Example 6
Identifying a TDR & Measuring Impairment: Present Value of Expected Future Cash Flows Method (Working Capital Line)

Management originated an $800,000 revolving working capital line of credit to support a medical device manufacturer. The repayment source of the loan is business cash flow. Terms call for interest-only payments due monthly at a rate of P+1% with a current rate of 7.5% (which is the loan's effective interest rate), a 25% clean-up of principal for 30 days each year, and annual renewal. The loan is secured by a UCC-1 filing on business assets. Management does not have a valuation of the business assets but estimates that the assets have only nominal value.

Revenues declined 30%, and liquid assets have declined to $77,000 from the company's year-end high of $825,000. As a result of poor operating performance, the borrower became past due with vendors and was unable to meet payroll. The decline in the company's operating income has led to a net loss and insufficient cash flow to cover operating expenses and the $200,000 clean-up per the terms of the line of credit. The line has not revolved as intended and is now fully extended.

In response, management termed out the loan with a 7-year amortization and reduced the interest rate from 7.5% variable to 6.5% fixed. By reducing the interest rate and waiving partial clean-up, the borrower's DCR improved from 0.75x to 1.10x. For loans that have undergone similar modifications, the bank's loss experience is 20% on Substandard working capital lines of credit and 30% on Substandard unsecured loans. Management estimates that the market rate for a borrower of similar risk is 12%.

1. Is the loan a TDR?

Yes. The borrower is experiencing financial difficulties, and the lender has granted concessions by waiving the clean-up, terming out the loan, and reducing the interest rate to a below market rate.

2. What is the appropriate impairment measurement method - the present value of cash flows method or the fair value of collateral method?

When relying on the income stream from business operations to repay the term loan, the loan would not be considered collateral dependent. Therefore, the present value of expected future cash flows method is appropriate. Furthermore, the collateral for the loan consists of business assets estimated to be of nominal value.

3. What is the impairment amount based on the following modified terms?

Loan Amount	**$800,000**
Interest Rate	**6.50%**
Term	**7 Years**
New Monthly Payment	**$11,880**
Loss Experience on Substandard WC Lines of Credit that Have Undergone Similar Modifications	**20%**
Loss Experience on Substandard Unsecured Loans that Have Undergone Similar Modifications	**30%**

A. Discounted Cash Flow Analysis

Payment Less 30%	$8,316
Discount Rate (Original Effective Interest Rate)	7.50%
Term	7 Years
PV of Payments	$542,000
Less: Loan Amount	$800,000
Impairment Amount	$258,000

B. Discounted Cash Flow Analysis

Payment	$11,880
Discount Rate (Original Effective Interest Rate)	7.50%
Term	7 Years
PV of Payments	$775,000
Less: Loan Amount	$800,000
Impairment Amount	$25,000

C. Discounted Cash Flow Analysis

Payment Less 20%	$9,504
Discount Rate (Market Rate)	12.00%
Term	7 Years
PV of Payments	$538,000
Less: Loan Amount	$800,000
Impairment Amount	$262,000

The best answer is A.

Answer A is the best answer because it uses the correct discount rate (the original effective interest rate) and takes default assumptions into consideration when estimating the expected future cash flows. Because management estimates the collateral has only nominal value, management concludes that using the loss experience on Substandard unsecured loans that have undergone similar modifications is more appropriate than the working capital line loss experience for default assumption purposes.

Answer B does not adjust the expected future cash flows for estimated default assumption. However, it uses the correct discount rate (the original effective interest rate).

Answer C uses a default assumption that does not reflect the lack of collateral protection on this loan. Although the answer adjusts the cash flows to estimate the default risk, it uses the working capital line loss experience, which is inconsistent with management's conclusion regarding the nominal value of the collateral available for repaying the loan. This answer also uses an incorrect discount rate. ASC 310 requires the discount rate to be the original effective interest rate, not the market rate of interest.

4. Does the impairment amount remain in the ALLL, is there a confirmed loss to charge off, or is it a combination of both?

The impairment amount remains in the ALLL. When the appropriate impairment measurement method is the present value of expected future cash flows, the resulting impairment amount stays in the ALLL. The impairment amount would be re-evaluated quarterly, and adjusted, if necessary, based on the borrower's demonstrated ability to repay the loan. In addition, the loan would need to be evaluated quarterly to determine whether a charge-off should be taken. When available information confirms that the loan, or a portion thereof, is uncollectible, this amount should be promptly charged off against the ALLL.

5. Should the loan be on nonaccrual at the time of the restructuring?

Yes. If the loan was not already on nonaccrual prior to the restructuring, it should be placed on nonaccrual at the time of the restructuring. The general rule for nonaccrual status in the Call Report instructions includes placing a loan on nonaccrual when "payment in full of principal or interest is not expected." The borrower's operating performance has declined significantly, resulting in a net loss and insufficient cash flow to cover operating expenses and the 25% annual clean-up of principal on the working capital line. Thus, management's credit analysis of the borrower's financial condition in conjunction with the restructuring indicates that full collection of principal and interest on the working capital line is not expected, which supports placing the loan in nonaccrual status not later than at the time of the restructuring. A loan cannot be modified as a way to avoid placing the loan on nonaccrual when such treatment would otherwise be warranted.

In order to return a nonaccrual TDR loan to accrual status, the following conditions must be met:

- Management must complete a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms;
- Management should be reasonably assured of repayment of all principal and interest under the modified terms; and
- The borrower must demonstrate a sustained period of repayment performance (typically at least 6 months).

Sustained payment performance may include payments made in the months prior to the restructuring. However, in this instance, the borrower was unable to make the required partial clean-up payment prior to the restructuring, so the borrower's past performance would not count toward the sustained period of repayment performance.

6. What is the appropriate loan classification at the time of the restructuring?

Substandard. The loan has well-defined weaknesses due to the borrower's inadequate cash flow, illiquidity, and lack of profitability, and there is a distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. The loan would need to be evaluated quarterly to determine whether a charge-off should be taken. When available information confirms that the loan, or a portion thereof, is uncollectible, this amount should be promptly charged off against the ALLL.

7. Can the bank discontinue reporting the loan as a TDR in the Call Report in calendar years following the year of the restructuring?

No. The loan would continue to be reported as a TDR because at the date of restructuring the 6.5% modified interest rate was below the 12% market rate for new debt with similar risk characteristics.