FDIC Telephone Seminar on Commercial Real Estate Loan Workouts and Related Accounting Issues

December 15, 2011

Coordinator: Welcome and thank you for standing by. At this time all participants are in a listen-only mode. During today's question-and-answer session, the command to ask a question will be star then 1 on your touch-tone phone.

Today's conference is being recorded. If you have any objections, you may disconnect at this time.

And now I'd like to introduce your host for today's call, Mr. Daniel Bean.

Daniel Bean: Thank you, good afternoon everyone. Welcome to today's risk analysis and our presentation entitled Commercial Real Estate Loan Workouts and Related Accounting Issues.

There will be a discussion by our presenters followed by a question-and-answer session at the end. The operator will come back on at that time to provide instructions for any of the queue to ask your questions. If you would like to submit a question during the presentation via email, please email your question to rac@fdic.gov. That's R-A-C @fdic.gov.

I would like now to turn this call over to Mindy West, Associate Director of Risk Management, FDIC.

Mindy West: Thank you, Dan. I'd like to welcome everyone to this seminar on commercial real estate loan workouts and related accounting issues. Thank you for taking the time from your busy schedules to join us today.

We're pleased to have a discussion of this important topic and to answer as many questions as possible about the CRE workout guidance and a variety of general accounting issues such as the allowance for loan and lease losses and troubled debt restructurings, which we often refer to as TDRs.

The FDIC has found that prudent CRE workouts are often in the best interest of the bank and the borrower. The FDIC has encouraged and will continue to encourage bankers not only to extend new credit to creditworthy borrowers, but also to work in a prudent manner with commercial borrowers who may be facing financial difficulties and challenges.

During today's seminar, the FDIC subject matter experts will answer questions regarding the application of the CRE workout guidance and related accounting issues that participants submitted in advance. We may unfortunately not be able to answer all of these questions, but we will certainly try to address most of the topics that you've raised.

For today's audio conference, we are joined by Bob Storch who is FDIC Chief Accountant and Suzy Gardner who is the Senior Examination Specialist in FDIC's policy section.

I would now like to turn it over to Suzy to lead off the discussion.

Suzy Gardner: Thank you Mindy. Good afternoon. As Mindy indicated, we plan to address as many of the questions that you've provided to us today regarding the CRE workout guidance and related accounting issues. By way of background, the agency issued a policy statement on prudent CRE workouts on October 30, 2009.

This guidance recognizes that prudent CRE loan workouts are often in the best interest of the bank and the borrower. As the guidance notes, loan workouts can take many forms including a renewal or extension of loan terms, extension of additional credit or a restructuring with or without concession.

Prior to engaging in a loan workout, an institution needs to assess the borrower's financial condition so management can make an informed business decision regarding whether or not it should consider a workout. Management should use this information to perform a realistic assessment of the borrower's and any guarantor's global debt service requirements and to determine their repayment capacity.

Management also should obtain updated information regarding the value of any collateral pledged on the loan. After performing an appropriate analysis of the borrower's financial capacity and considering market conditions, management should develop a well-conceived and prudent workout plan tailored to a borrower's specific financial circumstances.

The workout plan should result in a loan structure including loan terms such as the interest rate and the amortization schedule that is appropriate given the risk in the credit and the type of real property pledged as collateral. Well-conceived workout plans with creditworthy commercial borrowers should enable institutions to improve their repayment process while facilitating commercial borrowers' access to credit.

During an examination, examiners will review a bank's workout activities. Examiners will consider the institution's analysis of the borrower's or the guarantor's repayment capacity and their assessment. Examiners will also evaluate a bank's collateral reviews and supporting documentation as well as the major facts, assumptions and evaluation approaches used in the collateral evaluation.

The guidance also specifies that renewed or restructured loans to borrowers who have the ability to repay their debts under reasonable modified terms will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that's less than the loan balance.

Several participants have raised questions about why some workouts were adversely classified during recent examinations. Often times, the issue pertains to the borrower's ability to repay under reasonable modified terms. The reasonableness of a workout's terms has to be determined on a case by case basis and hinges on a borrower's overall financial condition and the type of real property pledged as collateral on the loan.

In addition, examiners will assess the institution's internal loan grading system to ensure that it accurately and consistently reflects the risk in workout arrangements. Examiners will not criticize institutions that engage in prudent loan workout activities after performing a comprehensive review of a borrower's financial condition, even if the restructured loans have weaknesses that result in an adverse credit classification.

Instead, examiners will take a balanced approach in assessing an institution's risk management practices for loan workout activity in light of economic circumstances and realistic business alternatives that bank management is facing.

With that, I would like to turn it over to Bob.

Bob Storch: Thanks Suzy, this is Bob Storch from the FDIC. I'd like to also welcome everyone to this afternoon's call. I'll be approaching the subject from the accounting side of the house and try to give an overview here at the beginning before getting into some of the questions. Some of the overview on the accounting standards that apply to troubled debt restructurings and workouts may indirectly answer some of the questions we received, but we'll try to also cover the standards again the context of the actual questions. The accounting framework that we're looking at now is the FASB Accounting Standards Codification. The two key sections are Subtopic 310-40 dealing with receivables that are troubled debt restructurings from the creditor's standpoint and then the more general guidance in Subtopic 310-10 on receivables. 310-40 was formerly FAS 15, troubled debt restructurings. And 310-10, or at least the portion that applies to troubled debt restructurings, also is formerly known as FAS 114, which deals with accounting by creditors for impairment of a loan.

The other important development within the past year is the FASB issued an Accounting Standards Update amending portions of Subtopic 310-40 on troubled debt restructurings. This was done in April in order to provide additional guidance to help creditors determine whether a concession has been granted to a borrower and whether a borrower is experiencing financial difficulties.

The guidance for public banking organizations took effect generally speaking in the third quarter of this year, assuming the organization's on a calendar year fiscal year. For private companies on a calendar year basis it would take effect in the beginning of 2012. The guidance that's in this Accounting Standards Update by-and-large sort of mirrors existing best practices for dealing with the accounting and reporting of troubled debt restructurings.

But there is some new guidance dealing with what's called insignificant delays in payments as part of a loan modification. In a nutshell, that guidance provides that after analyzing all the facts and circumstances, a creditor may determine that a delay in payment is insignificant. And if that's the case, the creditor would not have granted a concession to the borrower.

But the determination about whether a delay in payment is insignificant or not requires judgment, as does a lot of the application on these accounting standards, and needs to consider many factors which would include the amount of the delayed payments in relation to the loan’s unpaid principal or collateral value, the frequency of payments due on the loan, the original contractual maturity, and the unexpected duration of the loan.

There is some high level guidance about this Accounting Standards Update in the Call Report Supplemental Instructions that were issued in September and that's available on both the FDIC's Web site and the FFIEC or Federal Financial Institutions Examination Council's Web site.

So what is a troubled debt restructuring? The accounting standards say a restructuring of a loan is 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. So in entering into this type of an arrangement, the creditor is really trying to make the best of a difficult situation.

There's an effort by the creditor to try to protect as much of the asset as possible and also by doing so to hopefully obtain more cash or other value from the debtor or increase the likelihood that it will be received by granting the concession than by not granting the concession.

These concessions would arise most commonly from an agreement between the creditor and debtor, but they can be imposed by a bankruptcy court and that sort of thing. So if we go back to the definition of what a troubled debt restructuring is, we really have two questions to answer in determining whether a particular modification of the terms of a borrower's loan constitutes a troubled debt restructuring for accounting purposes.

The first question that has to be asked is, is the debtor experiencing financial difficulties? And then the second question is, has the creditor granted a concession to the debtor? If the answer to both questions is yes, then the modification of terms is a troubled debt restructuring. But if the answer to either one of those questions is no, then the modification is not a troubled debt restructuring.

What sort of changes in the terms of the loan could potentially be a troubled debt restructuring if the changes in fact turn out to be a concession? The standards talk about reducing the stated interest rate for the remaining life of the debt, forgiving principal or interest on the debt, and extending the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk.

Those are simply examples; they're not an exhaustive list. There's other types of changes to terms and conditions that would have to be taken into account. So in evaluating whether a particular restructuring is a troubled debt restructuring, the bank and an examiner both would need to look at all the individual facts and circumstances, consider all the aspects of the restructuring, and use some good judgment in evaluating it.

In terms of whether a debtor is experiencing financial difficulties, there has been guidance that's been followed from the Accounting Standards Codification. It has been in Subtopic 470-60, which is written in terms of –an evaluation from the debtor's side, but it's been longstanding practice to apply that guidance to evaluating it from the creditor's side as well.

The Accounting Standards Update issued in April of this year provided further elaboration on some of these criteria. One of the key indicators of whether a borrower is experiencing financial difficulties is that the borrower is currently in payment default on any of its debt, not just the debt that we're looking at for a modification of terms, but any of its debt.

The Accounting Standards Update widened default somewhat to also require more forward looking consideration of the borrower's repayment capacity and indicated that if it's probable the debtor would be in payment default on any debt in the foreseeable future, if the bank did not modify the terms of the loan, then the debtor may also be experiencing financial difficulties.

Another key indicator of financial difficulties is looking at the debtor's current capacity and ability to repay. The question would be, are the debtor’s cash flows sufficient to service the debt, both principal and interest, in accordance with the contractual terms of the existing agreement through maturity? If the cash flows would be insufficient, then that's an indicator of financial difficulties.

The Accounting Standards Update elaboration on that indicator would be to extend it from not just the existing debt to the bank, but to any other debt of the borrower as well. So be looking at the global obligations of that particular obligor. Obviously, as I said before, all the facts and circumstances have to be considered to determine whether financial difficulties are being encountered.

Then, from the perspective of whether a concession has been granted, all the facts and circumstances need to be considered, including all the terms and conditions of the loan and even whether the changes in the terms and conditions of the loan are outside of a creditor's normal policies or kinds of market practices. That gets back to the reasonableness of the modification as Suzy was talking about a few minutes ago.

In evaluating interest rate concessions, because that seems to be an area that drives the most questions, the agencies issued guidance through the Call Report Supplemental Instructions last year, and it's still provided each quarter, to indicate that a current market interest rate is an interest rate greater than or equal to the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risks.

Comparable risks means risk of the borrower experiencing financial difficulties. So a restructured loan does not yield a market interest rate simply because the rate charged under the restructuring agreement has not been reduced, but even an increase, either temporary or permanent, in the contractual interest rate cannot be presumed to be a rate that is at or above a market interest rate.

We really need to evaluate the borrower's financial condition at the time of the restructuring and compare the rate on the modified loan to rates the creditor would charge borrowers with similar financial characteristics on similar types of loans. The question really is, does the rate that the creditor is charging under the modified terms adequately compensate for the credit risk of the borrower who's experiencing financial difficulties?

One way of possibly evaluating that is to look at the rate on the lowest credit quality loan that the bank would currently originate and how the rate charged to the borrower experiencing financial difficulties on the restructuring compares to it.

If it's equal to or less than the rate that would be charged the lowest quality borrower the bank would be willing to make a new loan to, then presumably the rate on the restructuring is not at a market rate for a borrower experiencing financial difficulties.

Some of the guidance from the Accounting Standards Update that further explains troubled debt restructurings talks about the provision of additional collateral and guarantees. Here the Accounting Standards Update says that when the creditor has received additional collateral or guarantees as part of a restructuring, but they still do not adequately compensate for the risk, then the restructuring would be a concession.

The creditor has to do a good evaluation of the guarantor's ability and willingness to pay the balance owed, not just the financial condition of that guarantor.

With that, I think it's probably a good idea to move to some of the questions because they'll cover a number of these topics in more detail. And one of the first questions was, "When is a restructuring a troubled debt restructuring and when can we remove that designation for credit purposes?"

As mentioned before, the two key questions that have to be answered are, is the borrower experiencing financial difficulties and has the creditor granted a concession. When those two conditions exist, the loan is a TDR and is deemed to be an impaired loan. For accounting purposes, that's where the former FAS 114 comes into play.

And then the follow-on question is, "When can we remove the troubled debt restructuring designation for reporting purposes?" The short answer is that, except in very limited circumstances, the troubled debt restructuring designation remains in place as long as that loan remains outstanding. If the loan is sold or otherwise settled, charged off, or repaid, then the designation goes away.

But as long as the loan is outstanding, it would continue to have the troubled debt restructuring designation. Depending on whether the loan is in compliance with its modified terms or not, there will be different places in the Call Report in which to report the loan. So even if the loan is in compliance with its modified terms, it is still in fact a troubled debt restructuring. Call Report Schedule RC-C, Part I, Memo Item 1 is where the loan would be reported.

It the TDR is not in compliance with its modified terms, that means that it's either 30 days or more past due or is in nonaccrual status, the loan would be reported in Schedule RC-N, Memo Item 1, as well as in the appropriate loan category in the past due schedule.

The exception from continuing to report a restructuring as a troubled debt restructuring is fairly limited and there's been, at least in my experience, some misunderstanding of how the criteria apply.

The Call Report instructions have long stated, and this originally came from FAS 15, that if a troubled debt restructuring yields a market interest rate at the time of the restructuring -- and again that's a market interest rate in relation to the credit quality of the borrower experiencing financial difficulties -- and the modified loan is in compliance with its modified terms, it no longer needs to be reported as a troubled debt restructuring in the Call Report in calendar years after the restructuring.

This type of exception may be met when there's actually a forgiveness of principal so the debt service obligation of the borrower has been reduced. We have some additional questions on this later on, but when there's an A/B Note Structure it may be possible to have the loan drop off from disclosure as a troubled debt restructuring in that situation as well if the conditions are met.

Even if disclosure as a TDR is discontinued, the loan would remain an impaired loan as well. So the accounting that applies to individually impaired loans would continue to apply for credit purposes.

There was a follow-on question and the specific facts are that we have a borrower whose cash flow appears to be negative or near a ratio of 1:1, the cash flow is diminished, but they are still making payments on their loans from some unspecified source. The debtor hasn't asked for a concession, is this a troubled debt restructuring or not and the answer would be no. The loan terms have not been modified and the original contract remains in place. The mere fact that there's some indication of financial difficulties on the part of the borrower doesn't make an existing loan without any change in terms that represents a concession into a troubled debt restructuring.

Another question about the reporting of troubled debt restructurings deals with the classification of the loan for examination purposes. You may have some thoughts on this as well Suzy. It says, "If a troubled debt restructuring is always a troubled debt restructuring until it's paid in full and a troubled debt restructuring is always impaired, how can a troubled debt restructuring ever be anything other than a substandard loan?"

Because the Call Report Glossary defines impairment as a situation where it's probable that an institution will be unable to collect all amounts due, both principal and interest, according to the contractual terms of the loan agreement, the question is, ”For all practical purposes, doesn't that define a substandard credit?”

I think from an accounting standpoint -- and Suzy you can touch on the examination standpoint -- the literature says that when you have a loan that's undergone a troubled debt restructuring, the impairment designation is made in reference to the original loan agreement, not the modified terms.

Whereas I would imagine from an examination standpoint, we're looking more at the reasonableness of the modified terms and the borrower's ability to perform under them. Is that right?

Suzy Gardner: That's absolutely correct Bob. We are definitely looking at the borrower's ongoing capacity to make their payments based upon the revised terms of the loan agreement. The reality is that a lot of borrowers are experiencing cash flow difficulty and some of the banks are starting to enter into workouts or modifications where they're lowering the borrower’s interest rates or they're going to interest-only payments to enable the borrower to cash flow.

Depending on the nature of those credits, they typically are going to be classified substandard because the bank is entering into these arrangements due to the borrower's impaired ability to repay. Now, if you have a situation where the borrower demonstrates an ability to perform and the terms are reasonable overall, in time such loans could be upgraded back to a pass classification. But, the classification treatment has to be based on the facts of each situation.

We also have received questions about the classification treatment of a CRE workout. In this instance, the source of repayment for a CRE loan was rental income from an established office building. The borrower is experiencing a decline in cash flow due to a higher vacancy rate and having difficulty making his payments.

Based upon the financial information available, the borrower is experiencing financial difficulty. The bank restructured the loan from an amortizing basis onto an interest-only basis at a lower rate of interest for two years. The basis or the reason behind the modification was to give the office building a chance to increase its occupancy rate.

The revised terms resulted in a slightly positive debt service coverage ratio or DSC ratio of 1.08 times. This indicates the borrower has a slightly positive ability to pay based on the revised terms. Under the prior terms, which included amortization of the loan and a higher interest rate, the debt service rate equaled less than 1 at 0.82 times, indicating that the borrower did not have sufficient cash flow to service the debt.

In this instance, the restructuring granted concessionary terms due to the borrower's cash flow problem. The bank internally classified the loan substandard due to the borrower's inability to repay based upon reasonable modified terms.

The examiner reviewed the bank's internal rating and concurred. Conversely, the loan probably would not have been adversely classified internally if the borrower had sufficient cash flow to service the debt at a market rate of interest and on an amortizing basis. In addition, the restructuring resulted in a TDR based upon the borrower having financial difficulty and the bank granting concession.

Bob, would you like to discuss that further?

Bob Storch: Yes, I can, and I think before getting into some of the discussion about measuring impairment on troubled debt restructurings and so forth, a related issue to this whole classification question is an observation that there seems to be some view on the part of some that, by definition, troubled debt restructurings are impaired loans and therefore they are substandard loans basically forever, which you suggested is not the case.

The commenter's observation is if no matter how well the borrower performs or how properly structured the modified terms are, the loan would always be regarded as substandard, then that's really a disincentive for banks to work with borrowers, which is not the objective that we and all these banking agencies really have with these troubled debt restructurings.

So I think we would want to make it clear that while there may initially be a substandard classification, that's not a permanent fixture associated with that troubled debt restructuring for its remaining life. There would be some disclosure and accounting measurement issues about the troubled debt restructuring, but the classification can changed when facts would dictate that.

Suzy Gardner: Absolutely, we want to stress how important it is that the classification assigned to any particular loan depends upon the facts and circumstances present at that particular point in time. And classification can change both up and down over time.

We also need to make sure everybody understands the fact that we have a duty to identify the risks in a bank's loan portfolio. Internal classifications should reflect the risk in the loans, and examiners are there to normally confirm a bank's internal assessment of the risk in its own portfolio.

After a loan has performed over a reasonable period of time, which is generally considered a minimum of six months, then it's possible that a loan could get upgraded depending upon the facts and circumstances of the modification. I've had several bankers approach me asking me why was a loan that was restructured at 1% on an interest-only basis and is performing according to those terms considered to be a substandard credit by examiners.

And the reality of it is, is because those terms are below market. The terms are concessionary and the borrower is experiencing severe financial difficulty as demonstrated by the inability to cash flow more reasonable terms. We want to encourage bankers to work with their borrowers. At the same time, it's also very important to understand and appreciate the risk in a portfolio.

Bob, did you have another issue you wanted to cover?

Bob Storch: Yes, we've got a series of questions about measuring impairment and what makes a particular loan collateral-dependent and so forth. So before getting into those, it may be helpful to summarize what the accounting requirements are. And that will set the stage for responding to the questions and some of the examination treatment issues that relate to whether loans are collateral-dependent or not.

As I mentioned before, when a loan modification constitutes a troubled debt restructuring, the loan is considered impaired. And if a loan is impaired, then we apply what was formerly called FAS 114 on impairment measurement requirements.

For our regulatory reporting purposes -- and this has been true ever since FAS 114 took effect in the mid-1990s, it's reflected in the Call Report Instructions as well -- there's basically a bright line test for determining what measurement method applies to these troubled debt restructurings and more generally to all individually impaired loans.

The question that has to be answered first is whether this restructured loan or any impaired loan is collateral-dependent or not. And the definition of collateral-dependent from the accounting literature and the Call Report Instructions is that repayment is expected to be provided solely by the underlying collateral and there is no other reliable source of repayment.

And when we talk about repayment expected to be provided solely by the underlying collateral, that could come from either the sale of the collateral or the operation of the collateral. But those two sources, sale or operation, have different accounting and examination evaluation consequences. So it's important to recognize the difference even though in each case, the loan will be collateral-dependent.

If a loan that's a troubled debt restructuring or any impaired loan is not collateral-dependent, then for regulatory reporting purposes under GAAP, impairment would be measured based on the present value of the expected future cash flows on the loan discounted at the loan's effective interest rate.

The expected future cash flows should be the creditor's best estimate based on reasonable and supportable assumptions and projections. The key here is how supportable are the estimates of the cash flows. It would not normally be reasonable and supportable to say that the contractual repayment terms are the best estimate of the cash flows we'll be collecting.

These are loans to troubled borrowers, borrowers experiencing financial difficulties, so you really need to consider appropriate default and prepayment assumptions that would apply to that type of loan when looking at the best estimate of the cash flows.

The effective interest rate for the discounting process is the original effective interest rate on the loan, not the rate specified in the restructured loan agreement. Again, with troubled debt restructurings, we're reverting back to the original loan terms.

On the other hand, if a loan is a troubled debt restructuring and is collateral-dependent, the measurement of impairment is based on the fair value of the collateral.

If repayment or satisfaction of the loan is dependent on the sale of the collateral, the fair value estimate has to be reduced by the estimated cost to sell because that will reduce the proceeds available to repay the loan. On the other hand, if repayment or satisfaction of the loan is dependent on the operation of the collateral, then there wouldn't be any need to adjust the fair value for the estimated cost to sell.

Again, this is for purposes of measuring impairment and setting up a FAS 114 allowance. We haven't gotten to the question of what if any loss classification would be appropriate and whether any charge-off would be appropriate. We'll get to that shortly.

It's important to recognize -- and this is something that's touched on in the questions -- the GAAP literature permits the measurement of impairment on individually impaired loans, including troubled debt restructurings, that are collateral-dependent to be done on a discounted cash flow basis. GAAP only requires the use of the fair value basis if foreclosure is probable. It permits the use of a fair value basis when foreclosure is not probable.

But for regulatory reporting purposes, the agencies say that all impaired collateral-dependent loans -- whether foreclosure is probable or not -- should have their impairment measurement based on the fair value of the collateral.

So going to the questions again, the first one that begins to touch on this area says that a troubled debt restructuring is by definition an impaired loan. But is a TDR by definition collateral-dependent? The answer would be no, it really depends on the facts and circumstances. If the loan is a troubled debt restructuring and repayment would be solely dependent on the sale or the operation of the collateral, then it will be collateral-dependent.

But otherwise, and there are restructurings of unsecured loans, so certainly in those cases the TDRs would not be viewed as collateral-dependent. And the other thing to point out is merely because a loan is collateral-dependent -- and some commercial real estate loans when they're underwritten are collateral-dependent from day one -- that doesn't mean on day one the loan is impaired or a troubled debt restructuring either.

So collateral-dependent is a characteristic that has to be determined when evaluating the accounting for a troubled debt restructuring, but the fact that a loan is collateral-dependent doesn't automatically drive a TDR or impaired loan designation.

Moving to some of the other questions on troubled debt restructurings and the measurements of impairment, one says, "If a commercial real estate loan is being restructured based on a borrower's ability to repay from the operations of the property, then it would seem logical to measure impairment based on a discounted cash flow method instead of marking the loan to the fair value of its collateral. Is this correct?"

For regulatory reporting purposes as mentioned before, no it's not correct. For any collateral-dependent troubled debt restructuring, the impairment must be measured for regulatory reporting purposes based on the fair value of collateral method.

There is greater flexibility in measuring impairment when foreclosure is not probable for GAAP reporting, but the agencies -- when FAS 114 was first issued -- decided to limit the impairment measurement choices that are available under GAAP on a collateral-dependent impaired loan prior to foreclosure becoming probable.

Now may be a good time to turn to some of the questions dealing with collateral-dependent loans more specifically.

Suzy Gardner: Bob, one of the questions that we received pertains to an institution that's been offering interest-only payment terms on an unstabilized CRE property that's been impacted by a slow lease-up period. In this situation, the borrower really doesn't have any other source of repayment other than the cash flow from the rental income.

The current loan to value on the property is over 100%, but the borrower has sufficient cash flow to provide for a debt service coverage ratio in excess of 1 times on an interest-only basis. Leasing is picking up and they expect the borrower to be able to resume amortizing payments after the modification term is completed, but the LTV will still probably be in excess of 100%.

The question is whether or not the loan is collateral-dependent and would they need to charge off the loan amount in excess of the fair value of the collateral even though the debt service is adequate to service the debt? What we stress in the CRE workout guidance is the fact that we're focusing on the borrower's repayment capacity.

The question indicated in this particular scenario that on an interest-only basis, the borrower has sufficient cash flow to service the payment in excess of 1 times for the DSC ratio. So the borrower has some capacity to pay. The real question in my mind is at what interest rate?

Again, if you're lowering the interest rate so low that it really isn't a reflection of the risk in the credit, it doesn't mean that the loan should not be subject to adverse classification just because the borrower can service the debt on below market terms.

If you have a borrower who's able to meet reasonable repayment terms and has demonstrated the ability to do so on an ongoing basis, in all probability that credit will not be classified. We are looking at repayment capacity, an income-based approach rather than a collateral-based approach. As for whether or not the loan is collateral-dependent, it would again depend on the situation.

If you have a situation where you're looking at the ongoing operation for repayment based on reasonable terms, we would say the loan is performing as agreed and would not be subject to adverse classification, but it may or may not be collateral-dependent for accounting purposes. As for charging off the difference of the collateral's fair value versus the book value of a loan, in all probability the answer would be no. But again, it would depend.

And I hate to have to use that caveat, but it really is a fact-based situation. Are the modified terms at market? Are they reasonable? If they are, then no you would not need to charge off any potential deficiency balance. If you're using terms such as 1% on an interest-only basis, it's a reflection of a very high level of risk within this particular credit and that risk should be identified through a potential loss classification to the degree it is warranted.

Bob, do you have anything to add on that?

Bob Storch: I was just going to add that if we go back to the interagency guidance dealing with the allowance for loan and lease losses that was issued in December 2006, there is a statement in there that was carried forward from previous guidance as well.

It says, in general, any portion of the recorded investment in a collateral-dependent loan -- this is an impaired collateral-dependent loan -- in excess of the fair value of the collateral that can be identified as uncollectible and is therefore deemed a confirmed loss should be promptly charged off against the allowance.

So the key really is what portion of the loan balance is deemed to be uncollectible and that's where we get to a difference between the measurement of impairment under FAS 114 on these impaired collateral-dependent loans, including troubled debt restructurings, where we're looking at the fair value of the collateral today.

But from an examination evaluation and classification standpoint, you're looking at more facts and circumstances and where the loan may be at some stabilized point in the future assuming that that stabilization value is well-supported and documented.

So we have a difference -- and this seems to be where we get a lot of the questions -- between the FAS 114 impairment measurement and the examination classification of any loss identified and therefore the amount of any charge-off.

Suzy Gardner: I believe that's right. For risk purposes, we're looking at the borrower's ability to repay on reasonable terms and even though the loan could be collateral-dependent for accounting purposes, if repayment is going to be coming from the ongoing operation of the business or the borrower's cash flow, i.e., you're not planning to sell the property for repayment, then we're looking at that as the primary source of repayment.

In those situations, you would not have to recognize any deficiency balance based on fair value less costs to sell. So, we're looking at it from a risk perspective based upon the borrower's ability to repay. The reserve analysis for the impairment amount has to be based upon the fair value of the collateral, but not less costs to sell, and the bank would not have to charge off the collateral shortfall.

Bob Storch: Along that line, there were a series of questions that said something to the effect that we heard that the FDIC has recently begun interpreting paragraph

13 of FAS 114 to define a collateral-dependent loan as a loan whose repayment is dependent solely on the sale or operation of the collateral.

And the observation in some of these comments is that there was the view that from a GAAP perspective, collateral-dependent meant repayment provided solely by the sale of the collateral. There was a question asking for the source of our viewpoint on that. I would draw people's attention to -- and we'll go to the Codification -- Codification Paragraphs 310-10-35-22 and 23.

Paragraph 22 talks about using the fair value of the collateral as a method for measuring impairment if the loan that's impaired is a collateral-dependent loan.

And then Paragraph 23 goes on and says, “If a creditor uses the fair value of the collateral to measure impairment of a collateral-dependent loan and repayment or satisfaction of a loan is dependent on the sale of the collateral, the fair value of the collateral shall be adjusted to consider estimated costs to sell,” which is what we said before.

But Paragraph 23 does go on and say, “However, if repayment or satisfaction of the loan is dependent only on the operation, rather than the sale, of the collateral, the measure of impairment shall not incorporate estimated costs to sell.” So our view is that that paragraph clearly indicates that collateral-dependent can be based on sale as well as operation of the collateral.

And I would say that's not just a recent FDIC view. In the troubled commercial real estate workout guidance that Suzy referred to from October 2009, there's a Footnote 12 in this interagency guidance that says, “a loan is collateral dependent if repayment of the loan is expected to be provided solely by sale or operation of the underlying collateral.”

So this is a view on the definition of collateral-dependent that is not just a new development or a recent change, but it's a view that's been held for some period of time. And again, we think there's a sound basis for that in the accounting literature itself.

Let me go to one of the other questions here on collateral-dependent loans. The question is, "If a CRE loan is performing, but we cannot prove the ability to pay (i.e., stale financial statements), and the collateral value is insufficient to cover the loan, is that loan considered collateral-dependent?"

I don't know. From the question, it's hard to say whether this is an existing loan that we're just looking at and there's been no recent contact with the borrower, no effort to modify the terms, and so forth. It's very difficult to prove one way or the other what the source of repayment is. Presumably there is some information when the loan was underwritten originally about what the expected source of repayment is.

Whether that's changed or not, if the loan is performing, we still have to evaluate it, if it's within the scope of the loan review function, to see whether it's impaired. And impairment would consider if there is any information that suggests that it's probable that performance going forward would not be able to be done in accordance to the contractual terms.

In other words, an impaired loan can be a loan that's current today, but there's information that suggests it will not be able to remain current. If the bank's credit risk management is such that they're not getting regular financial information from their borrower -- particularly the largest borrowers that are typically the loans being individually evaluated for impairment -- it's difficult to judge the risk of those loans going forward.

So that's a difficult situation. I mean, there's a credit risk management or a credit risk administration issue raised by the question that, without more complete information, the accounting is going to be very difficult to reach a conclusion on.

Suzy Gardner: Bob, you're absolutely right. The lack of updated financial information, including all the appropriate supporting schedules, is a very difficult issue for both bankers and examiners in trying to assess the risk of a particular loan.

And if you have a situation where the borrower's performing and there are no indications that there's going to be any problem for the borrower to continue to perform, a bank may not need as much updated financial information as it might otherwise normally obtain. But as soon as you have some sort of indication that there could be an issue, you need to be requesting it.

And the reality is that the bank ought to be requesting this information on an ongoing basis just so it can continue to monitor the risks in the loans. So, while there's no regulatory requirement to obtain financial information on any particular type of frequency basis, obtaining it on some type of a regular basis is a very prudent practice just so everyone can monitor the risk in a portfolio and the borrower's ongoing ability to repay according to the contractual terms of the loan.

We also have several questions about A and B notes, Bob. And if we could turn to a couple of those. An A and B Note Structure was addressed in the prudent CRE workout guidance. What we talked about in that particular guidance is restructuring a loan so that it has two pieces, a new Loan A and Loan B. It's often thought of as Loan A being the good loan and Loan B being the bad loan.

And the questions that we received talked about whether or not the B Loan, i.e., the portion of the debt the borrower may not be able to service, has to be charged off. Or whether or not there's any type of extenuating circumstances where it would not have to be charged off and could be kept on the bank's balance sheet.

The whole premise behind this concept is that you're trying to reduce the on-book portion of the borrower's debt to a level that the borrower can repay according to reasonable modified terms. By doing that, in time after the borrower has demonstrated performance, that loan potentially can be upgraded to a pass credit. And thus it would lower your overall level of adverse classifications.

If you do not charge off the B Note, and you do not have to charge it off, but if you do not and it's still on the bank's books, then that debt needs to be aggregated with the balance owed on the A Note so that you have to determine the borrower's overall capacity to repay the entire amount of debt still on the bank's books.

So the answer is no, you don't have to charge off the B Note. But if you don't, we still have to look at the entire debt load of the borrower at the bank and their capacity to repay it. And in such situations where it hasn't been charged off and the borrower's overall capacity on a global cash flow basis indicates that they have difficulty or are not going to be able to service the entire debt, then the entire debt would be subject to adverse classification.

Bob Storch: That's right and with the decision not to charge off the B Note essentially you have two on-balance sheet notes with the same source of repayment so that's the reason I think that we tend to look at them together and aggregate them.

Related to this, there's a question that says, “Is there specific guidance anywhere on A/B Loan structuring?” There is one example I believe in the CRE guidance from October 2009.

The Call Report Glossary entry for nonaccrual loans on Page A-62 has an example of the A/B note structuring and the conditions that have to be met in order for the A Note to be returned to an accrual status, which is always another issue with these types of loans.

And then just to follow up, there is another question dealing with the A/B Note structure. This one says, "A loan was split into two notes as part of a TDR. Note A is performing as agreed based on current market terms. Note B with zero interest was charged off, but it wasn't forgiven. The collateral coverage is sufficient for both notes." That kind of leads me to question why the B Note was charged off.

But the portion of the loan principal at the time of the restructuring that's expected to be fully collectible along with contractual interest, that's supposed to be the A Note. So if you've dramatically charged down a portion of a loan that really is collectible, I think accountants would question that. But there may be a different safety and soundness perspective I suppose.

The question goes on and says, "Note A is performing as agreed under the modified terms with more than six months payment performance. Can Note A be returned to accrual?" That's the first part of the question and the short answer is just the six months payment performance alone will not be sufficient to return the loan to accrual status.

There really needs to be a current well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms so that we've got some evidence to support a conclusion that we're reasonably assured of repayment of the loan going forward, not just that there's been some performance for the past six months.

And then the follow-on question is, "Is the A Note still an impaired loan for accounting purposes?" And technically it still would be because the guidance for evaluating troubled debt restructurings for impairment is by reference back to the original note for which we charged off the B portion of what the principal balance was.

So there's an impaired loan, but assuming we meet the past performance -- historical performance -- and the performance prospects are favorable going forward, we have an accrual loan even though technically it's an impaired loan for accounting purposes.

Suzy Gardner: And just to follow up on that line of thought. In that particular instance, because you did the financial analysis in the beginning of the restructuring and you restructured the loan into the A and B note arrangement and the borrower has now performed for six months, in all probability the loan could be placed back onto accrual.

From a risk perspective, it's quite probable the loan would be upgraded from a substandard credit to a pass credit and then it would be treated as such going forward.

Bob Storch: Do we want to move away from the A/B Notes?

Suzy Gardner: Yes.

Bob Storch: Getting back to the subject of measuring impairment and collateral-dependent and so forth, many of these questions are touching on the same sort of issues we've already covered, but perhaps to answer it in a different way given the facts that are laid out here. This question says "When a loan is modified and deemed to be a TDR and is considered collateral-dependent, we have received mixed messages on how to measure impairment associated with the loan. Our CPAs state that the impairment should be measured by the fair value of collateral method since it is collateral-dependent. However, in discussions with examiners we've been told that impairment should be measured both by the fair value of collateral method as well as the present value of expected future cash flows method and then combine both impairment amounts."

I'm not quite sure what that means, maybe just compare both impairment amounts. The question then says, "Our goal is to comply with GAAP and regulatory guidance." If the loan is collateral-dependent, the statement in the question about the CPA stating that it should be measured based on the fair value of the collateral method, that is the appropriate approach in that set of circumstances.

And then there is a question dealing with the present value calculations that would apply even if you have an impaired CRE loan, but it's not collateral-dependent because there are some other sources of repayment rather than simply the sale or operation of the collateral. Then there's going to be a present value calculation.

The commenter observes that, "With all things remaining equal in the allowance analysis, the present value impairment amount will diminish over time and return to zero. So is it safe to assume a reversal of the entry is appropriate?" Well, an immediate reversal certainly wouldn't be appropriate; it's going to be an issue with respect to the passage of time.

If in fact the actual performance on the loan parallels the amount and timing of the expected future cash flows that were used for the present value calculation, over time the present value will increase and the shortfall that's the measure of the impairment would decrease. So the allowance would be decreasing on the loan over time assuming it's paying as had been anticipated when it was first restructured. And the numbers will converge down to zero when the loan fully repays assuming that's the outcome of this troubled debt restructuring.

And then there is a question about what sort of interest rates should be used on these present value calculations? It says, "If the contractual rate is variable, must the adjusted variable rate be used in calculating the present value impairment during the course of the troubled debt restructuring?"

GAAP accounting really gives an accounting policy choice for variable rate loans. It says that one choice is that every period, as the question asked, we're going to be using the adjusted variable rate, presumably the variable rate in effect at quarter-end. Or, the institution is allowed to freeze the variable rate for discounting purposes, obviously not for billing the borrower and so forth.

But the institution can freeze the rate at the variable rate that was in effect when the impairment was first identified. My understanding is in practice, that's the method that's used by most institutions because it simplifies the impairment measurement calculation. And then just one other question on this subject and we can go on to a different topic.

"If a loan matures and the rate is lowered and it is considered a troubled debt restructuring, what contractual rate is utilized to calculate the present value impairment since the loan that's matured no longer has a rate that's in effect?" Well, I guess that's true from a legal standpoint.

The accounting requirement would be to use the effective interest rate on the original loan that was the subject of the troubled debt restructuring even though it's matured, could not be repaid, and we've done a modification of terms that's a concession because of the financial difficulties of the borrower.

Suzy Gardner: I believe we're ready to start taking calls and questions from callers. Before we do, I wanted to address one more topic real quickly as we have received a lot of questions about evaluation issues pertaining to whether or not you have to have an appraisal when you are engaging in any type of workout or a restructuring.

The simple answer is no, you don't have to have an appraisal per se. You do need to have some sort of understanding about the value of the collateral so that you can make a better and more informed business decision as to what type of terms and restructuring you want to consider with a particular borrower.

Another instance is if you're doing subsequent transactions or restructurings and there's no new money being advanced. Again, you do not have to have an appraisal, but you would need an evaluation. Some of the things that you can consider if they are not already being addressed in your appraisal policy are situations where you might want to get an appraisal, but an appraisal isn't required.

Your appraisal policy also should provide a list of types of transactions or activities where you may want to get an evaluation or use other valuation information to basically monitor collateral values. One of the questions we did receive is whether or not you can use a broker price opinion or BPO or an automated valuation model or AVM for measuring impairment.

And again, it's going to come down to the quality of the information being used to assess the overall risk in the particular credit transaction. And so you may be able to use this type of information, but more often than not its primary purpose should be for monitoring trends in portfolios and things like that.

With that, would like to turn it over to any calls we may have on the line.

Coordinator: Yes ma'am, if you'd like to ask a question from the phones, please press star 1. You'll be prompted to unmute your phone and record your name as your name is required to introduce your question.

Our first question comes from (Dale Ginther), you're line is open.

(Dale Ginther): Thank you, thank you for some of the clarification provided today. My question relates to an A/B Note Structure. Suppose you have an accruing commercial real estate loan that has experienced some vacancy. The borrower comes to you and you intend to structure an A/B Note type of arrangement such that the A Note will be a pass credit and the B Note will be placed into nonaccrual status.

The loan was accruing up to the point that the borrower came to you. My question is, what kind of cash flow coverage are regulators looking for to be considered a pass credit? And my second related question is, I'm assuming that because the bank would identify this as a TDR that both the A Note and the B Note would be aggregated in determining and reporting TDR balances for Call Report and accounting purposes?

Suzy Gardner: That's a very interesting question. It's very difficult to try to structure an A and B Note arrangement where you have a pass credit and a substandard credit. And the reason why I say that is because your overall source of repayment and the collateral pledged for both of the loans are the same.

When you're looking at the same source for ultimate repayment and the same collateral, you can't say that Note A is going to be a pass just because it has a higher debt service coverage ratio and a better loan-to-value than this other note B that's also owed by the borrower and has the same source of repayment and the same collateral. It just really doesn't work that way. We're looking at the...

(Dale Ginther): Can I just interrupt for a second? The B Note has other collateral. That B Note is going to be collateral-dependent upon the sale of other properties. The borrower has pledged non-income producing properties. So the intent here is to try to structure the A Note so that it fits within an appropriate loan-to-value ratio and a cash flow coverage that works for the project based upon the tenants that are in place.

Suzy Gardner: I do appreciate the clarification. Would the source of repayment on the A Note be the primary source of repayment also for the B Note?

(Dale Ginther): No, the B Note is going to be dependent upon the sale of additional collateral pledged by the borrower unrelated to the project.

Bob Storch: So if I understand the situation, and it's getting pretty fact specific, it seems like in the restructuring, part of what was the old note now is going to be restructured into a separate note and new collateral is going to be provided but only on the B Note. And the previous collateral which was for the original loan balance, which now has been reduced by the amount of the B Note, is the sole collateral for the A Note.

I don't know if there's cross collateralization as well, as that could complicate matters. But is that how you're envisioning...?

(Dale Ginther): It's actually not new collateral being pledged, but because the B Note would be set aside, you know, let's say the borrower came in and gave you five different pieces of real estate that he currently has listed for sale that when those properties sell, he's going to deliver to you those proceeds. Completely different from the project real estate which has a cash flowing element and tenants in a building that are servicing the debt.

It just is not occupied to the point where it can service all of the debt. It can only service a component of the debt. So the intent is to have an appropriate cash flow coverage based on existing tenants, take the B Note, put it off to the side. Its repayment would be dependent upon the sale of this additional collateral pledged and deal with any shortages that might be there in the B Note separately.

Suzy Gardner: That's a very fact specific situation and it raises a lot of other questions that we would need to clarify before we feel like we can give you any type of an appropriate response. And so we would be more than happy to discuss this specific issue later if you'd like to contact me.

(Dale Ginther): Sure, can you answer the question on the A/B Note restructure in terms of the reporting? Our understanding would be that the A and the B Note balances would be aggregated for reporting purposes of a TDR, not just the B Note.

Suzy Gardner: Again, because you have introduced various facts, I would need to clarify them before I would be able to respond to you, such as initially I thought you were getting additional new real estate collateral, then you indicated you weren't. So if you wouldn't mind, I'd be happy to discuss this with you offline.

(Dale Ginther): Sure.

Bob Storch: And whether the B Note has been charged off. I mean, that's one of the critical criteria that's spelled out in our regulatory reporting Call Report Instructions. And that would have to be evaluated as well given the unique facts here I think.

(Dale Ginther): What's your number?

Suzy Gardner: My phone number is 202-898-3640.

(Dale Ginther): Thank you.

Suzy Gardner: Certainly, can we go to the next caller please?

Coordinator: Our next question comes from (Pam Molvar), your line is open.

(Pam Molvar): Hello, I have a TDR classification question and this does relate to single family loans. I was hoping to get a ruling on this. Our bank is contemplating a single family modification program to offer market interest rates to borrowers with high interest rates and LTVs that are current and have good FICOs.

And what we want to get a ruling on is would these be considered TDRs due to the fact that they have high LTVs?

Bob Storch: That's a very good question and I think you'd have to really do a full underwriting of those loans to see what sort of loan rate the borrower would qualify for. I know there's been questions like that raised with respect to some of the governmental restructuring programs and the like.

So I think that's another one where if we got all the facts of this particular arrangement you're thinking about offline, we'd be in a better position to answer rather than speculating right now and not necessarily understanding all the facts and circumstances.

Suzy Gardner: And this is a situation where the bank's internal pricing structure is critical. A bank can develop an internal pricing structure for the interest rates that would be charged for different types of loan situations based upon borrower's repayment capacity, based on loan-to-values or any other appropriate criteria.

Having that information can help you determine whether or not the rate and terms you're offering on a particular arrangement is at a market rate or terms given that particular borrower's financial situation.

(Pam Molvar): Okay but these borrowers aren't in financial difficulty. So that's where we're struggling is that we're just intending to offer this program to borrowers who are current and they have good FICOs. We just want to - we just would go through our portfolio and say okay these borrowers have, you know, interest rates over (unintelligible), but we absolutely know in the current market situation they would have trouble refinancing their loan based on their LTV.

But for retention purposes and just good portfolio management, we would like to offer them lower rates.

Bob Storch: If it could be clearly demonstrated that they're not experiencing financial difficulties, then you are outside the scope of accounting for modifications as troubled debt restructurings. I think that would be the short answer, but we need to really understand, you know, how you reach the conclusion from an accounting policy standpoint that the borrowers are not experiencing financial difficulties.

You laid out a number of factors that may lead to that conclusion, but I think we're probably best leaving it at that point here.

(Pam Molvar): Okay, thank you.

Coordinator: Our next question comes from (Dave), your line is open.

(Dave): We normally do gas station-C store loans at a 15 year amortization at origination. A customer at that time wanted to be aggressive, asked for a 10 year am which is what we did. A couple years into the note, they needed some payment relief and we rewrote it for 15 years which we typically would have done anyway. Is that TDR?

Suzy Gardner: No, it sounds like that was your original plan to use 15 years. You went to a more conservative approach on the amortization schedule. Now the borrower is going back to the original plan of a 15 year amortization. If you have a borrower who has the capacity to repay on reasonable terms, that's not a TDR.

Bob Storch: Yes, I think we'd have to establish that when you're underwriting the loan, in effect, at that two year point, that if they had walked in off the street so to speak with the same financial condition and asked for the 15 year loan, which is your customary terms, and they would qualify for it, I think that would enable you to conclude it isn't a troubled debt restructuring.

But without a full-blown underwriting, in the current environment when someone walks in and says I can't pay the loan terms I have, there's often a presumption that it is a modification that's a concession because of financial difficulties. So you almost have to prove that it's not in a current environment.

(Dave): Okay we have one more question as well.

Suzy Gardner: Go ahead.

(Dave): We have a loan we've identified that we want to do an A/B Note on and the note is currently 60 days past due for interest. And we determined that, you know, they would meet the criteria for a solid A Note should we give it a market rate of interest and a market rate of amortization. And it can handle that cash flow moving forward.

What if the bank could do to get them, you know, back to square one with respect to the past due interest in order for this ultimately - this A Note to become not a TDR note?

Suzy Gardner: It basically depends upon how you want to restructure the entire arrangement. It sounds like what you're contemplating is putting some sort of balance on this A Note that the borrower can cash flow at reasonable terms. And then everything else would be on the B Note.

So in this particular situation, it sounds like you may be contemplating capitalizing the past due accrued interest into the B Note which subsequently will be charged off.

Bob Storch: I would agree with that.

(Dave): And just one more quick one, is there anywhere that we can find out more information - you had touched on earlier the insignificant delays in payment or of payment. Where can we learn more about that?

Bob Storch: The best thing to do would be to look at the Accounting Standards Update itself, which is publicly available on the FASB Web site, www.fasb.org. It's Accounting Standards Update Number 2011-02. You know, you can get that freely available on their Web site outside of the Codification which is trickier to get into.

So you can download it or look at it and there's a section in there dealing with insignificant delays in payment. There are a few examples in the update trying to put some color on how you evaluate particular sets of facts and circumstances for insignificant delays in payment.

(Dave): Thank you.

Coordinator: Our next question comes from (Laura Medino), your line is open.

(Laura Medino): Hi, I have two questions in regards to taking off the Call Reporting of TDRs. The first one is, what is the best resource to use to determine whether or not an interest rate was a market interest rate or not at the time the loan was restructured.

For example, I've got a couple that we did earlier this year and I'm trying to determine what's the best resource to use to determine what the market interest rate would have been at that time. And my second question is, in determining if a borrower's in compliance with this TDR payment terms, does it matter if they were late with a payment, but they're current?

Bob Storch: Let me try to answer the second part first. The language about in compliance with the modified terms basically means that when you get to the first quarter Call Report of the year after which the modification that's a TDR took place, the loan is not 30 days or more past due and is not in nonaccrual status.

I mean, you may have an A Note for some reason or you may have a note that was in nonaccrual status when it went through the troubled debt restructuring and you haven't yet met the criteria for removing it from nonaccrual status. Maybe it's only been two months that they performed or something like that, so that you would still be in nonaccrual status at that point.

That's the general criteria for being in compliance with modified terms: the restructuring is not in nonaccrual status and it's not 30 days or more past due, which if it were would have the loan reported in Schedule RC-N rather than Schedule RC-C.

The first part on market rates of interest, I think the first thing you would want to look at is for loans of that type -- whether it's, you know, a construction loan or income-producing property CRE type loan -- what rate are you charging to new borrowers who'd be coming in for that type of lending at the time of the restructuring?

Presumably you're only granting those types of loans to well-qualified borrowers with a good collateral margin and all that sort of thing, all the good sound underwriting criteria.

Comparing the rate you're charging to the restructured borrower who is experiencing financial difficulties and may have collateral shortfalls or other types of well-defined weaknesses in the loan, presumably so you would be adequately compensated for that risk, you would need a rate given that risk profile that is higher than whatever you charge a new borrower. That would be one frame of reference.

There is some judgment involved obviously, but that may be a starting point for you.

(Laura Medino): Okay, so it sounds like it's more an internal thing and not like an external source of information?

Bob Storch: To the extent you can obtain information about what other banks would charge on similar types of loans, that would be another data point that you could consider. That may not be in the current environment as easy to find if they are not a lot of lenders granting that type of loan today. Of course, that could be an internal problem as well if you weren't granting that type of loan at the present time.

(Laura Medino): Okay, thank you.

Coordinator: Our next question comes from (John Lynch), your line is open.

(John Lynch): This question goes to essentially the two previous questions on interest rates on the current rates for new debt with similar risks. And I guess we have been struggling with a couple of things, one of the things is in a rate several years ago when we locked in interest rates, rates have come down since then in general.

And how do we talk to these borrowers at a rate that would be lower than what their contract rate was five years ago when rates were generally much higher? Not leaving it there, but driving it to some level, how can we if you will justify that in fact is a reasonable rate for a credit of that risk?

Suzy Gardner: I think this is a situation where having some sort of a pricing sheet or rate sheet would be very beneficial. And the reality is you're absolutely correct in that interest rates did decline significantly over a relatively short period of time. A lot of the loans that were originated back in the middle of the 2000s are coming up for maturity or renewal or the bank is reviewing them because they're starting to experience some cash flow difficulties with the higher interest rates.

And so if you had some sort of pricing sheet or a rate sheet that would reflect the type of rate that would be appropriate for the risk present in the loan and based upon the analysis of the borrower's financial condition such as their overall ability to repay, the debt service coverage ratio and/or the collateral analysis or a combination of the two, it would be very beneficial.

Because we do recognize that there are a lot of creditworthy borrowers who are unable to refinance because the value of their collateral has gone down. Even though if everything else had remained equal, they would have been able to refinance and take advantage of the lower interest rate.

So we want banks to consider making such arrangements, but you would need to document that the basis of the rate being provided to these particular borrowers is a market rate of interest. A pricing sheet helps to support your analysis in determining that the rate was appropriate and then being able to demonstrate that there are other loans with similar risk factors or characteristics that are receiving that same rate would be very helpful.

Bob Storch: I think I would add as well if you're working with a borrower, I think your primary objective should be trying to restructure the loan in a way that's going to maximize the potential for repayment of the loan and whether the rate that works given the cash flow characteristics of the borrower in fact is a market rate or less than a market rate probably ought to be your secondary concern.

I would think from a business standpoint, you want to get the loan restructured in a way that's going to optimize the ability of the borrower to repay and you to avoid losses and so forth. And if you get the additional benefit of that loan actually being at a market rate in an environment where rates generally declined and therefore it's not a concession, that's great.

But if it is in fact a concession to what the rate that you'd need to fully compensate for the risk and it's a troubled debt restructuring as a result, you know, there's accounting consequences there. But I think the long-term business judgment ought to prevail.

Suzy Gardner: Next question.

Coordinator: Next in queue is (Devin), your line is open.

(Devin): Yes, thank you. Do these same policies and guidelines apply to the banks that are working under the shared-loss agreements?

Hello?

Suzy Gardner: Yes, we're just taking a moment to think about that question. It's a very interesting question and I again would ask you to contact me offline so I can put you in contact with someone who's better prepared to respond to you about loss-share agreements.

Bob Storch: I mean, I believe under the shared-loss agreements, particularly on the single family, there are requirements to try to work with borrowers and modify terms and so forth. But the specifics of it under your particular loss-sharing agreement probably is best looked at on a one-on-one type basis.

(Devin): Let me just ask then. But the October 2009 commercial real estate policy guideline document, does that document apply to all banks, you know, whether they're a, you know, basically all banks?

Suzy Gardner: Yes it does. It's an interagency guidance document.

(Devin): All right so then if a bank was taken over by another bank, those same guidelines would be in effect?

Suzy Gardner: Yes sir.

(Devin): From a borrower's perspective (unintelligible) because I'm - particularly I just want to renew a loan that cash flows, that you know, never miss a payment, never late on a payment, have the ability to make my payments. But it appears as though that those guidelines are just ignored because there's not willingness it seems like for these banks to want to, you know, work with you with that shared-loss agreement in place.

Have you experienced any of that from anybody else?

Bob Storch: I thought there was the expectation that before a loan was submitted for a claim of a loss under the shared-loss agreement that there'd have to be some demonstration of working with the borrower and that sort of thing. But again, without knowing all the specifics of a loss-share agreement other than that generalization about its expectation about working with borrowers.

My understanding of it was that those agreements were not designed to provide an incentive for you to, you know, go to foreclosure and all those sorts of things, but there were provisions that were intended to encourage you to work with the borrower because obviously that's sort of a broader public policy objective that all the agencies have.

(Devin): Right okay, well that would be encouraging because that's not been my experience, but that's what I was hoping I would hear. You know, because I read that guideline and I'm very familiar with it, but it seems like in reality that may not be happening.

One last thing, you mentioned appraisals. When a bank gets your property appraised, whether it's under a shared-loss agreement or not, there seems to be some issue regarding the right of reviewing that appraisal. In my case, my particular property the bank appraised, it came in 50% lower than all the surrounding property, even lower than the county assessed value.

And I want to ask, you know, check the validity of the appraisal, but apparently I have not right. And I'm wondering if you guys have any guidelines or policies to whether or not, you know, when a bank uses an appraisal to either not renew a loan or call a loan due, would the borrower have any rights into, you know, checking the validity of that appraisal?

Suzy Gardner: Sir, I really do appreciate the point that you're making and I would like to discuss this with you offline if that would be all right with you.

(Devin): Oh absolutely.

Suzy Gardner: And I can also put you in contact with someone who can talk with you about loss-share agreements in more complete terms than I can at this particular point in time.

(Devin): Okay.

Suzy Gardner: So if I could ask you to maybe submit your question to me, I'll be happy to follow up with you.

(Devin): No problem, thank you.

Suzy Gardner: At this point, we'd like to go back to some of the email questions that we've received. We specifically want to address some questions regarding nonaccrual issues that are being raised. One of the questions that we received is, "If a loan is not performing, but in the process of being foreclosed, can a loan be kept on accrual if the bank is in the process of foreclosure and expects to be fully repaid including all accrued interest within 90 days?"

Well, it sounds like in this particular situation, you're meeting the Call Report criteria in that you're in the process of foreclosure and also anticipate being fully repaid, but it just begs the question what's the issue to begin with? Why is there a performance problem?

Bob?

Bob Storch: Well, when I saw that question, it says the loan is not performing which is presumably why foreclosure is taking place. The question I would have is, if it's not performing, it's in the process of foreclosure, why has the loan not already been placed on nonaccrual to begin with?

Because one of the criteria for nonaccrual status is the principal or interest has been in a period of default for 90 days or more, which I assume is the case in order to trigger a foreclosure action. There's an exception, unless the asset is both well-secured -- there's the suggestion here in the facts that that's the case -- and in the process of collection.

The process of collection means cash. Taking real estate is not process of collection. You're still going to have to convert that to cash. So the fact that you're going to have to go to foreclosure and all the vagaries in that process and ultimately selling would mean that that loan should not be on accrual status.

It should be in nonaccrual status. It may and arguably perhaps already should have been placed in nonaccrual status before the foreclosure action was initiated.

Suzy Gardner: Another question we received is, "If a loan is classified as a TDR, does it need to be placed on nonaccrual? What if it was never previously delinquent? Is there an exception for mortgage loans?"

Bob?

Bob Storch: Most troubled debt restructurings, if they're the larger commercial-type loans and if the bank has an effective loan review process, presumably would have already been identified as impaired loans even before the borrower came in and asked for a concession and so forth, which would have created a TDR.

So if the loan had already been identified as being an impaired loan, it probably would have been in nonaccrual status. And then we get to the question of once you've gone through a TDR, what are the conditions for returning a nonaccrual TDR back to accrual status, which the Call Report Glossary entry for nonaccrual status addresses.

On the comment about an exception for mortgage loans, I'm assuming they are probably implying single family residential mortgage loans. The Call Report Instructions don't require single family residential mortgages to be placed on nonaccrual status when they're in default for 90 days or more.

It's permitted, but it's not required. When the bank's policy is not to put them in nonaccrual, the bank has to take other appropriate accounting actions to ensure income is not overstated. So there can be some TDRs that are not in nonaccrual status.

Another situation in particular on the residential mortgages are the loans that were like the 2/28s and 3/27s where there was the payment shock issue and the borrower could perform under the original terms, but the significant increase in payment was what the borrower didn't have the resources to be able to accommodate.

If the troubled debt restructuring is designed in such a way that the amount of the payments going forward are equivalent to or less than what the payments the borrower has a demonstrated history of performance were before the modification and financial information indicates the borrower would be able to continue to perform at that original payment level, then there would be no basis for placing that residential mortgage on nonaccrual simply because of the restructuring.

Suzy Gardner: With that, we will turn it back over to Mindy.

Mindy West: Well thank you very much Suzy and Bob. And thank you all for your excellent questions. If you have additional questions or issues you'd like to discuss further, you can contact your primary regulator's designated point of contact.

We will be posting an audio recording or a transcript of today's seminar on the FDIC's Web site. You can check www.fdic.gov sometime after December 20 for this information.

So I'd like to thank everyone for calling in and goodbye for now.

Coordinator: This concludes today's conference. You may disconnect at this time.

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