RESCINDED

Office of Thrift Supervision **January 7, 2002**

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Regulatory Bulletin

RB 32-22

Handbook: **Thrift Activities**
Subject: **Various Sections**

Sections: 070; 240, 320

Thrift Activities Regulatory Handbook Update

Summary: This bulletin provides updates to the following Thrift Activities Regulatory Handbook Sections: 070, Overall Conclusions; 240, Troubled Debt Restructurings; and 320, Meetings with the Board of Directors. Please replace the existing handbook sections with the enclosed revised sections.

For Further Information Contact: Your Office of Thrift Supervision (OTS) Regional Office or the Supervision Policy Division of the OTS, Washington, DC. You may access this bulletin at our web site: www.ots.treas.gov. If you wish to purchase a handbook and a subscription to the updates, please contact the OTS Order Department at (301) 645-6264.

Regulatory Bulletin 32-22

SUMMARY OF CHANGES

OTS is issuing plain language updates to the following Thrift Activities Handbook Sections. Change bars in the margins of the handbook sections indicate revisions. We provide a summary of substantive changes below.

070 Overall Conclusions

Places more emphasis on the effectiveness of management practices.

Introduction: Clarifies guidance provided by this handbook section.

Report Comments: New subheading. Moves emphasis from comprehensive reporting to concise reporting.

Report of Examination: Omits the specific report types and refers the examiner to the ROE Instructions and the Thrift Activities Handbook to prepare safety and soundness examination reports.

Examination Conclusions and Comments: New subheading.

Plain Language: New section that presents examples of plain language principles.

Meeting with Institution Representatives: Adds emphasis on maintaining an open line of communication with the board of directors.

Disclosing Ratings: New subheading.

Supervisory Letter: Moves text to the end of the section.

Program: Revises the first Examination Objective to include risks and management practices. Revises the final Examination Objective and Procedure No. 6 to ensure the ROE is written in plain language. Adds new bullet to No. 9 and revises Nos. 3 and 13.

240 Troubled Debt Restructuring

Introduction: Clarifies accounting guidance. Revises description of the section to correlate to the narrative.

Returning Nonaccrual Loans to Accrual Status: Adds introductory paragraphs**.**

320 Meetings with the Board of Directors

Regular Meetings: Adds a new paragraph regarding examiners attending a meeting with the board that occurs during an examination. The purpose is to observe them in action and establish rapport.

Sample Agenda Outline: Adds disclosure of ratings to ROE results.

—Scott M. Albinson
Managing Director, Supervision

INTRODUCTION

This Section provides guidance on summarizing and effectively communicating conclusions to institution management and the board of directors. You develop conclusions from analyzing an institution's overall condition and viability through on-site examinations and other on-site and off-site regulatory reviews.

This section, written primarily from an examination perspective, refers to responsibilities of the examiner in charge (EIC). However, traditional titles, roles, and responsibilities vary among regional offices. Review your region's office structure and policy to determine where responsibility rests. Sometimes staff shares responsibility. For purposes of this section, we refer to "you" as the EIC and assistant examiners.

A primary goal of the regulatory process is to ensure savings associations operate in a safe and sound manner. For examinations and supervisory analyses to be most effective, you should identify the cause of any significant negative trends or problems and recommend a solution. A comprehensive yet concise analysis and summary of the institution's condition produce a more effective examination and allow directors and regulators to act promptly.

Your performance in this area is critical. You must be able to formulate conclusions and prioritize findings. Your ability to communicate findings to directors, management, and Office of Thrift Supervision (OTS) personnel significantly affects the regulatory process. Your findings help determine future strategies in the institution's regulatory profile and help directors correct weaknesses and capitalize on strengths.

This Section provides guidance in the following areas:

- Writing report comments.
- Developing conclusions and preparing comments.
- Formulating conclusions regarding the present condition and future prospects for the institution and for determining the institution's composite rating.
- Assigning CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings and an overall composite rating.
- Preparing a well developed, concisely written report of examination in plain language.
- Meetings with and presentations to institution representatives.
- Documenting off-site composite rating changes.

Report Comments

Examination reports should present a concise and balanced portrayal of an institution's condition and future prospects. Generally, report comments should include a synopsis of the work performed (scope) and your findings based on that scope. Your report conclusions should give the reader a clear understanding of the area reviewed.

A report of examination is factual and does not exclusively present negative or positive findings. It informs its readers, be they regulators, managers, or directors, of an institution's present condition and recommends a course of action to maintain or regain safe and sound operations.

You should identify strengths and weaknesses when necessary to provide a clear picture of the institution's prospects, or lack thereof, for future viability. Persons responsible for regulating institutions will need to have a balanced picture of its strengths and weaknesses.

Developing Conclusions and Comments

There are unique factors to consider when developing conclusions, comments, and ratings for each CAMELS component. Each comment should be complete and concise. Discuss each component's material strengths and weaknesses by identifying patterns and trends. Support your conclusions with appropriate analysis, including underlying deficiencies. State management's proposed corrective actions.

The following checklist will assist in developing report comments.

- Present the scope of the review.
- Clearly state your conclusions about risk, condition, and the effectiveness of management practices.
- Clearly identify patterns and trends, and their causes.
- Present comments in a meaningful order, discussing major strengths and weaknesses, with proper emphasis and tone accorded to individual topics.
- Identify problems relating to safety and soundness and substantive compliance issues.
- Include the deficient underlying practices when you note patterns of regulatory noncompliance.
- Support conclusions with appropriate analysis and prepare an effective summary that does not lose the reader in detail.
- Assess the effect of examination findings on future operations.
- Include a discussion of corrective action where necessary.
- Support the comments with work papers and other retained documents.
- Disclose the component rating.

Formulating Overall Conclusions

The development of substantive overall conclusions involves:

- Reviewing major findings from the examination (including trends).
- Considering the institution's operating environment (both internal and external factors).
- Converting ultimate determinations into ratings.
- Communicating results effectively.
- Facilitating the corrective action process.

There are both objective and subjective factors involved in a comprehensive analysis of the institution's present and expected future condition. You must weigh the significance of criticisms, deficiencies, and exceptions to offset strengths. This requires reviewing CAMELS comments and other findings for interrelationships. Whenever a practice or other factor materially affects safety and soundness, you must look at both the present and potential future effects.

Consider the following when evaluating the institution's present condition:

- Examiners' findings, including CAMELS comments and ratings, trends, patterns, exceptions, and other observations.
- Patterns of regulatory noncompliance, deficient procedures, and other factors causing noncompliance.
- Interrelationships between findings noted for each CAMELS component.
- Effectiveness of the corrective actions initiated to resolve earlier deficiencies.

Evaluate an institution's future condition by making an assessment of the following areas:

- Adequacy of policies and procedures, personnel, information systems, books and records, accounting and other internal controls, audit function, and asset review function.
- Overall compliance with laws, regulations, and policies.
- The board of directors' and management's ability to take prompt corrective actions.
- Strategic planning and the written business plan, including changes expected in asset and

liability composition, organizational structure, growth, etc.

- Management's ability to perform according to the business plan.
- Competitive, economic, and regulatory conditions. Include: management's ability to assess market conditions, trends, composition, and expected changes in economic conditions, competitive factors, and the regulatory environment.

One goal of the regulatory process is to prevent problems from developing or escalating in the future. Therefore, early identification of risk or weaknesses in management practices is key. Support any projections with adequate facts and analyses.

When developing a conclusion about the institution's future prospects, consider existing systems, policies, and procedures; the business plan; corrective action; projections for operating performance; management ability; market and economic factors.

Assigning Component and Composite Ratings

OTS uses a standardized system for rating savings associations it supervises. OTS rates thrifts according to the individual CAMELS components of Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Based on a quantitative and qualitative review of these components, OTS assigns an overall composite rating.

After formulating the conclusions, you can begin the rating process. Since it is difficult to provide a specific formula for this process, experience and judgment are critical. It is inappropriate to simply average the individual CAMELS ratings or use standard formulas. A high degree of correlation should exist between the composite rating and the component ratings. The composite rating should support objective information in the Examination Conclusions and Comments page, the CAMELS comments, and the work papers.

You should refer to Thrift Activities Regulatory Handbook Section 071, CAMELS Ratings, for a discussion of the composite and component rating criteria and disclosure to thrift directors.

OTS personnel use the ratings for a variety of purposes:

- To reflect trends for a particular institution.
- To make comparisons with peers.
- To assess the condition of the industry.

The CAMELS ratings help determine appropriate strategies including the following:

- Frequency and scope of off-site and on-site analysis.
- Enforcement actions.
- Meetings with institution representatives.
- Analyzing applications (i.e., mergers and acquisitions and subordinated debt issuance).

Because ratings determine a variety of critical decisions, a systematic and logical analysis is essential. While objective analysis and findings primarily determine ratings, there is some reliance on subjective factors, too.

REPORTING RESULTS

Regional offices use the following three vehicles to communicate findings to institution directors:

- The Report of Examination.
- Meetings with institution representatives.
- The supervisory letter (for off-site changes in the composite rating).

Report of Examination (ROE)

Refer to the Report of Examination (ROE) Instructions and the Thrift Activities Regulatory Handbook to prepare safety and soundness examination reports.

Examination Conclusions and Comments

The Examination Conclusions and Comments page of the ROE should be the focal point for reporting conclusions from any examination or review. To facilitate timely corrective action, direct report comments to the institution's board of directors even though the document remains OTS property. Complete the Examination Conclusions and Comments page according to the ROE instructions.

Consider the following primary factors when developing this page:

- Report items that are material and that relate to safety and soundness.
- Present information that provides the reader with a clear understanding of the overall condition, adequacy of management practices, causes of major problems, and recommendations for remedial action.
- For regulatory violations, include only material patterns of noncompliance, along with the identified root(s) of the problems(s). A simple listing of violations is usually ineffective as a regulatory measure, particularly in the case of an isolated incident or error. While it is appropriate, in certain situations, to include isolated violations in the report, you should not bring them forward to the Examination Conclusions and Comments page unless they are significant.
- State conclusions and comments briefly. Do not repeat analysis or support provided elsewhere in the report.
- Demonstrate how items interrelate. Do not simply list them.
- Document all conclusions in report comments, work papers, or other records.

Present conclusions in an order that first describes matters requiring immediate follow-up supervisory action. The severity of a problem will dictate its order of presentation. Concisely state how the problem affects the institution's other activities and any mitigating circumstances.

Address the following items on the Examination Conclusions and Comments page:

- The type of examination and whether there was a holding company examination. If applicable, state that there is a separate holding company report.
- The asset size of the institution, principal lines of business, and the date of the financial statements in the ROE.
- A statement of the scope of the examination or supervisory review.
- A concise statement of your conclusions about the overall condition of the institution.
- A brief discussion of the CAMELS components (if applicable) and positive and negative attributes of other significant items reviewed. Focus on patterns, trends, causes of problems, and projections for future operations.
- Identification of "troubled" condition, if applicable.
- Disclose the composite CAMELS rating if assigned, refer to the definition of the assigned rating, and explain the correlation between the institution's circumstances and the rating.
- A statement regarding the extent of compliance with any outstanding enforcement actions or mandatory PCA restrictions, if any.
- A reference to necessary corrective action(s) as described on the Matters Requiring Board Attention page.

If necessary, you may use the ROE cover page letter to expand on examination findings. Do not merely restate examination findings in the ROE cover page letter.

Plain Language

You should write the ROE in plain language using the following principles:

- Simple everyday words except for necessary technical terms.
- Short sentences that are direct and to the point, with phrases in the active voice.

- Identifying the "doer." For example, in this Handbook we use "you" to identify the examiner.
- Parallel ideas expressed in parallel constructions.
- Indented lists like this one, preceded by bullets or numbers.
- Descriptive headings that provide focus to subjects and break up long pages of text into manageable segments.

You may also refer to the OTS Style Guide available on the OTS Intranet under Tools.

Meetings with Institution Representatives

Meeting with institution representatives regularly during the examination will allow you to do the following:

- Introduce examiners to institution staff responsible for providing additional information.
- Discuss the scope of the examination at the start of the examination.
- Discuss preliminary findings and whether there is a need to expand the scope.
- Discuss results of the institution's internal asset reviews, its asset classifications, and any differences between the regulator's asset classifications and those of the institution.

After the on-site examination, meet with the institution's senior management for a post examination discussion concerning your conclusions and recommendations. Normally you would meet after preparing the preliminary draft examination report. The EIC and CEO determine the appropriate date and time. The EIC is responsible for notifying any other regulatory personal who should attend. You should prepare an agenda for the attendees, and any exhibits that will strengthen or clarify the presentation.

The purpose of the meeting is to discuss examination findings, elicit management's response to corrective action, verify conclusions, and answer management's questions. This meeting gives you an opportunity to discuss strengths and weaknesses noted and recommend corrective action if necessary.

Regulatory personnel should meet with the institution's board of directors when deficiencies are serious. When discussing the need for corrective action, be specific and agree on a time frame. Refer to Thrift Activities Regulatory Handbook Section 320, Meetings with the Board of Directors, for additional guidance. Although it is not necessary to meet with the board of directors after each examination at institutions with no serious deficiencies noted, we encourage regulatory personnel to meet periodically with the board after selected examinations to maintain an open line of communication.

Disclosing Ratings

You will disclose component ratings and composite CAMELS ratings at exit conferences with senior management and, when appropriate, the board of directors. Obtain sufficient concurrence from regional management, so that the ratings you disclose are final, or subject to revisions only in rare instances. If the ratings are subject to further review, let thrift management know that the ratings are not final.

We expect you to discuss the elements considered in assigning each component rating and those considered in assigning the overall rating. You should indicate that a careful evaluation of the institution's managerial, operational and financial performance and their compliance with laws and regulations determines the composite rating.

Supervisory Letter

When the regional office changes the composite ratings off-site, send a supervisory letter to the board of directors to notify them of the change. A change in the composite rating may result from changes in the institution's operating strategies or conditions. An on-site review may be appropriate when conditions warrant a downgrade in rating. When the composite rating changes, we advise evaluating the need to change all six CAMELS component ratings. Include in the supervisory letter a prohibition against outside disclosure and explain why the rating changed.

REFERENCE

Office of Thrift Supervision

OTS Thrift Safety and Soundness Report of Examination Instructions

Overall Conclusions

Program

Examination Objectives

To formulate conclusions regarding the risks, condition, trends, management practices, and future prospects of the thrift.

To formulate conclusions on the safety and soundness of the thrift and propose supervisory action, if needed.

To record management's response to examination findings, conclusions, and proposed corrective action.

To effectively communicate conclusions and recommendations, both orally and in writing, in the Report of Examination according to common core ROE instructions and plain language principles.

Examination Procedures

Wkp. Ref.

Level I

1. Review analyses, comments, exceptions, and conclusions from the work papers, and perform the following:
   - Resolve any contradictory conclusions. Support all conclusions with facts obtained during the examination.
   - Determine the significance of findings relating to safety and soundness and overall regulatory compliance.
   - Discuss findings with appropriate institution personnel and verify conclusions as appropriate.

2. Review the draft CAMELS comments. Talk with assisting examiners about their overall CAMELS observations and findings applicable to the comments, and determine whether conclusions are reasonable.

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3. Revise CAMELS comments so that they fairly represent examination results according to ROE instructions. Ensure conclusions are well supported in work papers and comments include any significant items noted in work papers. The tone and content of each comment should be concise and appropriate, as outlined in the Handbook.

4. Review the preliminary CAMELS component ratings and meet with assisting examiners. You should consistently apply the standard criteria set by OTS for determining ratings. Follow definitions and instructions pertinent to the rating system to ensure national consistency.

5. If necessary adjust the CAMELS component ratings using the instructions in Thrift Activities Regulatory Handbook Section 071, CAMELS Ratings. Review CAMELS comments again to ensure that they are consistent with component ratings assigned.

6. Develop overall conclusions and prepare the Examination Conclusions and Comments page. Ensure the report is written in plain language.

7. Determine the composite rating by weighing the importance of various criteria used to develop conclusions. To ensure national consistency, you should follow the rating instructions in Thrift Activities Regulatory Handbook Section 071.

8. Review the Examination Conclusions and Comments page again to ensure the tone and content supports the assigned composite rating.

9. Discuss findings with management, typically the CEO. We recommend that you use an agenda. Discuss at least the following topics:

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- The purpose of the meeting.
- All items that you might include in the examination report.
- Overall conclusions regarding the institution.
- Management's corrective action responses.
- Composite and component ratings.

10. After the meeting, correct any items in the ROE that are inaccurate, misleading, or misinterpreted.

11. The Matters Requiring Board Attention page should include corrective actions, if appropriate. These include specific recommendations to correct deficiencies listed in the report, or recommendations for: supervisory agreements, consent agreements, cease-and-desist orders, receiverships, conservatorships, civil money penalties, and criminal referrals to appropriate agencies. For suspected violations of criminal statutes, the EIC should refer to Thrift Activities Regulatory Handbook Section 360, Fraud/Insider Abuse.

12. Provide any information to the regional office that will be useful for revising the regulatory profile.

13. Prepare the ROE cover page letter, if necessary, in accordance with regional office policy.

14. Prepare to meet with the board of directors regarding findings. Refer to Thrift Activities Regulatory Handbook Section 320, Meetings with the Board of Directors, for instructions.

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Reviewed By: ____________
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15. Ensure that your review meets the *Objectives* of this Handbook Section.

Exam Date:
Prepared By:
Reviewed By:
Docket #:

INTRODUCTION

A savings association must sometimes renegotiate loan terms to assist borrowers who are unable to meet the original terms of their loans, and maximize recovery of loans to these borrowers. Such renegotiation may result in the savings association making modifications that result in loan terms it normally would not accept. These may include:

- A lower interest rate or even no interest.
- A reduction in principal.
- A lengthier term to maturity.
- A transfer of assets from the borrower.
- The substitution or addition of a new borrower.
- Some combination of these modifications.

This renegotiation, where the savings association grants concessions to the debtor/borrower, results in a troubled debt restructuring or TDR.

Troubled debt restructurings are compromises of indebtedness designed to improve collection or reduce losses on problem loans. Savings association policy and practice should require strict controls such as dual authorization requirements and monitoring by a senior committee to prevent unneeded compromises from occurring.

Generally accepted accounting principles (GAAP) for TDRs are set forth in the following Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS):

- No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, as amended by SFAS Nos. 114 and 121 (SFAS No. 15).
- No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS No. 118 (SFAS No. 114).

Troubled debts also require an evaluation of the probable loss from collection, as defined by SFAS No. 5, Accounting for Contingencies, as amended by SFAS No. 114 (SFAS No. 5).

This Section of the Handbook describes the following areas:

- Troubled debt restructurings.
- Accounting for TDRs, specifically SFAS No. 114 and Handbook Section 260, Classification of Assets.
- Loans to one borrower.
- Classification.

TROUBLED DEBT RESTRUCTURINGS

According to SFAS No. 15, a TDR occurs when a savings association grants a concession it would not otherwise consider because of economic or legal reasons pertaining to the debtor's financial difficulties. A TDR may include, but is not limited to, the following transactions or any combination of the following transactions:

- The transfer of assets from the debtor to the creditor to satisfy all or part of the indebtedness when the fair value of the assets received is less than the recorded investment in the receivable. The assets transferred may be receivables from third parties, real estate, or other assets.
- Issuance of an equity interest by the debtor to the creditor to satisfy all or part of a debt. The debtor must not grant the interest pursuant to existing terms for converting debt to equity.
- Modification of the terms of debt such as the following:
  - — A reduction of the interest rate for the remaining term.
  - — An extension of the maturity date with a stated interest rate lower than the current market rate for new debt with similar risk.

— Reduction in the outstanding principal amount due, or a reduction in the accrued interest due.

- Substitution or addition of debtor(s) when the substitute or additional debtor(s) control, are controlled by, or are under common control with the original debtor. When substitute or additional debtor(s) has no relationship with the original debtor after the restructuring, the association should account for the restructuring as a new loan in partial satisfaction of the original borrower's loan. In this situation, recognize any losses resulting from the new financing using the fair value of the new loan.

Not all concessions granted by the creditor constitute a TDR. For example, the following situations do not constitute a TDR:

- The assets received by the creditor for full satisfaction of the debt have a fair value equal to or greater than the recorded investment in the receivable.
- The creditor reduces the interest rate on the debt to reflect a decrease in the market interest rate.

Periods of declining interest rates may make refinancing of loans appealing to borrowers whose current contractual interest rates are higher than market interest rates. However, the value of the pledged collateral may decline. OTS encourages savings associations to work constructively with creditworthy borrowers, including instances where the refinancing of real estate-related loans involves an adjustment of the existing loan rates to current market rates. OTS will not criticize a savings association solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral declined in value. OTS will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

ACCOUNTING

SFAS Nos. 5, 15, and 114 prescribe GAAP for TDRs. SFAS No. 114 significantly changed GAAP for loss recognition in a TDR involving modification of terms.

SFAS No. 114 defines as impaired a loan subject to a TDR. Impairment of a loan exists when current information and events indicate that the savings association will be unable to collect "all amounts due" according to the contractual terms of the original loan agreement. All amounts due according to the contractual terms means the savings association will collect both the contractual interest payments and the contractual principal payments of the loan as scheduled in the loan agreement. A loan is not impaired during a delay in payment of the loan, if the creditor expects to collect all amounts, including interest at the contractual rate for the period of delay. Base support for collection of all amounts due upon the cash flow from the project and/or borrower, not the fair value estimate of the collateral.

SFAS No. 114 requires measurement of impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, it allows measurement of impairment based on the loan's observable market price, or the fair value of the collateral if the loan is collateral-dependent. A collateral-dependent loan is a loan where expected repayment depends solely on the underlying collateral. An impairment occurs when the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan. The recorded investment in the loan includes accrued interest, net deferred loan fees or costs, and unamortized premium or discount.

SFAS No. 114 and Thrift Activities Handbook Section 260, Classification of Assets, require that savings associations measure impairment based on the fair value of the collateral less costs to sell when foreclosure is probable. In addition, Section 260 requires savings associations to value and classify troubled, collateral-dependent loans on the collateral's fair value. Under Section 260, associations should not use the present value of the expected future cash flows or the loan's observable market price to value troubled, collateral-dependent loans. Thus, OTS has restricted savings associations to a single option, the fair value of the collateral (less costs to sell), for troubled, collateral-dependent loans. (See Thrift Activities

Handbook Section 260 for OTS policy regarding Valuation and Classification of Troubled, Collateral-Dependent Loans.)

The effective interest rate for a loan is the rate of return implicit in the loan. A savings association should consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs would likely reduce cash flows available to repay or otherwise satisfy the loan.

The cost to sell an asset generally includes the estimated incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs. Generally, costs to sell exclude insurance, security services, and utility costs.

An association recognizes an impairment by doing one of the following:

- Creating a valuation allowance with a corresponding charge to provision for loan losses.
- Adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to provision for loan losses.

Savings associations recognize losses for TDRs involving a modification of terms in accordance with the provisions of SFAS No. 114. Therefore, the association should base the effective interest rate for such loans on the original contractual rate, not the rate specified in the restructuring agreement.

Effective Date and Transition

SFAS No. 114 became effective for fiscal years beginning after December 15, 1994. For TDRs restructured before the effective date of SFAS No. 114, savings associations may continue to account for and disclose them in accordance with SFAS No. 15, as long as the restructured loan remains unimpaired based on the terms specified in the pre-SFAS No. 114 restructuring agreement. If such a TDR fails to perform as agreed, or if the savings association again restructures the loan, the effective interest rate reverts back to the contractual interest rate of the original loan.

The OTS policy regarding troubled, collateral-dependent loans (including collateral-dependent TDRs) is similar in many respects to certain provisions of SFAS No. 114. Thrift Activities Handbook Section 260 and SFAS No. 114 may require recognition and measurement of impairment independent of any TDR.

Timing

A TDR may occur before, at, or after the stated maturity of the debt. Time may elapse between the restructuring agreement and the effective date of the new terms of the restructuring. For GAAP purposes, the date of consummation of the restructuring agreement is the recognition date for the restructuring, not necessarily the completion date of the restructuring paperwork.

OTS acknowledges a TDR’s existence when there is an agreement between the savings association and the borrower consummating the restructuring. A TDR is presumed to exist if senior management of the savings association and the borrower reach an oral agreement and memorialize the agreement in written documentation, such as a memorandum to the files, setting forth the terms of the TDR.

An oral agreement may reflect the restructuring of a loan, but is not a long-term substitute for a written agreement. The association should document in writing the consummation of a TDR within a reasonable time frame. Normally, complete restructuring occurs within six months. A claim becomes dubious when negotiations continue for a long period without producing a final written agreement for a loan restructuring. The issue of timing is important when applying GAAP because it determines when and if a savings association should account for a problem loan as a TDR under SFAS No. 15.

Receipt of Assets

The association should record assets transferred in partial or total repayment of indebtedness, including an equity interest in the debtor, at their fair value less cost to sell. Fair value is the amount the debtor could reasonably expect to receive from a current sale between a willing buyer and a willing seller; that is, other than a forced or liquidation sale.

Savings associations should measure the fair value of an asset by the market value if an active market exists. If no market exists for the assets transferred, the association should use a forecast of expected cash flows from the asset, discounted at a rate commensurate with the risk involved to arrive at the fair value.

Repossession in Substance

A creditor cannot avoid accounting for an asset at its fair value by simply avoiding a formal foreclosure. In accordance with SFAS No. 114, a savings association treats an impaired collateral-dependent real estate loan as a repossession in substance (reported as REO) once it takes possession of the collateral. This treatment stands even if the lender has not obtained legal title. Examples of taking possession include managing the collateral, proceeding with the foreclosure process, and marketing the project for sale. Savings associations base loss recognition for other troubled collateral-dependent loans on the fair value of the collateral less costs to sell if they do not anticipate full payment of the amounts due. Such loans remain in the loan category.

If a repossession in substance occurs, you should consider whether an independent appraisal is necessary. Regulation 12 CFR § 563.170 empowers OTS officials to obtain independent appraisals.

Disclosure

A savings association must disclose a loan modified and accounted for as a TDR in its audited financial statements and on reports to OTS. Audited financial reports should disclose the following information pertaining to all impaired loans including TDRs, as required in SFAS Nos. 15 and 114, if material:

- The total recorded investment in the impaired loans at the end of each period, and (1) the amount of that recorded investment for which there is a related allowance for credit losses, and (2) the amount of that recorded investment where there is no allowance.
- The creditor's interest income recognition policy including the method of recording cash receipts.
- The activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

There is an exception to these disclosure requirements. There is no need to include a TDR involving a modification of terms in the disclosures in the years after the restructuring if both of the following conditions exist:

- The restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of restructuring for a new loan with comparable risk.
- The loan is not impaired based on the terms specified by the restructuring agreement.

Returning Nonaccrual Loans to Accrual Status

A 1993 interagency policy statement outlines a program of interagency initiatives to reduce impediments to the availability of credit to businesses and individuals.

TDR Multiple Note Structure

The agencies conformed their reporting requirements for TDR structures involving multiple notes.

A typical example of a TDR multiple note structure is where the savings association restructures the original troubled debt with the borrower and splits the debt into two notes. The first note, or the "A" note, represents the portion of the original loan principal amount that the savings association expects to collect in full, along with contractual interest. The second note, or the "B" note, represents the portion of the original loan that the savings association charges off.

Under interagency guidance, a lender may return the “A” note to accrual status conditioned on satisfaction of the following:

- The restructuring qualifies as a TDR, as defined by SFAS No. 15, and there is economic substance to the restructuring.
- The association must charge-off the portion of the original loan represented by the “B” note before or at the time of the restructuring. The association must support the charge-off by a current, well-documented credit evaluation of the borrower’s financial condition and prospects for repayment under the modified terms.
- There is reasonable assurance of repayment and of performance in accordance with the modified terms of the “A” note.
- There is a sustained period of repayment performance (generally a minimum of six months), either immediately before or after restructuring, in accordance with the modified terms, involving payments of cash or cash equivalents.

The savings association would initially disclose the “A” note as a TDR. The savings association could eliminate such disclosure in the year following the restructuring, provided the “A” note meets the following additional conditions:

- The “A” note yields a market rate of interest. To be considered a market rate of interest, the interest rate on the “A” note at the time of the restructuring must be equal to or greater than the rate the savings association is willing to accept for a new receivable with comparable risk.
- The “A” note performs in accordance with the modified terms.

Past Due Loans

Under interagency guidance, past due loans may be returned to accrual status, even though the loans are not fully current, and any previous charge-offs not fully recovered, provided the past due loans meet the following conditions:

- There is reasonable assurance of repayment within a reasonable period, of all principal and interest amounts contractually due (including amounts past due).
- There is a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms, involving payments of cash or cash equivalents.

However, savings associations would continue to disclose past due loans that meet the above conditions, until they are fully current.

LOANS TO ONE BORROWER

The restructuring of a troubled loan constitutes a renewal, but is not a new loan for purposes of the loans-to-one-borrower (LTOB) rule, 12 CFR § 560.93, provided that the savings association advances no additional funds to the borrower. In the case of a non-conforming loan, the savings association should take reasonable efforts, consistent with safety and soundness, to make the loan conforming. In addition, the savings association should document its efforts to bring the loan into conformance. If the efforts are unsuccessful, the savings association may renew, restructure, or modify the nonconforming loan with the following provisions:

- The transaction is not done with the purpose of evading the lending limits.
- There can be no substitution of borrowers.
- The association cannot advance additional funds.

CLASSIFICATION

As with all assets of savings associations, TDRs are subject to the classification requirements of 12 CFR § 560.160, Asset Classification. Restructured loans will not automatically result in adverse classification. Conversely, a loan accounted for as a TDR is not exempt from the classification process. When evaluating TDRs for possible classification, you should use the same criteria as for all other loans. TDRs are probable candidates for adverse classification. As a practical matter, TDRs have demonstrated weakness and often require some loss recognition.

OTS will not criticize a savings association solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral has declined in value. You will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 560.93	Lending Limitations
§ 560.160	Asset Classification
§ 560.172	Re-evaluation of Real Estate Owned
§ 563.170	Examinations and Audits; Appraisals, Establishment and Maintenance of Records
Part 564	Appraisals

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies (as amended by No. 114)
No. 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings (as amended by Nos. 114 and 121)
No. 114	Accounting by Creditors for Impairment of a Loan (as amended and superseded in part by No. 118; also amends Nos. 5 and 15, in part)
No. 118	Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures (amends and supersedes, in part, No. 114)
No. 121	Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of (amends No. 15)
EITF 96-22	Applicability of Disclosures Required By FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring Into Two (or More) Loans

American Institute of Certified Public Accountants (AICPA)

AICPA Audit and Accounting Guide for Banks and Savings Institutions (April 1, 1996).

Statement of Position (SOP) 92-3, Accounting for Foreclosed Assets (SFAS No. 121 supersedes significant portions of this SOP).

Other References

Revised Interagency Guidance on Returning Nonaccrual Loans to Accrual Status (June 10, 1993)

Troubled Debt Restructurings
Program

Examination Objectives

To assess the savings association's policies, procedures, and controls on troubled debt restructurings (TDRs) and to determine whether the policies are adequate to ensure that TDRs benefit the savings association.

To determine if savings associations report TDRs and repossessions in substance in accordance with OTS policy and GAAP.

To assess the reasonableness of concessions granted to borrowers by management under TDR agreements.

To assess the risk that TDR policies and practices pose to the savings association and ultimately to the FDIC insurance funds, its members, and the public.

Examination Procedures

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Level I

1. Evaluate the adequacy of the savings association's policies, procedures, and controls on troubled debt restructuring to ensure that the savings association structures TDRs to its benefit.

   ______________________________ ________

2. Ascertain through review of minutes, audit reports, and other management reports whether the savings association properly approves TDRs in accordance with policy and reports pertinent information to the savings association's board of directors.

   ______________________________ ________

3. Obtain from management a current list of TDRs. Determine whether the savings association correctly reports TDRs in audited financial statements and in reports to the OTS. Discuss missing material disclosures with the regional accountant.

   ______________________________ ________

4. Review Level II procedures and perform those necessary to test, support, and present conclusions derived from performance of Level I procedures.

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Exam Date: ____________
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Reviewed By: ____________
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Level II

5. If the effect of TDRs is material relative to regulatory capital or earnings, test TDRs for compliance with the savings association's policies and procedures and for compliance with GAAP. You may rely on the savings association's work papers and internal and external audit work as appropriate.

____ ________

6. Ensure that your review meets the *Objectives* of this Handbook Section. State your findings and conclusions, and appropriate recommendations for any necessary corrective measures, on the appropriate work papers and report pages.

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Reviewed By: ____________
Docket #: ____________

INTRODUCTION

Meetings between regulatory staff and the board of directors – the individuals ultimately responsible for an institution's affairs – serve a variety of functions. They provide opportunity for interaction, and they facilitate long-term communication, which is especially important when the regulatory process reveals significant adverse information. Meetings help keep directors and regulators mutually informed by providing them an opportunity to discuss any of the following items:

- The examination process and findings.
- The institution, its functions, and plans.
- The general financial environment.
- Industry-related concerns.

Meetings give regulators an opportunity to obtain commitments from the board for corrective action.

Meetings with the board are distinct from management meetings, also known as exit conferences, closing conferences, or exit interviews. Examiners meet with executive management near the end of an examination to review overall findings and obtain commitments for corrective action. (See Thrift Activities Regulatory Handbook Section 070, Overall Conclusions.) The examiner in charge (EIC) should notify management of all examination-related items slated for discussion with the board, except recommendations to remove management.

TYPES OF MEETINGS

There are two primary types of meetings between regulators and the board: regular – those relating to examinations; and special – not primarily for presenting examination findings. However, a meeting can serve multiple purposes. For example, a regular meeting can serve to acquaint regulators with the board, enhance communication, and present findings.

Regular Meetings

A regular meeting can result from regular, special, or limited examinations. Its primary purpose is to discuss findings and agree on corrective action. A secondary purpose is to gather information regarding a new function for the institution. These meetings can also enhance the directors' understanding of the regulatory process and establish a rapport and build lines of communication with regulators.

You should consider attending a regularly scheduled board meeting that occurs during an examination. The purpose is not necessarily to discuss findings although it may be an opportunity to discuss scope and preliminary findings. The main objective, however; is to observe the board in action and establish a rapport.

If an institution's rating is adverse, you should arrange to meet with the board after the examination. Any of the following indicators denote an adverse rating:

- A composite rating of 4 or 5.
- A composite rating of 3 if the rating represents a downgrade from the previous examination.
- A CRA rating of Needs to Improve or Substantial Noncompliance.
- A Holding Company rating of Unsatisfactory.

Generally you should meet with the boards of all 3-rated institutions. However, the EIC, in concurrence with the field manager, determines whether it is necessary to meet if the 3 rating is not a downgrade from a prior examination.

Sometimes you might schedule a meeting with the board of an institution that does not have an adverse rating. This is appropriate when the EIC notes adverse trends, increased risk profile, or other matters that need to be brought to the board's attention. If no issues exist, the EIC should honor any request from management to forgo a meeting.

If an institution's assets exceed $1 billion, you should schedule a meeting with the board regardless of adverse trends. The field manager must concur with any decision to forgo a meeting.

While you normally meet after the examination, you could arrange a regular meeting during the last week. This is appropriate if you have already discussed the examination results with management. Your meeting can also coincide with the board's next regularly scheduled meeting. You can mutually agree on another time to meet as long as that date is within 60 days of completing the examination. Also when scheduling, consider whether directors would benefit from receiving a copy of the report of examination (ROE) prior to the meeting.

The meeting agenda should include the following issues that warrant the board's attention:

- A comparison of the institution's policies, practices, and reporting systems with those of a well-managed, comparable institution.
- Corrective action taken by senior management.
- The institution's internal control system and internal audit coverage.
- The extent to which senior management and directors are receiving information needed to manage the institution effectively.
- Significant concerns regarding the quality of earnings.
- Management's long-term plans.
- Effectiveness of management personnel.
- The board's involvement in the institution's affairs.

Try to discuss ways to correct deficiencies without directing a course of action. If there are no major deficiencies, discuss the institution's overall condition and try to get the board's view of its future operations. Encourage directors to discuss matters that interest them.

Special Meetings

Reasons to schedule a special meeting include the following:

- To effect a supervisory action, such as a supervisory agreement or cease and desist order.
- To gather information in order to act on a proposal, application, or request by the institution.
- To discuss an institution's progress toward corrective action.
- To become acquainted following a change in directorate or a change in regulatory staff.
- To comply with directorate's request to meet.

MEETING PREPARATION, PRESENTATION, AND DOCUMENTATION

Prepare yourself thoroughly when meeting with the directorate. You should conduct yourself professionally and prepare sufficient documentation to ensure appropriate follow-up. A successful meeting will include all of the following steps:

- Preparation
  - — Ensure that the scheduling and selection of attendees satisfies the meeting's goal. See the discussion below on participation.
  - — Choose attendees and determine their responsibilities.
  - — Select a chairperson.
  - — Determine time and location.
  - — Develop an agenda. Refer to the discussion below.
  - — Notify participants of the meeting and its purpose.
  - — Meet with regulatory staff participants to discuss the agenda and other related issues.
  - — Prepare and organize supporting data, including comparative figures and ratios that

  indicate trends and graphs to illustrate significant points or trends.

  — Prepare any handouts or overheads for presentation.

- Presentation

  — Conduct the meeting in a professional, objective fashion.

  — Present the agenda (refer to discussion below) and follow it within reason.

  — Establish good communication and maintain creditability.

  — Encourage directors' involvement and solicit questions.

  — Answer questions accurately. When unable to do so, refer inquiries to the OTS regional or Washington office.

  — Obtain commitment from board to correct deficiencies, if appropriate.

- Documentation

  — Evaluate and document results of the meeting. Refer to the discussion below.

Participation

You should meet with the entire board to ensure all directors are aware of regulatory findings and commitments to correct deficiencies. If all directors cannot attend, you can meet with a group, such as the audit, examination, or executive committee if:

- Outside directors are present.
- There are no material or adverse findings.
- The circumstances do not require a full board.

Honorary directors can participate in meeting discussions, but may not vote. Any person or organization connected with the institution, auditor, or holding company representative can attend the meeting upon board resolution. However, you can excuse such people if appropriate. As a rule, state supervisory authorities should attend meetings with the boards of state-chartered institutions.

EICs should meet regularly with the board. This allows them to discuss strengths and weaknesses noted during the examination and to answer any questions. Sometimes it is advantageous for the EIC to attend special meetings, too.

Agenda

To ensure an orderly meeting, you should prepare a detailed outline of discussion topics. The following outline is not all-inclusive but intended only as a guide:

Sample Agenda Outline

- Introductory remarks by regional office representative

  — OTS policy regarding board meetings

  — Purpose of meeting

  — Type and scope of examination

- ROE results

  — Overall condition of the institution

  — Capital

  — Asset quality, internal loan review, and reserves

  — Management (including quality, depth, and continuity)

  — Earnings

  — Liquidity

  — Funds management

  — Sensitivity to market risk

  — Internal controls and audit coverage

  — Policies and procedures

  — Reporting systems

  — Management information systems

  — Management reports to the board

  — Reports of the board and committees

- Thrift Financial Reports
- Planning process
- Personnel
- Compliance systems
- Legislative and regulatory compliance (identify significant violations)
- Supervision by board
- Service corporation and holding company examination results
- Summary

• Corrective action (after discussion with appropriate regulatory staff)
  - Summary of problems
  - Board commitments

• Disclosure of ratings

• Other matters

• Questions from the board

• Overall conclusions

Documentation

After the meeting, prepare a memorandum to record results, date, time, location, and participant's names and titles. Describe the items discussed, the board's reactions, and any commitments for corrective action. If the board promises corrective action, send the memorandum to them for concurrence.

At the conclusion of any meeting conducted by the board (rather than the regulators), you should ask for a copy of the minutes and review them for accuracy.

Keep a copy of the post-meeting memorandum and agenda in the appropriate supervisory file. You should amend the institution's regulatory profile to reflect any changes or future commitments as a result of the meeting. See Thrift Activities Regulatory Handbook Section 050.

REFERENCE

Office of Thrift Supervision

OTS Thrift Safety and Soundness Report of Examination Instructions