2012 Bankers Outreach Accounting

FDIC

Agenda

- ORE
- Troubled Debt Restructurings
- Non-accrual Rules
- Call Reports - Construction Loans
- Business Combinations
- Goodwill Impairment
- ALLL Comments/Observations

Other Real Estate

Other Real Estate

- ASC Subtopic 310-40 – Receivables –Troubled Debt Restructurings by Creditors (formerly FAS 15)
- ASC Topic 360 – Property, Plant, and Equipment (formerly FAS 144)
- AICPA Statement of Position (SOP) 92-3
  - Rescinded but kept provisions for Call Reports

Other Real Estate

- ORE is recorded at FV less estimated costs to sell
  - Becomes the new cost basis
  - Presumed to be held for sale

- ORE – holding period
  - Carried at lower of
    - Cost basis established at acquisition
    - FV less estimated costs to sell
  - Determined on asset-by-asset basis

Other Real Estate – Disposals

- ASC Subtopic 360-20 (formerly FAS 66)
  - Methods
    - Full Accrual
    - Installment
    - Cost Recovery
    - Reduced-Profit Method
    - Deposit
  - Every method results in moving the ORE to Loans
    - Exception - Deposit Method
  - Any Loss should be recognized immediately

Other Real Estate Disposals

- Conditions to meet Full Accrual Method
  - Sale consummated
  - Down payment and continuing payments are adequate to demonstrate a commitment to pay for the property
  - Receivable is not subject to future subordination
  - The usual risks and rewards of ownership have been transferred

Other Real Estate Disposals

- Full Accrual Method
  - Meet down payment requirements
  - Contractual payments must be sufficient to repay the loan over the customary loan term for the type of property involved
  - Seller's financing of the transaction is **recorded as a loan**
  - Any profit from sale is recognized immediately

Other Real Estate Disposals

- Installment Method
  - Buyer’s down payment is not adequate
  - Recovery of the cost of the property is reasonably assured if the buyer defaults
  - Recognizes a sale and the corresponding **loan**
  - Any profits on the sale are only recognized as the bank receives payment from the purchaser/borrower

Other Real Estate Disposals

- Cost Recovery Method
  - Does not qualify for either the full accrual or installment method
  - Recognizes a sale and the corresponding **loan**
  - All income recognition is deferred
  - Loan is maintained in **nonaccrual status** while this method is being used

Other Real Estate Disposals

- Reduced-Profit Method
  - Received an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full accrual method
  - Recognizes a sale and corresponding **loan**
  - Any profit on the sale are only recognized as the bank receives payment from the purchaser/borrower
  - Seldom used in practice

Other Real Estate Disposals

- Deposit Method
  - Sale has not consummated
  - Asset continues to be reported as **foreclosed real estate (ORE)**
  - No profit or interest income is recognized
  - Payments received are reported as liability until sufficient payments or other events occur which allow the use of one of the other methods

Other Real Estate Disposals

- Finance ORE sales at below market rates
  - Properly account for sale
  - Apply ASC 835-30-15 (formerly APB 21)
    - Discount to determine any gain or loss

Troubled Debt Restructurings

Troubled Debt Restructurings

- Applicable Accounting Standards
  - Accounting Standards Codification (ASC) Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors
    - Formerly FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings,* as amended
  - FASB Accounting Standards Update (ASU) 2011-02, Receivables (Topic 310): *Clarifications to Accounting for Troubled Debt Restructurings by Creditors*
    - Issued April 2011
    - Amends ASC Subtopic 310-40
    - Effective Date:
      - Public - generally 7/1/11
      - Non-public– generally for 2012

Troubled Debt Restructurings

- Applicable Accounting Standards
  - ASC Section 310-10-35, Receivables, - Overall – Subsequent Measurement
    - Formerly FAS 114, *Accounting by Creditors for Impairment of a Loan,* as amended

Troubled Debt Restructurings

- Other Sources of Guidance
  - Call Report Instructions
    - Glossary – “Troubled Debt Restructurings”
  - Call Report Supplemental Instructions
    - Addressed since September 2010
  - Policy Statement on Prudent Commercial Real Estate Loan Workouts (October 2009)
    - Includes examples that are helpful

Troubled Debt Restructurings

- Identifying a TDR
  - A restructuring constitutes a TDR "if a creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider"
  - Creditor's objective – make the best of a difficult situation
    - Grants concession in attempt to protect as much of its asset as possible
    - Expects to obtain more cash or other value, or increase probability of receipt, by granting concession than by not granting it

Troubled Debt Restructurings

- Identifying a TDR
  - Concessions arise:
    - Agreement between creditor or debtor
    - Imposed by law or court (e.g., bankruptcy)

  - Types of transactions may be TDRs:
    - Transfer of real estate or other assets in full or partial satisfaction of debt
    - Issuance of equity interest in full or partial satisfaction of debt
    - Modification of terms
    - Combination of any of these

Troubled Debt Restructurings

- Modification of terms:
  - Reduction of stated interest rate for remaining original life
  - Extension of maturity date at below market rate
  - Reduction of face amount
  - Reduction of accrued interest

Troubled Debt Restructurings

- Not all loan modifications are TDRs
- Modification constitutes a TDR only when both exist:
  - Debtor is experiencing financial difficulties
  - Creditor grants a concession
- Identifying whether a loan restructuring is a TDR is based upon individual facts and circumstances and requires use of judgment

Troubled Debt Restructurings

- Indicators that debtor is experiencing financial difficulties:
  - Currently in default on any debt
  - Probable would be in default in foreseeable future without the modification (added by ASU 2011-02)
  - Declared or in process of declaring bankruptcy
  - Significant doubt of going concern
  - Has securities that have been, or in process of, or under threat of being delisted from an exchange
  - Cash flow insufficient to service contractual terms of debt
  - Cash flows insufficient to service any debt (added by ASU 2011-02)
  - Without current modification, can't obtain funds elsewhere at market rate

Troubled Debt Restructurings

- When evaluating a loan modification to a borrower experiencing financial difficulties, an analysis of all facts and circumstances is necessary to determine whether the bank has made
  - A concession to the borrower with respect to the market interest rate
    - Debtor is precluded from using the borrower’s effective rate test to conclude whether a concession was granted
  - Some other type of concession that could trigger TDR accounting
    - Terms or conditions outside of the bank’s policies or common market practices

Troubled Debt Restructurings

- A restructured loan yields a current market rate if the restructuring agreement specifies an interest rate greater than or equal to the rate that the institution was willing to accept at the time of the restructuring for a new loan with comparable risk
  - A restructured loan does not automatically yield a market rate simply because the interest rate charged under the restructuring agreement has not been reduced
  - An increased interest rate cannot automatically be presumed to be an interest rate that is at or above market

Troubled Debt Restructurings

- In determining whether a loan has been modified at a market interest rate
  - Analyze borrower's current financial condition, including credit history and scores, loan-to-value ratios or other collateral protection, borrower's ability to generate cash flow sufficient to meet the repayment terms, and other factors normally considered when underwriting and pricing loans
  - Compare rate on the modified loan to rates the institution would charge customers with similar financial characteristics on similar types of loans
  - Determination requires the use of judgment

Troubled Debt Restructurings

- ASU 2011-02 guidance
  - If repayment of principal at original maturity is primarily dependent upon value of collateral, creditor should consider current value of collateral at time of restructuring in determining whether principal will be paid
  - If obtain additional collateral or guarantees as part of restructuring
    - It is a concession when it is not adequate compensation for other terms of the restructuring
    - Creditor must evaluate guarantor’s willingness and ability to pay the balance owed

Troubled Debt Restructurings

- ASU 2011-02 guidance
  - Restructuring that results only in a delay in payment that is insignificant is not a concession
  - Factors to consider together
    - Amount of payment subject to delay is insignificant relative to unpaid principal and interest and will result in insignificant shortfall in contractual amount due
    - Delay in timing is insignificant relative to frequency of payments, debt's original contractual maturity, or debt's original expected duration (i.e. any of these 3)
  - Consider cumulative effect of past restructurings

Troubled Debt Restructurings

- Should loans that are TDRs be placed in nonaccrual status?
  - Most loans (other than retail loans) that undergo a TDR will already have been individually identified as impaired prior to the restructuring and likely would also already be in nonaccrual status at the time of restructuring
    - If nonaccrual prior to restructuring because payment in full of principal and interest not expected. In order to return to accrual status:
      - Reasonable assurance of repayment under modified terms (based on credit evaluation) plus
      - Demonstrated repayment performance for a minimum of 6 months

Troubled Debt Restructurings

- Call Reports – effective March 31, 2011
- Report TDR by loan category
  - Commercial, industrial, consumer and all other
- 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
  - Schedule RC-C, part 1, Memorandum item 1
    - In compliance with modified terms
  - Schedule RC-N, Memorandum item 1
    - Not in compliance with modified terms

Troubled Debt Restructurings

- Sole exception: A TDR that yields a market rate at the time of restructuring and is in compliance with its modified terms need not be reported as a TDR in calendar years after the year the restructuring took place

- Compliance with modified terms
  - Must not be in nonaccrual
  - Must be current or less than 30 days PD on its contractual principal and interest payments under the modified terms

Nonaccrual Rules

Nonaccrual Rules

- Call Report Glossary - "Nonaccrual Status"
  - Source of guidance on
    - Placing assets in nonaccrual status,
    - Treatment of payments received on assets while in nonaccrual status, and
    - Restoring nonaccrual assets to accrual status for regulatory reporting purposes
  - Accounting standards do not include comparable nonaccrual guidance

Nonaccrual Rules

- General rule for placing assets in nonaccrual status
  - Bank decides to maintain asset on a cash basis because of deterioration in borrower's financial condition
  - Payment in full of principal <u>or</u> interest is not expected
  - Principal <u>or</u> interest in default for 90 days or more unless asset is <u>both</u> well secured <u>and</u> in the process of collection

Nonaccrual Rules

- "Well secured"
  - Asset is secured by
    - Collateral in the form of liens on or pledges of real or personal property whose realizable value is sufficient to discharge debt (principal and accrued interest) in full, <u>or</u>
    - Guarantee of a financially responsible party

Nonaccrual Rules

- "In the process of collection"
  - Collection is proceeding through
    - Legal action, including judgment enforcement procedures, <u>or</u>
    - Other collection efforts that are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future

  - Commencement of collection efforts, plans to liquidate collateral, ongoing workouts, foreclosing on or repossessing collateral, and restructuring of asset do not, in and of themselves, allow an asset to meet this definition

Nonaccrual Rules

- Exceptions to Rules:
  - ASC Subtopic 310-30 (formerly SOP 03-3)
  - AICPA Practice Bulletin No. 6
  - Consumer loans and 1-4 family residential mortgages that are 90 days or more past due
    - Such loans should be subject to alternative methods of evaluation to ensure that income is not materially overstated
    - However, if such a loan is in nonaccrual status on bank's books, report as nonaccrual in Call Report

Nonaccrual Rules

- Treatment of previously accrued interest on assets placed in nonaccrual status
  - Handle in accordance with GAAP, i.e., evaluate collectibility
    - On loan with sufficient collateral protection to cover principal and accrued interest, reversal of interest not required
  - Acceptable treatment includes reversing all accrued interest
    - Credit accrued interest receivable
    - Debit interest income for uncollected year-to-date accrued interest
    - Debit ALLL for uncollected prior year accrued interest <u>if</u> ALLL methodology considers collectibility of accrued interest

Nonaccrual Rules

- Cash interest payments received on nonaccrual assets
  - If collectability of remaining recorded investment in a nonaccrual asset is <u>in doubt</u>, any payments received (including those designated as interest) must be applied to reduce recorded investment to extent necessary to eliminate this doubt
  - If remaining recorded investment (after charge-off of any identified losses) is <u>deemed fully collectible</u>, some or all cash interest payments may be treated as interest income on a cash basis
    - Analysis of collectability must be supported and documented

Nonaccrual Rules

- Restoring nonaccrual asset to accrual status
  - No principal and interest is due and unpaid and expects repayment of remaining contractual principal <u>and</u> interest
  - Loan becomes well secured and in the process of collection
  - Loan not yet current but borrower has resumed paying full contractual principal and interest payments, <u>and</u>
    - All payments contractually due are reasonably assured of repayment within a reasonable period, <u>and</u>
    - Sustained cash repayment performance in accordance with contractual terms for at least six months

Nonaccrual Rules

- If interest payments were applied to reduce asset's recorded investment while in nonaccrual status, do not reverse these entries and credit interest income
  - After asset has been returned to accrual status, interest income can be recognized based on the effective yield to maturity on the loan, which will result in interest applied to principal being accreted over asset's remaining life
    - Effective yield is the discount rate that would equate the present value of the future cash payments to the recorded investment in the loan

Nonaccrual: Example 1

- Loan put on nonaccrual in September 2008 and borrower agreed to pay interest payments.
- During this time, the payments were applied to principal only.
- Loans reinstated to accrual status in September 2010 after receiving 6 months of regular P& I payments.

Nonaccrual: Example 1

- Bank recaptured $85M of interest income immediately
- Payment amount was established with 15 year amortization
- Bank began applying all payments to back interest while still accruing additional interest
- Loan will not show any principal reduction for 4.5 yrs
- Was this correctly handled?

Nonaccrual: Example 1

- NO!!!!!
- Can’t reverse the prior application of the payments

Nonaccrual: Example 2

A $10 million loan is secured by income producing real estate. Cash flows are sufficient to service only a $9 million loan at the current market rate. The loan is in nonaccrual. The bank restructures the loan by splitting into two separate notes. Note A is for $9 million and carries a current market rate of interest. Note B is for $1 million and carries a below market rate of interest. The bank charges off all of Note B, but does not forgive the debt.

Can the bank return Note A to accrual status?

Nonaccrual: Example 2

Depends!

All of the following conditions must be met:

- The restructuring qualifies as a TDR as defined in ASC Subtopic 310-40 (FAS 15)
- The charge-off is supported by a good faith credit evaluation of the credit
- The ultimate collectibility of all amounts contractually due on Note A is <u>not</u> in doubt
- There is a period of satisfactory performance by the borrower on Note A (before or after the restructuring)

Nonaccrual

- If loan is impaired, should it be on Nonaccrual??
- NOT NECESSARILY – IT DEPENDS
- Impairment –defined in GAAP
  - Probable
- Nonaccrual – not defined in GAAP
  - Expected

Construction Loans

Call Report Instructions

Construction Loans

- Construction loans secured by real estate should continue to be reported in Schedule RC-C, line 1.a. after construction is completed unless and until
  - the loan is refinanced into a new permanent loan by the reporting bank or is otherwise repaid,
  - the bank acquires or otherwise obtains physical possession of the underlying collateral in full satisfaction of the debt, or
  - the loan is charged off.

Construction Loans

- 1-4 Family Residential Construction Loans include
  - Bridge loans to developers on 1-4 family residential properties where the buyer will not assume the same loan, even if construction is completed or principal amortization payments have begun.

Construction Loans

- March 2011 Call Reports – clarification
- Combination Construction-Permanent Loans
  - Contractual Agreement **at time of construction loan** to provide permanent financing after construction is complete

Construction Loans

- Combination Construction-Permanent Loans
  - Expected owner-occupant will be borrower's residence or place of business
  - Not expected to be owner-occupant of the property, but repayment derived from rental income rather than sale of property

Construction Loans

- Defines when a construction loan is deemed to be refinanced into a permanent loan
  - Amortizing permanent loan to new borrower
  - Prudently underwritten new amortizing loan at market terms to original borrower
    - Appropriate interest rate, maturity, LTV
    - No longer dependent upon sale of the property for repayment
    - Clear identified ongoing source of repayment sufficient to service debt (P & I) over reasonable and customary period relative to the type of property securing new loan
      - No interest only loans
      - No short-term balloon loans

Construction Loans

- Builder gets short term loan with balloon and
  - Builder converting to model home/office – still construction loan
  - Builder leasing out property – still construction loan

Construction Loans

- Risk and Exit Strategy unchanged – still construction loan
- Investment properties – must be able to show investor has track record of maintaining and managing rental properties

Business Combinations

Business Combinations - Issues

- FV
- Bargain Purchase Gain
- Impairment

Business Combinations

- Biggest Concern – FV
  - It is management's responsibility to report fair values in accordance with ASC Topic 820
    - Loans –
      - a) Determine the Expected Cash Flows over the loans' expected life/maturity and make Credit Adjustment for expected losses
      - b) Use the Appropriate Discount Rate and make Yield Adjustment
    - Deposits - Fair Value should be based on rates, terms and maturity with a premium/discount calculated.

Business Combinations

- Biggest Concern – FV
  - Core Deposit Intangible
    - Deposit premium is not determinative of FV
    - FV of CDI is estimated using a PV technique
    - Should reflect current market conditions at acquisition date
      - Not a later date during measurement period

Business Combinations

- Biggest Concern – FV
  - Contingent Consideration
    - Recognized acquisition date FV as part of consideration exchanged
    - Assumptions used in FV

Business Combinations

- If no expertise in fair value measurements, engage a qualified third party expert to provide professional guidance and support for the preparation of FV measurements.
- The use of outside experts does not relieve management of its responsibilities to ensure that FV estimates are measured in accordance with GAAP
- **Management must sufficiently understand the bases for the measurement and valuation techniques used**

Business Combinations Issues

- Re-evaluate Day 1 values
  - Usually issues with information available on Loans
    - Loan Files
    - BPO versus AV
- Amount bid on failing institution may not represent the FV of these items in accordance with ASC Topic 820

Business Combinations

- Loss Share Agreements
  - Paying off Indemnification Asset early
  - Valuation of Assets and Updated Loss Estimates
    - Big factors in decision making
  - If offer presented by acquiring institution is less than estimated cumulative loss estimate, FDIC may accept offer
  - FDIC will not accept any offer lower than the calculated midpoint estimate for cumulative losses
    - Requires evaluation of the projected range (low, midpoint, high) of the current market loss and cumulative loss values
  - As of June 2011, 2 LSAs were terminated early in the Dallas Region

Business Combinations

- Significance of expected bargain purchase gain will be reviewed when pro forma regulatory capital levels in application are evaluated
- Conditions may be imposed on the acquiring institution in the approval of the acquisition
  - Capital Preservation
  - Dividend Limitations
  - Independent Audits or Agreed Upon Procedures
  - Independent Valuations
  - Legal Lending Limit

Goodwill Impairment

Goodwill Impairment

- Proposed ASU, "Intangibles – Goodwill and Other (Topic 350): Testing Goodwill for Impairment
  - Would allow to first assess qualitative factors to determine whether it's necessary to perform the two-step test
  - Fair value of reporting unit needed for qualitative test would not have to be calculated unless more likely than not that its FV is less than its CV

Goodwill Impairment

- Includes examples of qualitative factors including
  - Economic/industry conditions
  - Overall financial performance/trends
  - Changes in management
  - Share price
- Effective for annual and interim impairment tests performed for fiscal years beginning after 12/15/11
- Early adoption permitted

ALLL Comments and Observations

ALLL Comments/Observations

- Substandard versus Impairment

- Substandard
  - Well defined weaknesses
  - Distinct possibility of some loss
- Impairment
  - Probable will be unable to collect contractual payments
    - Judgment about performance – not collateral protection

ALLL Comments/Observations

- Substandard Loans
  - Not automatically impaired Under ASC Topic 310
  - Still have defined weaknesses in credit
  - If significantly PD or NA – evidence of impairment
  - If performing and deemed not impaired - separately track and analyze these loans
    - Probably need higher risk factors in ASC Subtopic 450-20 (formerly FAS 5) bucket

ALLL Comments/Observations

- Banks still not recognizing losses timely
  - Distorts loss history
- Negative provisions because of improved credit quality
  - ALLL should be directionally consistent with asset quality
  - Consider suspending provisions
  - Credit trends should be legitimate and sustainable

ALLL Comments/Observations

- Removing loans from FAS 5 pools for historical loss purposes
- ALLL Models
  - "*Some institutions remove loans that become adversely classified from a group of nonclassified loans with similar risk characteristics under FAS 5.*
  - *The net charge-off experience on the adversely classified that have been removed from the group of nonclassified should be included in the historical loss rates for that group of loans.*
  - *Even though the net charge-off experience on adversely classified is included in the estimation of historical loss rates that will be applied to the group of nonclassified loans, the adversely classified loans themselves are no longer included in that group for purposes of estimating credit losses on the group*."
    - *2006 Interagency Policy Statement - Footnote 20*

ALLL Comments/Observations

- Prudent Commercial Real Estate Loan Workouts
  - Financial Institution Letter 61-2009
- Performing/operating loans should not be classified just because collateral value declines
- If operating CRE, impairment can be allocation to ALLL versus charge off
- Even though impairment is performance based, examiner judgment comes into play.
  - Liberal terms, extensions, renewals are misleading and can obscure performance, credit weaknesses, and ability to pay
- Loss classification may not equal impairment measurement
  - Differences between credit risk management and accounting and regulatory concepts (accrual status, TDRs, ALLL)
- If bank has loan that is not supported by adequate analysis and documentation, examiners should use reasonable judgment in reviewing loan and classification

Questions