Example 4
TDR: Accrual Status and Classification

A $2,000,000 loan to a manufacturing company is secured by the industrial building it occupies. The company's financial condition deteriorated due to losing contracts to a competitor with superior product innovations. The loan is 90 days past due. The current LTV is 91%.

The loan is classified Substandard and was placed on nonaccrual status with all previously accrued but uncollected interest reversed against appropriate income statement and balance sheet accounts. Management granted a modification to give the borrower time to develop and deploy new products. The modification agreement changed the monthly payment to interest only at the note's original interest rate for one year with a return to the original contractual payment thereafter. The DCR improved from 0.7x prior to the modification to 1.20x after the modification based on the interest-only payments. The agreement states that the past due interest is now due at maturity, but it was not capitalized into the loan balance on the bank's books. The modified loan is a TDR due to the financial difficulty of the business and the concession granted.

With its new products, the company obtained new sales contracts, and its financial condition is significantly improving. Accounts receivable, inventory, and accounts payable are approaching normal levels. The Current Ratio (current assets divided by current liabilities) has improved from 0.6:1 to 1.65:1 since the modification. Following the year of interest-only payments, the borrower has returned to making the original amortizing payments for the last 6 months. Based on a current, well-documented credit analysis of the borrower's financial condition, the DCR is now 1.30x based on the amortizing payment. Interest payments have been applied to the loan balance since the loan was placed on nonaccrual. The current loan balance is $1,802,684, resulting in an improved LTV of 82%.

1. May this loan be returned to accrual status, and if so, when?

A. No, TDRs are impaired loans and must be kept on nonaccrual because payment in full of principal and interest is not expected according to the original terms.

B. Yes, 6 months after the date of the modification.

C. Yes, 18 months after the date of the modification.

The best answer is C.

Answer C is the best answer because the TDR loan meets all 3 conditions for returning a nonaccrual TDR loan to accrual status 18 months after the modification, including demonstrating 6 months of sustained historical repayment performance based on a reasonable repayment schedule. In this case, the reasonable repayment schedule is the return to the original amortizing payment structure one year after the modification. After month 12, the borrower began to make reasonable amortizing payments and has performed in accordance with the contractual terms for 6 months; therefore, at month 18, the loan could be considered for return to accrual status.

As a reminder, the 3 conditions for returning a nonaccrual TDR loan to accrual status are:

- Management has completed a current, well-documented credit analysis of the borrower's financial condition and prospects for repayment under the modified terms;
- Management must be reasonably assured of repayment of all principal and interest contractually due according to the modified terms; and
- The loan must show sustained historical repayment performance, which generally means 6 months of principal and interest payments.

Answer A incorrectly assumes that TDR loans must always be on nonaccrual. Even a loan that has been formally restructured can return to accrual status once management is reasonably assured of repayment of all principal and interest in accordance with a reasonable repayment schedule; the decision is supported by a current, well-documented credit analysis of the borrower's financial condition and prospects for repayment; and a reasonable period of sustained historical repayment performance has occurred.

Answer B does not conform to the requirements to return a nonaccrual TDR loan to accrual. Although the loan could eventually return to accrual status if certain conditions are met, at 6 months after the modification, the borrower is still in the interest-only period of the restructuring. A 6-month period of sustained interest-only performance does not demonstrate the collectability of the loan because it does not provide for repayment of principal. Therefore, the borrower has not yet demonstrated an ability to make amortizing payments for a sustained period.

2. Can this loan be upgraded from Substandard to Pass?

A. Yes, upon the date of the restructuring.

B. Yes, when the loan is returned to accrual status.

C. No, because the loan did not yield a market rate of interest at the date of restructuring.

The best answer is B.

Answer B is the best answer because the requirements for upgrading a loan to Pass and returning a loan to accrual status are very similar. Assuming the loan met the requirements for returning to accrual status, the loan can be upgraded to Pass with proper analysis and complete documentation to support the decision. Prudently restructured loans should not be adversely classified or criticized unless well-defined weaknesses exist that jeopardize repayment. In this example, the DCR and LTV are reasonable, and borrower trends, including the repayment performance after the loan returns to amortizing payments, are favorable, which indicate that an upgrade to Pass may be appropriate.

Answer A incorrectly assumes that TDR loans can be upgraded while well-defined weaknesses exist. On the date of restructuring, there are still well-defined weaknesses in the credit; specifically, the borrower’s financial condition had deteriorated and it had not yet demonstrated that new products could be successfully developed and deployed to gain new sales contracts, and it has not demonstrated a sustained period of repayment performance.

Answer C incorrectly assumes that a loan must yield a market rate of interest at the date of restructuring to be upgraded later to Pass.