Example 8
A/B Note Structure

Management originated a $10,000,000 loan secured by a shopping mall with expected lease up in 12 months. Due to weak economic conditions, the shopping mall only achieved a 58% occupancy level with an “as is” MV of $9,000,000, yielding a 111% LTV. Costs to sell are estimated to be 11% of the “as is” MV. The borrower was unable to service the debt with a DCR of 0.80x. Current financial information indicates the borrower and the guarantor have limited resources available to support this credit. The loan was placed on nonaccrual after it became 90 days delinquent.

If the bank were to foreclose on and sell the property, management would expect to receive proceeds of $8,010,000 net costs to sell based on the property’s “as is” MV. After carefully analyzing the financial condition of the business, management determines that the collateral is able to generate cash flow sufficient to service an $8,000,000 loan at the current market rate of interest for new debt with similar risk characteristics. As its workout strategy to mitigate credit loss, management restructures the loan by splitting the original note into 2 separate notes, one of which is supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms.

The A Note is for $8,000,000 and carries a current market rate of interest for new debt with similar risk characteristics. The A Note’s characteristics include an adequate DCR and LTV. The B Note is for $2,000,000 and carries a below-market rate of interest. Management charges off the B Note as uncollectible due to the borrower’s lack of repayment capacity. The terms of the B Note do not call for any interim payments; principal and interest are due at the maturity of the B Note, which is not until after the maturity of the A Note.

1. **In this situation, where management splits the loan into an A/B note structure, does the B Note have to be charged off in order for the A Note to potentially receive favorable examination treatment?**

Yes. Because the restructured loans are supported by the same source of repayment, the uncollectible portion of the $10,000,000 loan, which is represented by the B Note, must be charged off before potentially favorable examination treatment can be considered for the A Note. In addition, the B Note has been structured to defer all required payments until maturity in order to strengthen the ability of the borrower to service the A Note and ensure the latter is at market terms. After charging off the B Note, which could be viewed as a contingent receivable, the A Note is reasonably assured of repayment and performance according to reasonable modified terms.

2. **Assume that the B Note was not charged off. How would that affect the A Note’s accrual status and Call Report treatment?**

It would be unlikely that the A Note could return to accrual status, and the A Note would need to be reported indefinitely as a TDR on the Call Report.

The A Note could not return to accrual status because the repayment of the aggregate debt would not be reasonably assured since both notes would be reported as on-balance-sheet assets and are supported by the same source of repayment. Likewise, the A Note would still be reported as a TDR on the Call Report. For the A Note not to be reported as a TDR in calendar years after the year of the restructuring, the A Note must yield a market rate at the time of the restructuring and be in compliance with its modified terms. To be considered in compliance with its modified terms for Call Report purposes, the TDR must be in accrual status and must be current, or less than 30 days past due under the modified terms. Therefore, by not charging off the B Note, the A Note cannot return to accrual and must continue to be reported as a TDR on the Call Report.

(Example 8 Continued)

3. Since the loan was delinquent before the restructuring, can the A Note return to accrual status if the B Note has been charged off?

Yes. After a period of sustained payment performance, the A Note may be returned to accrual status provided the following conditions are met:

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

As long as any of these conditions has not been met, or if the terms of the restructuring lack economic substance, the A Note should continue to be reported as a nonaccrual loan.

4. Can the bank discontinue reporting the A Note as a TDR in the Call Report in the calendar years following the year of restructuring if the B Note has been charged off?

Yes, given that the A Note bears a market interest rate at the date of the restructuring, if the A Note is in compliance with its modified terms (as described in the response to Question 2 above), which includes having been returned to accrual status, the loan would no longer be required to be reported as a TDR in the Call Report in calendar years after the year in which the restructuring took place. However, the A Note should continue to be measured for impairment under ASC 310.