Example 3
TDR: Accrual Treatment

Management originated a term loan to finance a commercial office building. The loan was amortized over 20 years and due in 10 years. One of the major tenants vacated the building when its lease expired, which lowered the occupancy level and resulted in a DCR of 0.75x. A new tenant has not been found. The borrower has demonstrated sustained payment performance for the last several years, which includes the period since the loss of the major tenant. The cash flow shortage has been covered by the guarantor. The loan has paid as agreed and been on accrual status since inception. However, the guarantor approached the bank, indicating that he would no longer be able to fully pay the cash flow shortfall.

Management obtained current financial information on the business (borrower) and guarantor. After carefully analyzing the financial information, management determined that amortizing payments with the interest rate reduced from the original rate of 7% to 5% for one year would improve the loan's DCR to 0.90x. When the guarantor's excess cash flow from other sources is included, the global DCR would be 1.10x. Based on the latest "as-is" appraisal performed shortly before the restructuring, the LTV is 85%. Management agreed to a 12-month modification in order to provide adequate time for the borrower to improve occupancy and cash flow for the remaining term of the loan. The loan modification is supported by a current, well-documented credit evaluation of the financial condition of both the borrower and the guarantor. Prospects for repayment under the revised terms appear reasonable.

The modification is a TDR because both prongs of the TDR test have been met. The borrower is in financial difficulty because payment default is probable without a modification and management granted a concession by lowering the interest rate for 12 months to a rate below the market rate for a new loan with comparable risk.

What is the appropriate accrual treatment after restructuring?

The loan was on accrual prior to the restructuring. An accruing loan that is modified in a TDR can remain in accrual status if, based on a current, well-documented credit analysis, collection of principal and interest in accordance with the modified terms is reasonably assured, and the borrower has demonstrated sustained historical repayment performance for a reasonable period before the modification. The loan in this example can continue to accrue interest based on the loan's prior performance, given that the borrower and the guarantor together had performed in a timely manner under the original contractual terms, the payments made during the past six months are consistent with the modified terms, and management reasonably expects repayment of principal and interest under the modified terms as detailed in their well-documented credit evaluation. Also, the bank has sufficient collateral or other sources of repayment that reasonably support the ultimate collection of principal and interest.