upon which 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. (FR Y9C Glossary Entry)

Example #1

- A loan with a borrower is 90 days past due with respect to principal and interest. The loan is secured by U.S. Treasuries and has a 50% LTV. Based on legal proceedings, the bank expects the collateral account to be liquidated and made available to the bank in the next 30 days.

- *As the loan in this example is both well secured and in the process of collection, the loan would not need to be considered nonaccrual. However, the loan would be considered impaired under accounting guidance as the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement (the amount of the impairment may be zero in this case, but the loan would still be considered impaired).*

Example #2

- Sales on an ADC project have stalled, and no meaningful take downs are expected. The original note was not performing as agreed, and has been renewed at interest only for two consecutive years. Following the restructure, quarterly payments have been made as agreed. However, the principal/guarantor has also made two principal bullet payments at each renewal (15% curtailment). Recent appraisal supports collateral coverage of 1:1 after estimated costs to sell. The guarantor has substantial outside sources of income and is selling other unencumbered properties with proceeds to curtail principal.

- *Principal curtailment is occurring through guarantor support rather than take down on lots. The loan is certainly impaired as the relationship has not performed by contractual loan terms. However there is a reasonable expectation that P&I can be expected as long as the borrower continues to cooperate. A case for accrual treatment can clearly be made.* *(This does not prevent the bank from opting for conservative treatment)*

Myth #2

Uncollateralized balances on loans deemed to be "Collateral Dependent" must be charged off.

Why is this important?

- **As a general classification principle, for a troubled CRE loan that is dependent on the <u>sale of the collateral</u>, any portion of the loan balance in excess of the market value of the collateral less cost to sell should be classified loss**

  (SR 09-7 Policy Statement on Prudent Commercial Real Estate Workouts)

- **Collateral Dependence affects the valuation methodology:**
  - Present Value of Estimated Future Cash Flows
  - Observable Market Price
  - Fair Value of Collateral <u>(required for collateral dependent loans)</u>

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SR 09-7 versus ASC 310

SR 09-7

Collateral Dependent

"Repayment of the debt will be provided solely by the sale of the underlying real estate collateral"

Supervisory Letter 09-7, Policy Statement on Prudent Commercial Real Estate Workouts Page 9 of 33

ASC 310-10-35-16

Collateral Dependent

"A loan is considered to be collateral dependent if repayment of the loan is to be provided solely by the sale or operation of the underlying collateral"

Example

- A loan to a hotel has been in and out of delinquency and existing loan terms provide for minimal curtailment. The principal has multiple business interests and global financial strength is questionable at best. A recent appraisal relied heavily on the income approach to reflect a collateral shortfall of $3 million on a $16 million balance. However several external factors now appear to be driving recent increases in occupancy and income. Borrower has also recently liquidated another property and is employing proceeds to renovate subject. Loan will be restructured at maturity in six months.

- *The property will continue as a going concern although cash flow for P&I will be marginal. Charge-off is not warranted although a specific LLR may be appropriate.*

Myth #3

A restructured loan is not considered a TDR if there has been no concession on the interest rate.

Troubled Debt Restructures

A loan restructuring or a modification is a TDR “if the creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession to the debtor that it would otherwise not consider”.

ASC 310-40-20

A Concession has also been made if……

- If the borrower cannot refinance the funds elsewhere at similar terms to the new note (even if you have raised the interest rate)
- If the amortization terms are more accommodating than is typical for a loan of that type
- If the delay in timing of the restructured payment is significant

Accounting Standards Update No 2011-02 Receivables (Topic 310)

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Examples

- A restructured owner-occupied residential mortgage with an interest rate of 7%. Present balance of $320,000 with a 30 year term. Balloon payment due at maturity of $100,000. (deferred amortization structure)
- A Commerical Equipment Loan on a monthly repayment schedule is 90 days past due. A new two-year note has been negotiated with an interest rate well above market terms. The first installment is due in 90 days from note date. (significant delays/deferral of payments)
- Any loan to a borrower experiencing financial difficulties that represents a departure from typical business practices (high LTV, deferred amortization, questionable collateral)

Myth #4

(1) A TDR must be classified

(2) A TDR must be nonaccrual

TDR Classification Guidance

- Renewed or restructured loans who have the ability to repay their debts under reasonable modified terms will not be subject to adverse classification solely because underlying collateral has declined to an amount that is less than the loan balance.
- Loans to sound borrowers that are renewed or restructured in accordance with prudent underwriting standards should not be classified or criticized unless well defined weaknesses exist within the credit.
- Renewals or restructurings of maturing loans to commercial borrowers who have the ability to repay on reasonable terms will not be subject to adverse classification, but should be identified in the institutions internal grading system and may warrant close monitoring.

SR 09-7 - “Prudent Commercial Real Estate Loan Workouts”

TDR Accrual Guidance

- Principally is based on the manner of restructuring and the terms of the surviving note.
  - For multiple note structure where, e.g., an A/B note structure is used, "A" note can be placed back on accrual status if there is reasonable assurance of repayment and performance by modified terms.
  - In contrast, loan should remain on nonaccrual if there is no contractual note split, even if an internal charge-off has been recognized.

SR 09-7 - "Prudent Commercial Real Estate Loan Workouts"

Quick Hits

- Other Real Estate Owned – Disposition
  - Self Financed OREO Sales
  - Appropriate Accounting Treatment
- Uniform Retail Classifications
  - Guidance is still in effect
  - “Going the Extra Mile” – Charge Offs

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Questions?

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