Regulatory Update

Atlanta Regulatory Conference Call

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Topics

- **Allowance for Loan and Lease Losses (ALLL) in the Current Environment**

- **Troubled Debt Restructuring - Measuring Impairment**

ALLL in the Current Environment

Foreclosure Filings Ticked Up in October: Report
11/15/2012
American Banker - Online
By Brian Browdie

Foreclosure filings ticked up in October compared with the previous month but continued to decline on an annual basis, underscoring the fitful nature of the housing recovery.

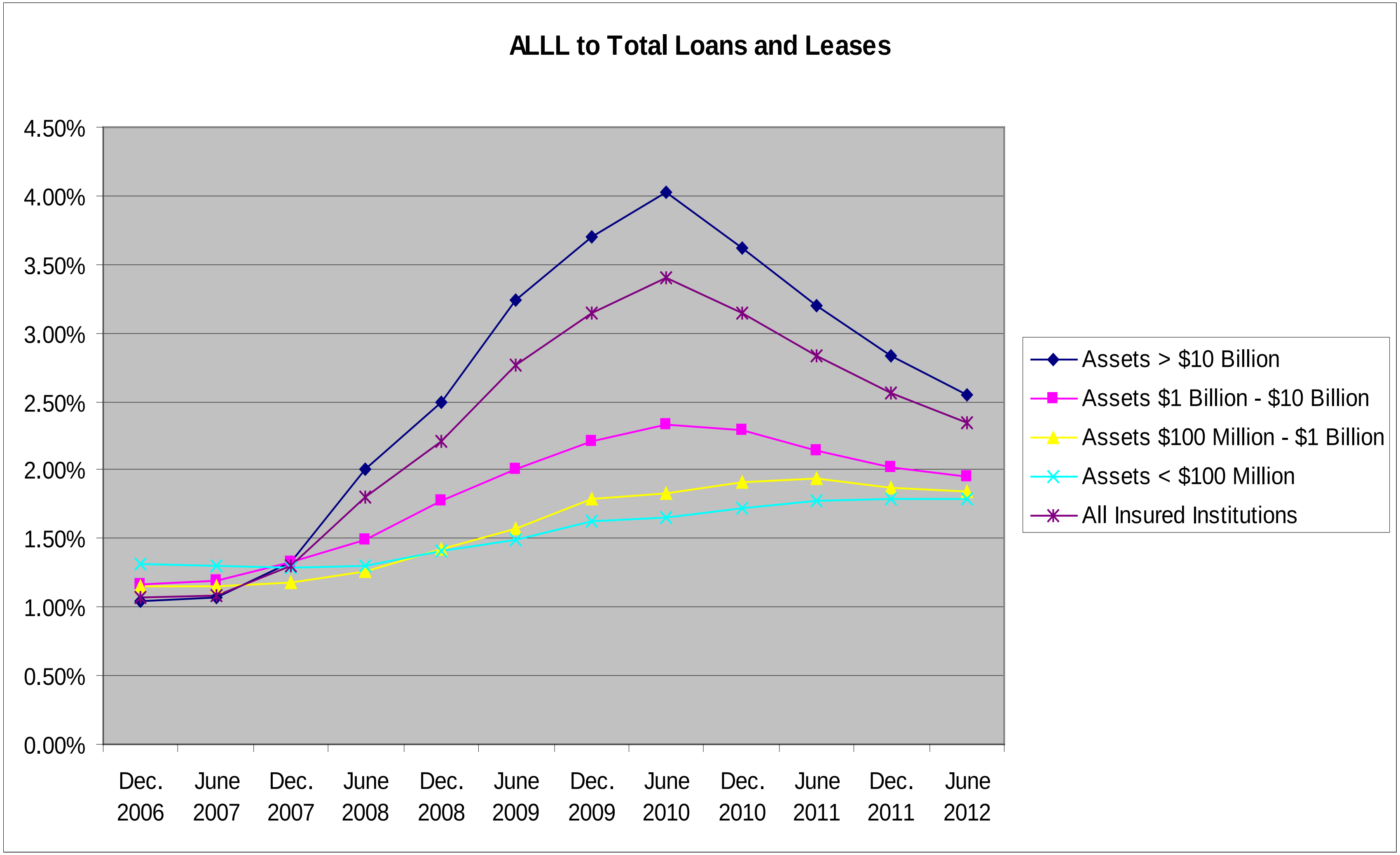
Bernanke: Housing Market Not 'Out of the Woods'
11/15/2012
American Banker - Online
By Donna Borak

WASHINGTON — Federal Reserve Board Chairman Ben Bernanke said Thursday that the housing market is "far from being out of the woods," despite initial signs pointing to a recovery.

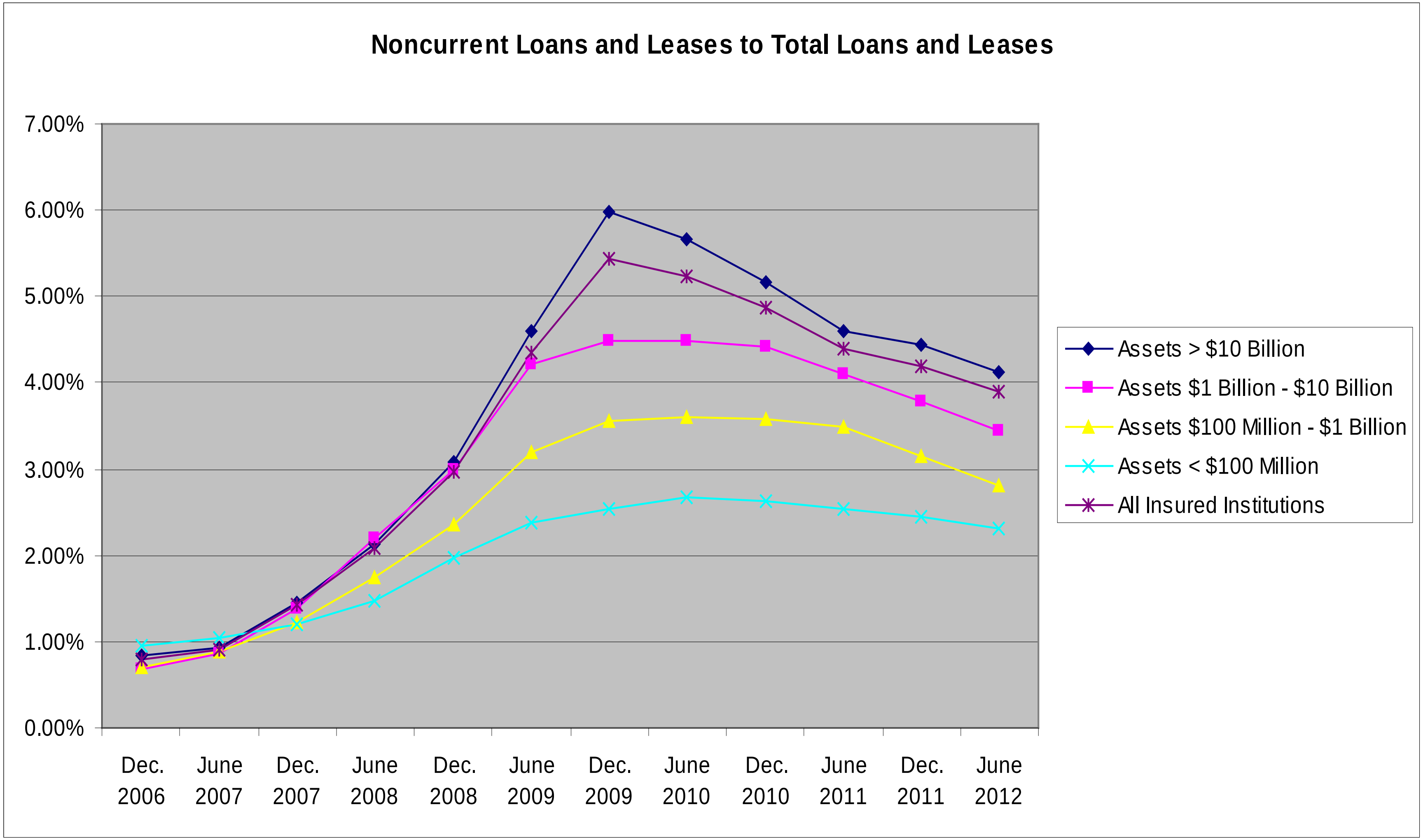
ALLL in the Current Environment

- ALLL represents one of the most significant accounting estimates in an institution's financial statements and regulatory reports
  - Arriving at an appropriate ALLL involves a high degree of management judgment and results in a range of estimated losses
  - ALLL estimates should consider all available information existing as of the financial statement date, including qualitative or environmental factors such as industry, geographical, economic, and political factors
  - ALLL estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio

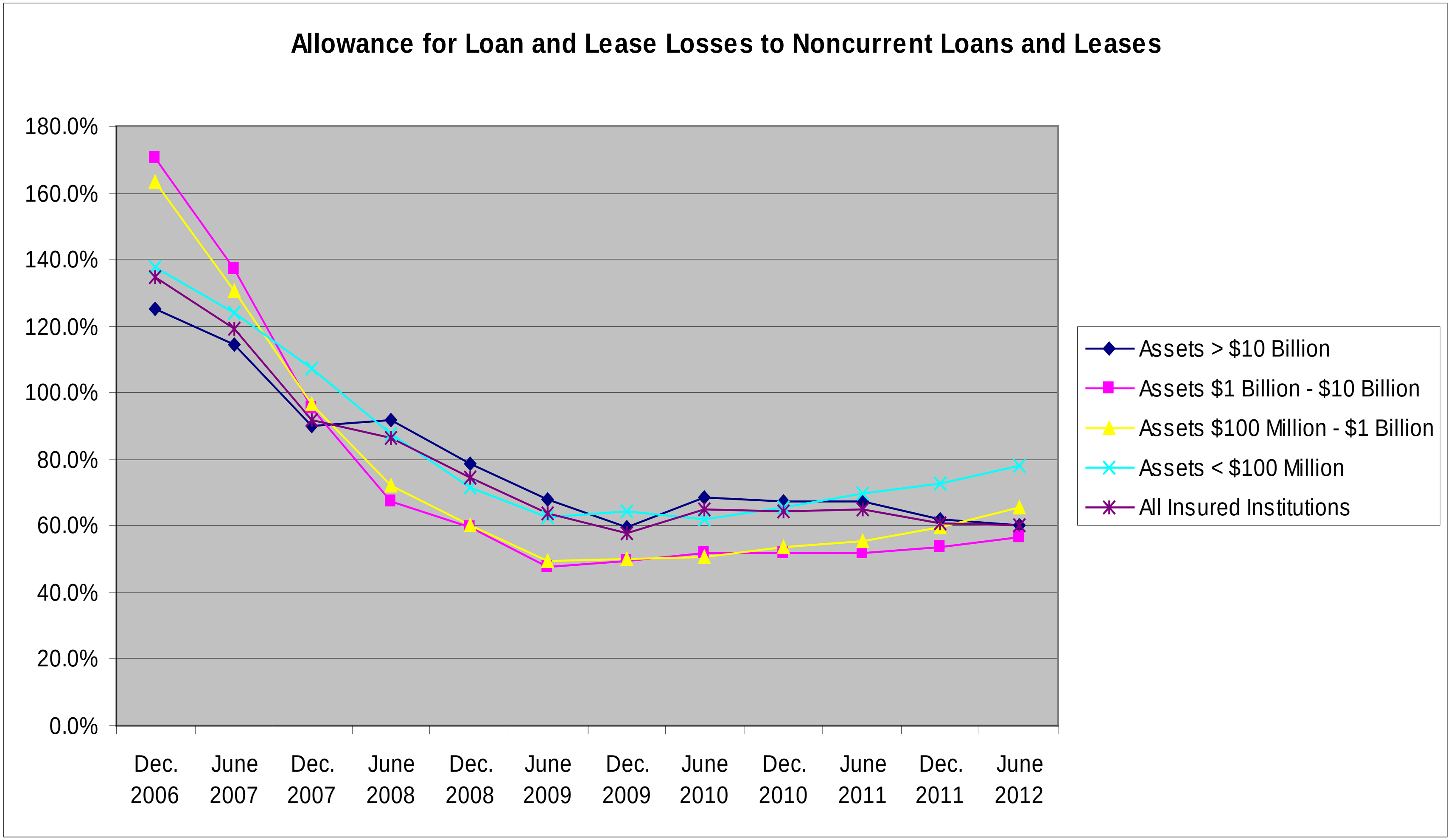
ALLL in the Current Environment



ALLL in the Current Environment



ALLL in the Current Environment



ALLL in the Current Environment

- Although recent trends for some credit quality indicators show improvement, institutions should exercise prudent judgment when determining the appropriate level for the ALLL, including the level of provisions in relation to net charge-offs
- Risk in loan portfolios remains elevated, e.g.,
  - Percentage of real estate loans in nonaccrual status exceed long-term averages
  - Net charge-offs as a percentage of loans and leases exceed long-term averages

ALLL in the Current Environment

- Exercising prudent judgment includes evaluating all relevant qualitative factors that affect collectibility
  - Consider effect of macroeconomic factors, e.g.,
    - Sluggish economic growth in U.S., recession in Europe, slowing of growth in Asia
    - Stubbornly high unemployment
    - Real estate values that remain well below their peak
    - Impact of drought on agricultural sector
  - Have underwriting standards been loosened to attract new loans?
  - Are new and less familiar loan products being offered to boost loan volume?

ALLL in the Current Environment

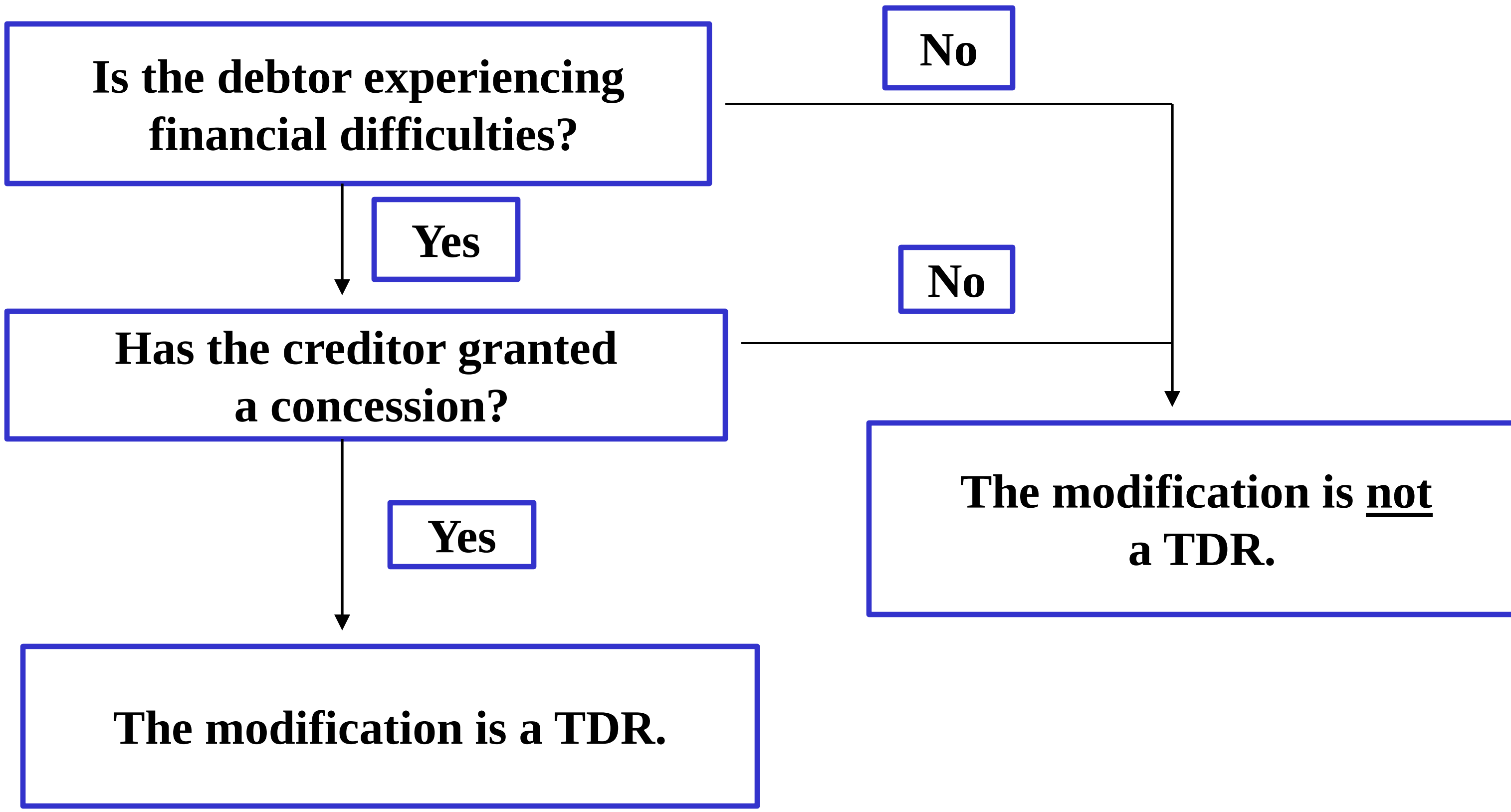
- Directional Consistency - ALLL Level and Risk Indicators
  - Consider the level and trend in various factors including:
    - Adverse Classifications
    - Non-accrual Loans
    - Past Due Loans
    - Charge off History
    - Loan Concentration Levels

ALLL in the Current Environment

- Documentation
  - Average Loss Rate
  - Analysis of Historical Losses
    - Loan Type
    - Internal Risk Rating
  - Qualitative Factor Adjustments
  - Impairment Decision & Measurement

Identifying TDRs

- When is a modification of terms (within the scope of ASC Subtopic 310-40) a TDR?



Identifying TDRs

- Indicators that a debtor is experiencing financial difficulties
  - Debtor is currently in payment default on any of its debt
    - Added by ASU 2011-02: It is probable that debtor would be in payment default on any debt in foreseeable future without the modification, i.e., debtor may be experiencing financial difficulties even if not currently in payment default
  - Debtor has declared or is in process of declaring bankruptcy
  - Significant doubt as to whether debtor will continue to be a going concern

Identifying TDRs

- Indicators that a debtor is experiencing financial difficulties (cont.)
  - Debtor has securities that have been, are in process of being, or are under threat of being delisted from an exchange
  - Based on debtor's current capabilities, debtor's cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity
    - Added by ASU 2011-02: Cash flows will be insufficient to service any debt
  - Without current modification, debtor cannot obtain funds from sources other than existing creditors at an effective interest rate equal to current market interest rate for similar debt for a nontroubled borrower

Measuring Impairment on TDRs

- When a loan modification constitutes a TDR, the loan is considered impaired
  - If the loan is one that falls within the scope of ASC Section 310-10-35 (former FAS 114), the loan usually would already have been identified as impaired before the restructuring
  - If a loan modified in a TDR was excluded from the scope of ASC Section 310-10-35 before the restructuring because it was part of a "large group of smaller-balance homogeneous loans that are collectively evaluated for impairment," the creditor must begin to apply this ASC Section to the modified loan
    - Thus, ASC Section 310-10-35 applies to TDRs of 1-4 family residential mortgage loans and consumer loans

Measuring Impairment on TDRs

- Measure impairment on a loan that is a TDR in accordance with ASC Section 310-10-35 (former FAS 114)
  - Determine whether the restructured loan is collateral dependent or not
  - A loan is collateral dependent if repayment is expected to be provided solely by the sale or operation of the underlying collateral

Measuring Impairment on TDRs

- If loan that is a TDR is not collateral dependent, measure impairment based on present value of expected future cash flows discounted at loan’s effective interest rate
  - Estimates of expected future cash flows should be creditor’s best estimate based on reasonable and supportable assumptions and projections
  - Best estimate is not normally the contractual cash flows under the modified terms
  - When estimating expected future cash flows, consider appropriateness of using default and prepayment assumptions relevant to a pool of loans with similar characteristics, i.e., a pool of similar impaired loans

Measuring Impairment on TDRs

- If a loan that is a TDR is collateral dependent, measure impairment based on fair value of the collateral
  - If repayment or satisfaction of loan is dependent on sale of collateral, reduce fair value by estimated costs to sell
  - If repayment or satisfaction of loan is dependent on operation of collateral, do not reduce fair value by estimated costs to sell
  - Costs to sell are “incremental direct costs to transact a sale,” including “broker commissions, legal and title transfer fees, and closing costs”

Measuring Impairment on TDRs

- Whenever a loan has undergone a TDR, the collectibility of the loan should be reviewed quarterly and any portion of the loan that is deemed uncollectible should be charged off
  - When a modification involves only an interest rate concession on a loan that is not collateral dependent, a bank would not normally be expected to charge the loan down to the calculated present value at the time of restructuring, but would maintain a “FAS 114” allowance
  - If a loan modification includes the forgiveness of principal, a charge-off should be taken (to the extent necessary) at the time of restructuring for the amount forgiven

Measuring Impairment on TDRs

Collateral Dependent - Repayment is dependent on the sale of collateral

Loan Amount		$115,000
Fair Value/As is Value	$100,000	
Cost to Sell	10,000	
Fair Value (less) Cost to Sell		90,000
PLLL/ALLL		$ 25,000
Confirmed Loss (if uncollectible)		$ 25,000

Measuring Impairment on TDRs

Collateral Dependent - Repayment is dependent on operation of collateral

TDR terms are reasonable and income producing property is stabilizing

Loan Amount		$115,000
Stabilized Value	$110,000	
As is Value		100,000
PLLL/ALLL		$ 15,000

Measuring Impairment on TDRs

Collateral Dependent - Repayment is dependent on operation of collateral

TDR terms are unreasonable and income producing property is stabilizing

Loan Amount		$115,000
Stabilized Value	$110,000	
As is Value		100,000
PLLL/ALLL		$ 15,000
Loan Amount – Stabilized Value		$ 5,000
(Charge-Off if uncollectible)		

Measuring Impairment on TDRs

Collateral Dependent - Repayment is dependent on operation of collateral

TDR terms are unreasonable and income producing property is not stabilizing

Loan Amount		$115,000
Stabilized Value	$110,000	
As is Value		100,000
PLLL/ALLL		$ 15,000

Loan Amount – As is Value	$15,000
(Charge-Off if uncollectible)	

Measuring Impairment on TDRs

- Fair value should be estimated in accordance with ASC Topic 820, Fair Value Measurement (formerly FAS 157, "Fair Value Measurements")
  - Fair value is defined as "the price that would be received to sell an asset . . . in an orderly transaction between market participants at the measurement date," i.e., not a forced liquidation or distress sale
  - Fair value should reflect the current condition of a property, not the potential value of the property at some future date

Measuring Impairment on TDRs

- Aggregation of impaired loans, including loans that are TDRs
  - When impaired loans have risk characteristics in common with other impaired loans, “a creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans”
  - When aggregation is used, it generally is applied to retail loans

Reporting and Disclosure of TDRs

- In the Call Report, until a loan that is a TDR is paid in full or otherwise settled, sold, or charged off, the loan must be reported as a TDR in:
  - Schedule RC-C, part I, Memo item 1, if it is in compliance with its modified terms, or
  - Schedule RC-N, Memo item 1, if it is not in compliance with its modified terms
  - Sole exception: A TDR that yields a market interest rate at the time of restructuring and is in compliance with its modified terms need not be reported as a TDR in Schedule RC-C, part I, Memo item 1, in calendar years after the year of the restructuring
    - This may occur if the modification includes a reduction in principal or uses an A/B note structure

Once a TDR, Always Classified?

- Accrual criteria met
- Economic substance of restructure
- Well-documented analysis

Other TDR Guidance

- Call Report Instructions
  - Glossary entry for “Troubled Debt Restructurings”
- Call Report Supplemental Instructions
  - Has addressed “Troubled Debt Restructurings and Current Market Interest Rates” since September 2010
- Policy Statement on Prudent Commercial Real Estate Loan Workouts (October 2009)
  - Examples of TDR treatment in Attachment 1

Questions?

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