FEDERAL DEPOSIT 1933

Supervisory Insights

Devoted to Advancing the Practice of Bank Supervision

Vol. 9, Issue 1 Summer 2012

Inside

The Risk Management Examination and Your Community Bank

Stress Testing Credit Risk at Community Banks

Results from the Credit and Consumer Products/Services Survey

Accounting for Troubled Debt Restructurings

FDIC

Supervisory Insights

Supervisory Insights is published by the Division of Risk Management Supervision of the Federal Deposit Insurance Corporation to promote sound principles and best practices for bank supervision.

Martin J. Gruenberg
Acting Chairman, FDIC

Sandra L. Thompson
Director, Division of Risk Management Supervision

Journal Executive Board

Division of Risk Management Supervision
George E. French, Deputy Director and Executive Editor
Michael J. Dean, Acting Deputy Director
James C. Watkins, Deputy Director

Division of Depositor and Consumer Protection
Sylvia H. Plunkett, Senior Deputy Director
Jonathan N. Miller, Deputy Director
Robert W. Mooney, Deputy Director

Regional Directors
Thomas J. Dujenski, Atlanta Region
Doreen R. Eberley, New York Region
Kristie K. Elmquist, Dallas Region
Stan R. Ivie, San Francisco Region
James D. La Pierre, Kansas City Region
M. Anthony Lowe, Chicago Region

Journal Staff

Kim E. Lowry
Managing Editor

Shannon M. Beattie
Financial Writer

Paul S. Vigil
Financial Writer

Supervisory Insights is available online by visiting the FDIC's Web site at www.fdic.gov. To provide comments or suggestions for future articles, request permission to reprint individual articles, or request print copies, send an e-mail to SupervisoryJournal@fdic.gov.

The views expressed in ***Supervisory Insights*** are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. In particular, articles should not be construed as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this publication was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Federal Deposit Insurance Corporation.

Issue at a Glance

Volume 9, Issue 1 Summer 2012

Letter from the Director 2

Articles

The Risk Management Examination and Your Community Bank 3

The FDIC is committed to open communication with community banks, recognizing this is critical to administering an effective supervisory process. A key component of this communication is ensuring bankers understand examination programs and regulatory expectations. This article presents an overview of the examination and supervisory process, and suggests ways to enhance communication between bankers and supervisors.

Stress Testing Credit Risk at Community Banks 9

The recent banking crisis illustrates how quickly market conditions can deteriorate, straining community bank loan portfolios. Stress testing can help financial institutions evaluate lending risks and capital adequacy under stressed, but plausible, scenarios and develop appropriate strategies to mitigate the risk. This article describes the credit-related stress-testing process, discusses its usefulness in managing risk, and provides simple examples of how community banks can conduct stress testing.

Results from the FDIC's Credit and Consumer Products/Services Survey: Focus on Lending Trends 16

Completed by FDIC examiners at the conclusion of each examination, the Credit and Consumer Products/Services Survey gathers examiner insights on underwriting practices, new and evolving banking products and activities, commercial real estate market conditions, and funding practices. This article shares recent Survey results with a focus on lending activity, including trends in underwriting, factors influencing banks' ability and willingness to lend, use of loan workouts, and loan growth patterns across the country.

Regular Features

Accounting News: Accounting for Troubled Debt Restructurings 26

Insured financial institutions modify loans for a variety of reasons. A modification is identified as a troubled debt restructuring when a borrower is experiencing financial difficulties, and the bank grants a concession it would not otherwise consider. This article provides a summary of the accounting for troubled debt restructurings, including a discussion of regulatory reporting issues.

Regulatory and Supervisory Roundup 39

This feature provides an overview of recently released regulations and supervisory guidance.

Letter from the Director

The FDIC has long understood the value of open communication between bank regulators and community bankers. The FDIC has developed a series of initiatives, inaugurated by "The Future of Community Banking" conference held earlier this year, to further this dialog, ensure community bankers understand our supervisory approach, and explore the challenges and opportunities facing this sector of the banking industry. As part of these outreach efforts, this issue of ***Supervisory Insights*** features "The Risk Management Examination and Your Community Bank." This article provides an overview of the examination and application processes to help banks better navigate their examinations and suggests ways to enhance communication between bankers and supervisors.

Also of particular interest for community banks, "Stress Testing Credit Risk at Community Banks" describes the credit-related stress-testing process, discusses its usefulness in managing risk, and provides relatively simple and straightforward examples of how community banks can conduct stress testing.

"Results from the FDIC's Credit and Consumer Products/Services Survey: Focus on Lending Trends" summarizes recent Survey results with a focus on lending activity, including trends in underwriting, factors influencing banks' ability and willingness to lend, use of loan workouts, and loan growth patterns across the country.

And finally, this issue of ***Supervisory Insights*** provides a summary of the accounting for loan modifications that are considered troubled debt restructurings, including a discussion of regulatory reporting issues.

We hope you have the opportunity to read the articles in this issue and find them interesting and useful. We welcome feedback on articles as well as ideas for topics for future issues. Please e-mail your comments and suggestions to SupervisoryJournal@fdic.gov.

Sandra L. Thompson
Director
Division of Risk Management Supervision

The Risk Management Examination and Your Community Bank

The on-site examination is perhaps the single most important point of contact between the FDIC and the banks it supervises. Regardless of whether an examination results in a satisfactory evaluation as is generally the case, or in a recommendation for a corrective program, our experience has been that the cultivation of open lines of communication before, during, and after an examination can make for a more effective and satisfactory process for all concerned. In that spirit, the purpose of this article is to provide an overview of the examination process and call attention to the FDIC's commitment to enhance communication with community banks and help them better navigate their examinations.

The FDIC's Community Bank Initiative and Other Outreach

The FDIC has developed a series of community bank initiatives for 2012 to further our dialogue and better understand the challenges and opportunities facing these important institutions. These initiatives include a national conference earlier this year that focused on the future of community banks and their unique role in supporting our economy; a series of roundtable discussions between FDIC officials and community bankers in each of the FDIC's six regions; and a major research initiative to examine key issues related to community banks, including their evolution, characteristics, performance, and role in local communities. In addition, as part of this initiative, the FDIC is reviewing its examination and rulemaking processes to see if we can identify ways to improve our processes and communications while maintaining our supervisory standards. The FDIC will continue to use an array of outreach tools to communicate with community banks, including Directors College programs, participation at industry-sponsored events, and publications such as this one, where the industry can learn about emerging banking trends and gain a better understanding of the supervisory process.

Effective Communication throughout a Bank Examination

Financial performance ratios and other quantitative measures are only part of the comprehensive process that supervisors use to evaluate an institution's overall condition. Bank examinations rely on an assessment of both qualitative factors and quantitative measures of financial performance and condition to determine examination ratings and document conclusions. Although making these determinations is ultimately the FDIC's responsibility, a constructive dialogue between examiners and bankers can enhance the FDIC's understanding of an institution's policies, business strategies, risk management programs, and financial position. The FDIC pursues many avenues to foster a dialogue with community banks including pre-examination discussions with senior bank management, invitations to directors to meet with examination personnel during on-site reviews, telephone contacts between examinations, and various outreach events at national and state levels.

Bankers often tell us that maintaining communications with supervisory staff helps them understand the FDIC's expectations and can be a useful source of information about supervisory and regulatory matters.

The Risk Management Examination

continued from pg. 3

Some community banks find it extremely helpful to develop productive working relationships with their field supervisors (FSs) and assistant regional directors (ARDs). These FDIC managers lead our operational role in examinations, application reviews, and other requests. By establishing a working relationship with these individuals as well as state banking department personnel, bankers can use the regulators as a resource and gain insight into regulatory expectations and procedures.

Benefits of Open Communication with the Regulators

- Allows banks to better monitor the progress of an examination, ask questions, or request clarification to ensure that supervisory findings are well understood.
- Ensures examiners understand the bank's perspective on important supervisory matters.
- Minimizes the likelihood of surprises at the conclusion of a bank examination or supervisory determination for regulatory applications.
- Enables banks to benefit from supervisors' expertise on FDIC regulations and policies, emerging risks, banking product innovations, and the deployment of technology.

It is the Examiner-in-Charge's (EIC's) responsibility to keep management apprised of examination progress and findings, but bankers should not hesitate to proactively request or initiate additional opportunities for communication.

The examination process and opportunities for enhancing communication are explained below.

Before an Examination

Pre-examination planning is designed to ensure that banks' and examiners' time and resources are used effectively and can sometimes reduce the length of the on-site examination. Banks are informed of an upcoming risk management examination by telephone call or letter. At this time, the bank likely receives preliminary requests for information that will be used to scope the review. The EIC or other staff member from the local field office typically contacts the institution 45 days before the commencement of an examination to begin planning discussions with the chief executive officer (CEO) or other designated members of management. CEOs should use this opportunity to discuss the scope and timeline of the review with the EIC to understand the focus of the examination.

Management is then provided with an examination request list, which outlines the data, reports, documents, and policy manuals that examiners need to initiate their work. Banks usually provide information for the examination request list through *FDICconnect*. If a bank's risk management programs and monitoring tools extend beyond the materials requested by the EIC, CEOs should share this information with the EIC during the pre-examination process to ensure all aspects of the bank's risk management program are appropriately considered. It is the EIC's responsibility to use this requested material as effectively and efficiently as possible, which can result in significant progress on examination activities before the on-site review begins.

In advance of the examination, the EIC will discuss with bank management financial performance trends, recent significant transactions, and future plans; these discussions will enable the EIC to adjust the examination scope and develop an efficient, risk-focused examination plan. Pre-examination discussions allow the CEO or other members of management to brief the EIC on the bank's organizational structure, business lines, market conditions, risk management processes, and strategic plans. Before the examination begins, the CEO and EIC should schedule several meetings during the on-site

An example of effective communication *immediately before* an examination

Several weeks before an examination began, bank management contacted the EIC to advise him of certain irregularities related to the recent resignation of a bank officer. The EIC met with bank management one week before the examination team arrived to assess the impact of these irregularities. These early discussions allowed the EIC to complete his review of the situation, resulting in a more narrowly scoped, risk-focused examination.

review to discuss the examination's progress and preliminary findings.

During an Examination

The scope of the examination will depend in part on the bank's specific exposures and unique risks. For example, institutions with credit concentrations or new product lines should expect a certain level of examiner review of those areas. Examiners also will follow-up on prior regulatory recommendations and review the bank's efforts to ensure compliance with new laws and regulations.

Dialogue between the CEO and the EIC during the examination is intended to help bank management understand the preliminary findings and keep management current on the progress of the examination. These conversations present opportunities for bankers to ask questions, provide additional information, or request clarification. Bankers sometimes find such meetings to be a useful source of information about FDIC regulations and policies. Apart from the specific findings of an examination, some bankers report that they have benefitted from examiners' informal observations, based on experience in numerous community bank examinations, about matters such as risk management processes, banking product innovations, internal controls, and the use of technology.

At the conclusion of the on-site examination, the EIC will schedule an exit meeting with senior management to ensure bank management has a clear understanding of the findings and proposed ratings. During this meeting, the EIC will explain

What can bankers expect from an FDIC examination?

FDIC supervisory staff commits to:

- Explaining the anticipated timeline and the scope of the review.
- Conducting an orderly examination and making every effort to avoid disruptions or duplicate information requests.
- Conducting business professionally and respectfully.
- Clarifying regulatory expectations and explaining examination findings in plain English.
- Meeting with bank management (or board members, as requested) during the examination to provide updates on examination progress and findings.
- Listening to and considering the bank's concerns about examination conclusions and providing sufficient opportunity for feedback and clarification before the examination is completed.

continued from pg. 5

An example of effective communication *during* an examination

During the examination, the EIC expressed concern about the structure of a bank's internal audit department. Management believed that contracting with an outside firm might resolve the concern, but first discussed its options with the EIC. The EIC explained existing regulatory guidance on audit structure and, following this discussion, management instead decided to expand the existing internal audit staff. This approach improved audit coverage and, going forward, enhanced the flexibility of the internal audit program.

the FDIC's conclusions and recommendations, confirm management's responses and commitments, and discuss preliminary assigned ratings and content of the written Report of Examination. Bank management should use this exit meeting to affirm commitments to examination recommendations and discuss any concerns with the examination conclusions.

Following the Examination

Following the on-site review, the EIC generally will arrange a meeting with the institution's board of directors. For risk management examinations, the EIC, along with the field office management or a regional office representative, will participate in a meeting with the directorate or a significant board committee. The board meeting is intended to inform the directorate of examination findings, affirm management's commitments to address key weaknesses or recommendations, and provide board members with an opportunity to talk with FDIC staff. The EIC generally focuses his or her presentation on matters requiring the board's attention, substantive findings and recommendations, proposed ratings, and expected follow-up actions by the bank. The EIC will encourage board members to participate in the discussion, as the FDIC strongly believes board leadership is critical to the success of the banking organization.

Finally, field office management or the regional office staff member will place examination findings in context with industry trends and share insights on new regulatory initiatives.

Before finalization, the Report of Examination undergoes a quality control review by the field or regional office to ensure the content is accurate, the findings are consistent with FDIC policies, and the tone is appropriate given the institution's overall condition. Once these reviews are completed, the Report of Examination is transmitted to the bank's board of directors. The board should review the Report[1] in its entirety, discuss the findings and recommendations during the next meeting, and monitor management's action plan for addressing any cited weaknesses or recommendations. If requested in the transmittal letter accompanying the Report of Examination, a written response to the examination should be prepared, ratified by the directorate, and submitted to the FDIC and state authority within the requested timeframe. If a formal or informal corrective program is proposed, senior management and board members are encouraged to meet with the FDIC regional office and state officials to discuss the provisions of the program and voice any questions or concerns. This discussion often occurs at a board meeting.

[1] 12 CFR § 309.6 http://www.fdic.gov/regulations/laws/rules/2000-3800.html.

Tips for Navigating the Examination Process

Before an Examination

- Meet with the EIC and brief him or her on the bank's strategy, performance, key exposures, and risk management efforts.
- Fulfill the examination information request list and, if necessary, ask for clarification if requested items do not appear to be applicable to the institution.

During an Examination

- Schedule progress meetings with the EIC.
- Discuss any concerns with examiner findings early in the process.

Following the Examination

- Provide a written response to the examination with follow-up actions that appropriately address supervisory recommendations.
- Schedule a meeting with the FDIC if the final Report of Examination raises questions.

Expressing Concerns about Examination Findings

Banks should expect our examination findings to be fair, fact-based, and consistent with FDIC policies and procedures. The FDIC prefers to have an ongoing dialogue during examinations to discuss preliminary findings and allow management to respond. Although there may be cases when regulators and bankers "agree to disagree," the FDIC wants to ensure our position considers all perspectives. At the bank's discretion, concerns about examination findings can be raised to the FS or ARD. The bank also may present issues or concerns to our regional executives, including the regional director and deputy regional director, as these individuals are actively involved in working through significant matters with institutions as they arise. If these informal channels do not resolve an institution's concerns with supervisory findings, the institution has a range of appeal options detailed in the March 1, 2011 Financial Institution Letter titled *Reminder on FDIC Examination Findings*.[2]

Other Communications with Banking Supervisors

Between regular community bank examinations, the FDIC uses off-site monitoring and on-site visitations as part of our risk monitoring program. Our interim activities may include telephone calls or other contacts with the CEO to follow-up on examination findings, unanticipated external events, consumer complaints, or significant changes in data reported in the Consolidated Reports of Condition and Income. These contacts are a normal part of our supervisory process and allow bankers to ask questions, request

[2] FIL-13-2011, *Reminder on Examinations*, March 1, 2011, http://www.fdic.gov/news/news/financial/2011/fil11013a.html.

continued from pg. 7

What are bankers' options if they have concerns with the examination process or related requests?

- Bank management should discuss concerns with the EIC.
- If this discussion does not satisfactorily address the matter, bank management should contact the EIC's supervisor (the Field Supervisor).
- If those efforts are unsuccessful in resolving issues, we encourage banks to contact the appropriate FDIC regional office.
- Should discussions with regional office personnel not resolve bank management's concerns, the bank may informally or formally appeal examination findings.
- Alternatively, the bank can contact the FDIC Office of the Ombudsman at 877-ASK-FDIC (Option 3) or Ombudsman@fdic.gov.

*FDIC staff is **strictly prohibited** from retaliating over disagreements or complaints.*

clarification, or discuss steps taken to address examination findings.

Another possible and significant contact between examinations occurs when a bank seeks regulatory approval via an application to engage in certain transactions and activities, including branching, mergers and acquisitions, investments in real estate, capital retirement, and changes in control. When planning to submit an application, bankers should feel free to contact the FDIC regional office to discuss the request, the required content of the application, and the anticipated processing timeline. Bankers may find it helpful to meet with regional office staff and state officials to walk through more complex proposals and gain insights into legal requirements. Our regional office staff is available to answer questions and provide an update on the application's status.

As with examinations, if an institution is dissatisfied with the processing of the application, bank management should voice those concerns to the application reviewer or ARD to better understand the FDIC's procedures, information needs, and expected timeline. Once a determination on the application is reached, the institution is notified in writing. If the bank's application is denied, in certain cases the bank may seek an appeal as described in the FDIC's *Appeals of Material Supervisory Determinations – Guidelines and Decisions*.[3]

Conclusion

The FDIC continues to explore ways to strengthen its working relationships with the banking industry and individual community banks. Bankers are encouraged to contact field supervisors and regional office staff with questions or concerns regarding the regulatory process or recent developments at their institutions. FDIC supervisors are available to share insights, offer perspectives, and direct bank management to resources that may help resolve issues or concerns. Bankers also are encouraged to send suggestions to the FDIC's Community Banking mailbox at CommunityBanking@fdic.gov.

William R. Baxter
Senior Examination Specialist
wbaxter@fdic.gov

Marianne H. Lloyd
Field Supervisor, New York Region
mlloyd@fdic.gov

[3] FDIC. *Appeals of Material Supervisory Determinations – Guidelines and Decisions*, April 13, 2010, http://www.fdic.gov/regulations/laws/sarc/.

Stress Testing Credit Risk at Community Banks

The recent banking crisis illustrates how rapidly market conditions can deteriorate and subject banks to considerable strain. One result of this experience is that stress testing has come to occupy a more prominent place in the supervision of large banks. The Supervisory Capital Assessment Program, its successor the Comprehensive Capital Adequacy Review, and the stress-testing requirements of Section 165 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* are, collectively, an important set of supervisory expectations for large banking organizations.

Stress-testing expectations for community banks are more discrete and limited.[1] Existing supervisory guidance states that banks with significant concentrations in commercial real estate (CRE) or subprime lending should conduct portfolio stress tests of these exposures as part of their ongoing risk management activities (see text box on page 10). Outside the credit risk arena, standard asset-liability management techniques such as analyzing the effect of interest-rate shocks, or other interest-rate simulations, amount to a form of stress testing. Finally, interagency guidance states that all institutions should plan for ways to meet their funding needs under stressed conditions.

Community banks looking to conduct CRE stress tests in accordance with supervisory guidance, or otherwise considering the use of stress tests for risk management, may find that it is hard to know where to start. Confusion is understandable: some stress-testing approaches can be complex, and there are a variety of analytical approaches from which to choose.

These difficulties notwithstanding, there are simple approaches to credit-risk stress testing that can be implemented by a community bank. While not a substitute for strong loan underwriting and grading, credit administration, risk limits and governance of the credit-granting process, stress testing can help institutions evaluate lending risks and capital adequacy under stressed but plausible scenarios. Some community banks have used stress tests to develop a more comprehensive understanding of potential loss exposure and incorporated the results into their risk management and capital planning processes. Experience from bank examinations suggests that community banks that proactively manage their lending function and attempt to plan for, measure and control their vulnerability to adverse events have been better able to make adjustments and improve performance over time.

This article describes the credit-related stress-testing process and explains how community bank boards of directors and senior management can use this process to better manage risk. The article emphasizes that smaller community banks can effectively perform stress testing in a simple and straightforward manner to achieve the goals of outstanding supervisory guidance. The article includes two simple examples of stress-testing methodologies. These are offered as an informational resource only, not as a supervisory directive.

[1] See FDIC Press Release 54-2012, *Agencies Clarify Supervisory Expectations for Stress Testing by Community Banks*, issued May 14, 2012 (http://www.fdic.gov/news/news/press/2012/pr12054.html).

continued from pg. 9

Outstanding Supervisory Guidance for Stress Testing Credit Exposures

The 2006 *Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices* and the 2001 *Expanded Guidance for Evaluating Subprime Lending Programs* state that institutions with CRE and subprime lending concentrations should perform portfolio-level stress tests or sensitivity analyses to quantify the impact of changing economic conditions on asset quality, capital, and earnings. These issuances recommend that institutions consider the sensitivity of the performance of portfolio segments with common risk characteristics to prospective changes in market conditions. Importantly, the guidance emphasizes that the sophistication of stress testing should be consistent with the size, complexity, and risk characteristics of the portfolios and balance-sheet structure.

Definition of a Stress Test

Stress testing is a forward-looking quantitative evaluation of stress scenarios that could impact a banking institution's financial condition and capital adequacy. These risk assessments are based on assumptions about potential adverse external events, such as changes in real estate or capital markets prices, or unanticipated deterioration in a borrower's repayment capacity. Stress tests are most useful when customized to reflect the characteristics particular to the institution and its market area, and can be used to evaluate credit risk in the overall loan portfolio, segments of portfolios, or individual loans. Stress tests also can be used to evaluate whether existing financial (such as capital and liquidity) and operational (such as staffing and internal systems) resources are sufficient to withstand an economic downturn or unexpected event.

The FDIC does not endorse a prescribed method for stress testing, and outstanding stress-testing expectations for large institutions *are not* required for community banks.[2] Rather, the extent and depth of an institution's credit-related stress testing should be commensurate with its unique business activities, portfolio size, and concentrations. Stress tests can be performed effectively by bank staff or, at the institution's discretion, a competent third party, using methods ranging from simple spreadsheet computations to more complex software applications. For example, some smaller community banks have successfully implemented relatively simple, yet effective, CRE loan stress-testing processes while larger institutions have created similarly effective stress assessments with greater sophistication and complexity.

[2] Community banks and other institutions with total assets of less than $10 billion are not subject to the stress-testing requirements established in Section 165 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* or the *Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion In Total Consolidated Assets*, issued May 14, 2012.

Types of Stress Testing

Financial institutions can create a variety of stress tests to evaluate credit portfolio risk and the potential impact on capital. These types of generalized stress tests can be used by community banks to meet supervisory expectations (e.g., expectations contained in the 2006 CRE Guidance) or by institutions seeking to complement and enhance their other risk management activities. As suggested by this list, there is no one right way to conduct stress tests.

Transactional Sensitivity Analysis – Before making a commitment for financing a commercial property or project, an institution can analyze financial and market assumptions provided by the borrower or through the appraisal process to determine the degree to which the cash flows generated by the property or project can withstand market fluctuations and service the loan per contractual terms. For example, a bank could assume the departure of a key tenant in a commercial real estate project and measure the resulting effect on loan performance. The results of such stress analyses can help an institution determine whether to make a loan and if so, formulate a more appropriate loan structure, pricing, or other prudential terms to mitigate credit risk. Further, individual stress tests can be aggregated and studied to assess the impact on the portfolio.

Stressed Portfolio Loss Rates – Applying a set of portfolio or portfolio-segment loss rates that might be expected during downturn conditions can help community banks identify the extent to which capital might be at risk given the bank's balance-sheet structure and loan mix. For example, a bank could use portfolio loss rates from a previous economic recession and apply those to their current portfolio.

Scenario Analysis – An institution may want to evaluate how a certain portfolio or portfolio segment (e.g., second lien mortgages) may respond to different levels in a key performance metric (e.g., housing prices or interest rates).

Loan Migration Analysis – Institutions with larger portfolios and more comprehensive internal databases can evaluate how a downward migration in internal loan ratings, consistent with migrations that might be expected during adverse financial conditions, would impact asset quality and capital. This analysis would also assist institutions in determining possible actions to address potential migration or deterioration in the portfolio.

Reverse Stress Testing – With reverse stress testing, an institution assumes a known adverse outcome, such as severe credit losses that reduce regulatory capital ratios to below satisfactory levels, and determines the loss event and associated circumstances that could lead to that outcome. This type of analysis helps institutions quantify the level of capital and earnings buffer it has to absorb financial shocks and helps identify those circumstances that, either singularly or in combination, would have the greatest adverse impact.

Examples of Credit-Related Stress Tests that Can Be Used by Community Banks

Examples of credit-related stress tests are presented below for illustrative purposes.[3] These relatively non-complex stress tests can produce useful information about a community bank's vulnerability to adverse circumstances and provide insights for boards of directors and management to consider when determining if action should be taken to mitigate outsized risks.

Portfolio-level example using stressed loss rates

The first example illustrates a portfolio-level stress test using stressed loss rates in two scenarios corresponding to moderate and severe levels of stress. For each scenario, a set of portfolio loss rates and average balances

[3] These examples are not intended to be viewed as a standard stress-testing format or methodology endorsed or expected by the FDIC. They are presented to illustrate that simple, straightforward stress tests can provide useful insight into concentrated credit portfolios held by community banks.

Stress Testing Credit Risk

continued from pg. 11

are estimated in step #1, covering a two-year period of projections. These loss estimates could be derived, for example, from the bank's own experience during stress periods or from peer portfolio performance. Projections that assume historical or peer loss rates will be more informative and relevant if potential losses are adjusted, even if only judgmentally, to reflect the risk in the bank's own portfolio. The loss rate estimates are then applied to portfolio balances to produce an estimate of aggregate losses. The next steps (step #2 and step #3) estimate the impact of these portfolio losses on earnings (which also are estimated) and capital. In this example, the bank's construction and development lending concentration and other exposures could affect the capital position in the assumed severe scenario.

1. Estimate Portfolio Losses Over the Stress-Test Horizon

		Stress Period Loss Rates Over Two Years		Stress Period Losses Over Two Years	
	Estimated Portfolio Balances, in $	Moderate Case Stress	Severe Case Stress	Moderate Case Stress, in $	Severe Case Stress, in $
Construction & Development	124	14.0%	25.0%	17	31
Commercial Real Estate	22	2.5%	5.0%	1	1
Residential Mortgage	372	2.9%	6.5%	11	24
Other Loans	125	5.0%	10.0%	6	13
Totals	643			35	69

2. Estimate Revenues and Impact of Stress on Earnings

	Moderate Case Stress, in $	Severe Case Stress, in $
Pre-provision net revenue (over two years)	31	25
Less Provisions (e.g., set to equal estimated losses from step 1)	35	69
Less Tax Expense (Benefit)	(1)	(13)
Net After-Tax Income	(3)	(31)

3. Estimate Impact of Stress on Capital

	Moderate Case Stress, in $	Severe Case Stress, in $
Beginning Tier 1 Capital	88	88
Net Change in Tier 1 Capital (e.g., set to equal Net After-Tax Income from step 2)	(3)	(31)
Ending Tier 1 Capital	85	57
Estimated Average Assets	850	816
Estimated Tier 1 Leverage Ratio	10%	7%

Risk-Stratification Matrix for a CRE Loan Portfolio

Another relatively simple analysis is a risk-stratification matrix based on debt-service coverage (DSC) and loan-to-value (LTV). In this three-step example, an institution could:

1. Stratify and aggregate a segment of CRE loans that represents a meaningful sample of the portfolio based on current DSC and LTV, and slot the results in the matrix as a percentage of total risk-based capital. For a smaller institution, the largest 10 or 20 CRE loan exposures may be sufficiently representative. The intensity of potentially higher risk exposures is highlighted in pink (elevated risk) and red (more severe).

2. Devise plausible assumptions about adverse trends in cash flows and collateral values for the 10 or 20 exposures, and then re-slot the results to create a stressed scenario. In some cases, this may be as simple as applying a uniform "haircut" (for example, 20 percent) to the current cash flows and collateral values.

3. Compare the pre-and post-stress-test results to assess the portfolio's vulnerability to certain realistic stress events that could impact the institution. Portfolios with strong DSCs and LTVs may show limited migration to problem-credit status, while the opposite may be evident for portfolios with a large volume of loans originated at or near the institution's minimum acceptable underwriting standards.

Institutions embarking on a stress-testing process may want to prioritize work based on the largest exposures or portfolio concentrations, the riskiest segments of the portfolio, and watch-list credits. Insight gained from initial stress testing can provide the foundation for more expansive tests if this is deemed necessary. Consistent with outstanding supervisory guidance, stress testing of concentrated non-owner occupied CRE and subprime lending portfolios should be a primary focus. However, community banks seeking to enhance their risk management processes may find value in evaluating risks in owner-occupied CRE and other concentrated lending categories (such as C&I or residential loans) given a downward adjustment in regional and local economic circumstances or collateral values.

Pre-Stress

Debt-Service Coverage	CRE Loan-To-Value 60-69%	70-79%	80-89%	90+%
>1.75x	5.0%	45.5%	38.0%	7.5%
1.51x to 1.75x	19.0%	74.0%	53.0%	15.0%
1.26x to 1.50x	22.5%	58.0%	60.0%	12.5%
1.16x to 1.25x	7.5%	35.0%	17.5%	0.0%
1.01x to 1.15x	0.0%	5.0%	25.0%	0.0%
<=1.0x	0.0%	0.0%	0.0%	0.0%

Note: Cell data represent the volume of loans, as a percentage of total risk-based capital, that meet the LTV and DSC criteria for that cell.

Post-Stress

Debt-Service Coverage	CRE Loan-To-Value 60-69%	70-79%	80-89%	90+%
>1.75x	0.0%	5.0%	15.0%	7.5%
1.51x to 1.75x	0.0%	7.5%	45.0%	12.5%
1.26x to 1.50x	5.0%	12.5%	20.0%	25.0%
1.16x to 1.25x	0.0%	20.0%	17.5%	12.5%
1.01x to 1.15x	0.0%	50.0%	125.0%	70.0%
<=1.0x	0.0%	10.0%	35.0%	5.0%

Note: Cell data represent the volume of loans, as a percentage of total risk-based capital, that meet the LTV and DSC criteria for that cell.

continued from pg. 13

Common Risk Measures for Developing Stress Tests for Individual CRE Loans

These risk measures have been used to assess the effect of financial, economic, and market factors on CRE loan repayment. Many of these measures also apply to other loan categories. Institutions may find it beneficial to conduct stress tests using one or a combination of these risk factors:

- debt-service coverage
- loan-to-value ratios and capitalization rates
- property net operating income
- collateral value depreciation (regional and local)
- CRE sector performance (office, retail, multi-family, warehouse/industrial, lodging)
- interest-rate levels on variable-rate loans
- contractual terms (amortization, balloon payments) that may introduce refinancing or repayment risk
- occupancy status
- lease rates
- unit absorption rates for real estate developments
- economic factors such as changes in local employment and house prices

Using Stress-Test Results

Banks gain the most benefit from stress-testing exercises when they are incorporated into the overall risk management and strategic planning processes. For example, results of portfolio-level stress tests can be reviewed by boards of directors and senior management as one component of their analysis of lending concentrations, the adequacy of capital and the allowance for loan and lease losses, and the overall risk facing the institution. Additionally, stress-test results for individual loans can be used by loan officers and credit committees to better understand a borrower's or property's risk characteristics and position the bank (as lender) for unexpected adverse circumstances. Also, institutions with sound risk management practices surrounding stress testing, including board oversight and direction, appropriate policy guidance, and an effective internal control and validation process, will have greater confidence in the reliability of stress-test results.

The strategic value of stress testing may be greatest during the expansionary phase of business cycles. During times when losses are minimal and property values are rising, stress-testing assessments of riskier assets and concentrated positions can help management anticipate potential risks arising from lower-than-expected obligor cash flows, deteriorating local or regional economic circumstances, or declining real estate values. Directorates can use stress-test results as part of establishing risk tolerances and ensuring that remedial or mitigating action is taken when elevated risks become evident. If a board determines

that the institution's current risk profile exceeds tolerable levels, it may want to review credit-exposure limits, loan underwriting standards, the need for additional capital or staffing, or other financial, operational, or administrative measures.

Conclusion

Community banks can implement an effective stress-testing process in a straightforward manner to help the board of directors and senior management understand the potential impact of adverse scenarios. Clearly, institutions with total assets of less than $1 billion tend to have less complex credit portfolios and a particularly intimate understanding of their borrowers and local economic conditions. Therefore, when an institution is subject to a supervisory expectation to conduct stress tests (as with the 2006 CRE guidance) or otherwise wishes to conduct stress tests, it may be sufficient for such institutions to analyze the portfolio in a simple spreadsheet to simulate base-case and severe stress scenarios. To the extent loan portfolios include speculative, risky, or concentrated elements, an institution can stress test these exposures to identify potential vulnerabilities to enable the board of directors to make informed strategic decisions. Used in this way, stress testing can be a valuable tool to assist institutions in strengthening credit-risk management practices.

This article should not be construed as supervisory guidance or establishing regulatory expectations.

William R. Baxter
Senior Examination Specialist
wbaxter@fdic.gov

Thomas F. Lyons
Acting Chief, Policy and Program Development
tlyons@fdic.gov

The authors thank Steven Burton, Chief; Margaret Hanrahan, Senior Examination Specialist; and John Weier, Chief for their valuable contributions to this article.

Results from the FDIC's Credit and Consumer Products/Services Survey: Focus on Lending Trends

In late 2009, FDIC examiners were asked to begin completing the *Credit and Consumer Products/Services Survey* (Survey) at the conclusion of risk management examinations. Replacing a previous underwriting survey, the revised Survey solicits examiner assessments on the level of risk and quality of underwriting related to nine credit products as well as information on new or evolving banking products and activities, local commercial real estate (CRE) market conditions, and funding practices.

Initial results from the Survey were presented in the Winter 2010 issue of ***Supervisory Insights***[1] with a discussion of bank responses to ongoing economic and competitive challenges, including general underwriting trends and out-of-territory lending. The FDIC continues to gather and analyze the Survey data and this article summarizes recent results and provides insights on lending trends and the changing risk profiles of insured institutions.

Approximately 1,200 to 1,400 Surveys are generated by FDIC examiners every six months at insured institutions of varying sizes and types across the country. During 2011, more than 2,700 Surveys were completed. Between October 2009 and year-end 2011, 90 percent of the roughly 4,600 institutions directly supervised by FDIC have been captured by a completed Survey, representing more than half of all insured institutions.

In addition to being communicated through ***Supervisory Insights***, Survey results are made available to FDIC supervisory staff. Survey data are combined with other financial, economic, and examination data so that supervisory staff can better evaluate financial and operational trends, conduct enhanced forward-looking analyses, and make informed decisions regarding supervisory policies, examination scheduling, and examination risk scoping.

Improvements in Credit Risk Profiles

The Survey asks examiners to provide an overall assessment of the credit risk embedded in a bank's loan portfolio. This risk is reflective of current and past loan underwriting practices, local economic conditions, and other factors. While stresses persist in some loan portfolios exposed to weak real estate markets, the 2011 Survey results indicate that examiners are seeing improving trends in overall credit risk profiles and underwriting practices. These trends reflect the gradual improvement in asset quality at many institutions as they work to recover from the financial downturn.

During 2011, the percentage of respondents designating one or more portfolios as "high" risk declined.[2] In addition, the percentage of respondents labeling underwriting as "generally

[1] Jeffrey A. Forbes, David P. Lafleur, Paul S. Vigil, and Kenneth A. Weber "Insights from the FDIC's Credit and Consumer Products/Services Survey," ***Supervisory Insights***, Winter 2010. http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin10/index.html.

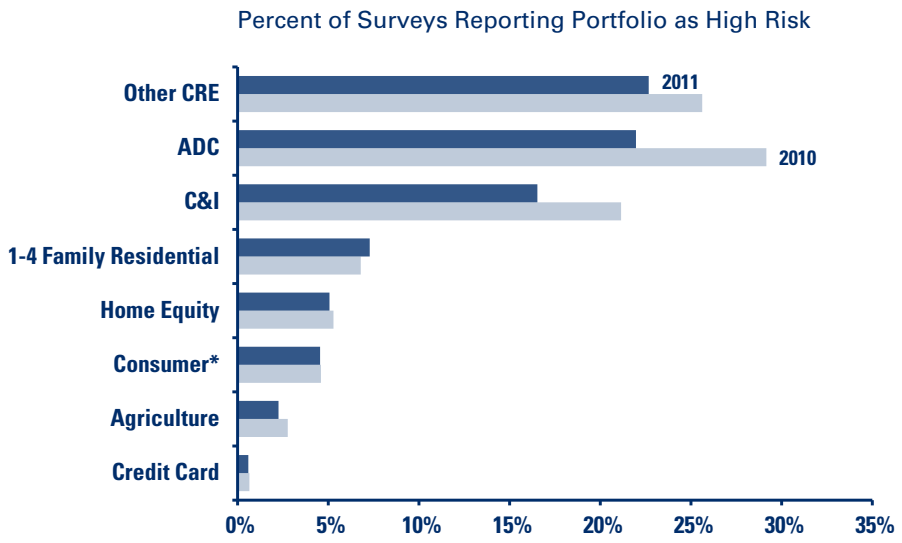
[2] The Survey asks examiners to describe the risk in nine loan portfolios as "low," "moderate," or "high." The nine portfolios are commercial and industrial, construction, permanent commercial real estate, residential mortgage, home equity, reverse mortgage, agricultural, consumer, and credit card.

liberal" declined, while there was an increase in the percentage of institutions considered to have "generally conservative" underwriting practices.

Examiners noted overall improvement in credit risk profiles across three major loan types. As shown in Chart 1, FDIC examiners characterized risk in the other CRE[3] portfolio as "high" in 23 percent of Surveys completed in 2011, down from 26 percent in 2010. The percentage of acquisition, development, and construction (ADC) portfolios assessed as "high" risk dropped from 29 percent in 2010 to 22 percent in 2011, and the percentage of "high" risk commercial and industrial (C&I) portfolios declined from 21 percent to 16 percent. The percentage of "high" risk designations in 2011 among the other six loan types remained low and relatively unchanged from 2010.

Examiners also are citing fewer instances of liberal lending.[4] During 2011, C&I had the highest percentage of respondents characterizing underwriting practices as "generally liberal" with 11 percent, down from 13 percent in 2010. The percentage for CRE dropped from 12 percent in 2010 to 10 percent in 2011, and ADC declined from 14 percent to 9 percent. Similar to 2010, less than 5 percent of the Surveys identified "generally liberal" underwriting practices in the other six loan types.

Chart 1: Percentage of Portfolios Considered High Risk is Declining



Source: FDIC Surveys completed in 2010 and 2011. *Excludes credit card.

[3] Permanent CRE loans, which includes all CRE loans except for acquisition, development, and construction (ADC) loans.

[4] The Survey asks examiners to characterize current underwriting practices in the nine loan portfolios as "generally conservative," "about average," or "generally liberal."

continued from pg. 17

Table 1: Higher-Risk Practices are Most Common in ADC Lending

Higher-Risk Acquisition, Development, and Construction Practices	2010	2011
Funding projects on a speculative basis (i.e. without meaningful pre-sale, pre-lease, or take-out commitments)	31%	22%
Funding loans without consideration of repayment sources other than sale of the collateral	30%	24%
Failing to verify the quality of alternative repayment sources	34%	28%
Use of unrealistic appraisal values relative to the current economic conditions and/or the performance observed in similar credits	27%	22%

The Survey also includes questions addressing lending practices that may present elevated risk to an insured institution. Although less common in 2011 than 2010, such practices continue to occur most frequently in ADC lending. Respondents identified four higher-risk practices associated with construction lending that were being conducted frequently enough to warrant notice or as a standard practice by more than 20 percent of surveyed institutions (see Table 1). A common characteristic among these practices is an over-reliance on sale of collateral for repayment. During periods of expansion when market conditions are strong, projects are completed and loans paid as agreed. However, as was evidenced during the recent economic downturn, many ADC loans became nonperforming as developers could not generate sales and alternative repayment sources were often limited or nonexistent.

Loan Underwriting Mostly Unchanged or Tighter in 2011

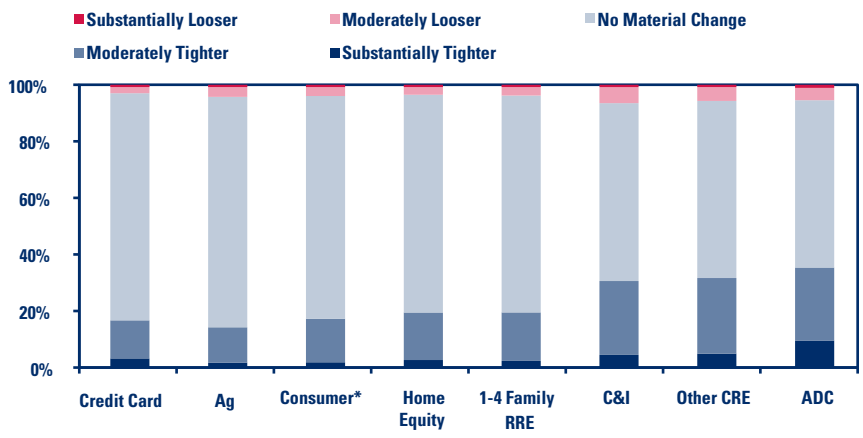
Another purpose of the Survey is to elicit examiners' views on whether the institution has tightened or loosened its underwriting standards since the last examination. This insight supplements assessments of the overall risk profile by identifying areas where credit risk may be increasing or decreasing. These results reinforce the results in the previous section that both the level and direction of credit risk industry-wide are generally decreasing (again, noting continued stress in some loan portfolios that are exposed to weak real estate markets).

For the examinations captured in the Survey during 2011, roughly 65 percent of respondents indicate there has been no material change in loan underwriting practices since the last examination. However, when examin-

ers did report a change in underwriting practices, a greater percentage of institutions were viewed as tightening rather than loosening their underwriting standards (see Chart 2 for data about changes in underwriting for the nine loan types). As reflected in Chart 3, the percentage of institutions that are tightening standards is higher for institutions assigned a less than satisfactory composite rating of "3," "4," or "5" under the Uniform Financial Institutions Rating System (UFIRS).[5] Similar to Survey findings in 2010, Surveys completed in 2011 indicate that more institutions tightened rather than loosened loan underwriting standards, most notably in the commercial-related portfolios (C&I, ADC, and other CRE). As of Spring 2012, informal observations from examiners and industry participants suggest that the ongoing trend toward tighter underwriting observed in 2010 and 2011 may be nearing an end. We will continue to monitor these trends.

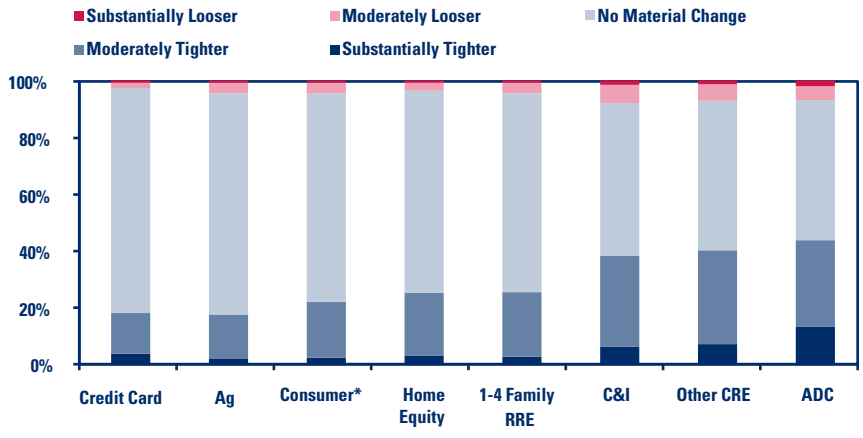
The primary factors influencing changes in underwriting practices are economic conditions, the financial condition of individual banks, and responses to regulatory observations. An institution that is financially stressed or operating in a market that is suffering economically often responds by tightening credit standards. A similar response occurs when a bank faces unfavorable regulatory findings, ratings, or enforcement actions.

Chart 2: Most Portfolios Reflect No Material Change in Underwriting



Source: FDIC Surveys as of December 31, 2011. *Excludes credit card.
Note: Percentage share of those banks that offer each loan product only.

Chart 3: Underwriting Being Tightened More Often at Institutions Rated Less Than Satisfactory



Source: FDIC Surveys as of December 31, 2011. *Excludes credit card.
Note: Percentage share of those banks that offer each loan product only.

[5] Under the UFIRS, each institution is assigned a composite CAMELS rating based on an evaluation and rating of the following component factors: adequacy of **C**apital, quality of **A**ssets, capability of **M**anagement, quality and level of **E**arnings, adequacy of **L**iquidity, and **S**ensitivity to market risk.

continued from pg. 19

Chart 4: Restructured Loan Volumes Continue to Climb

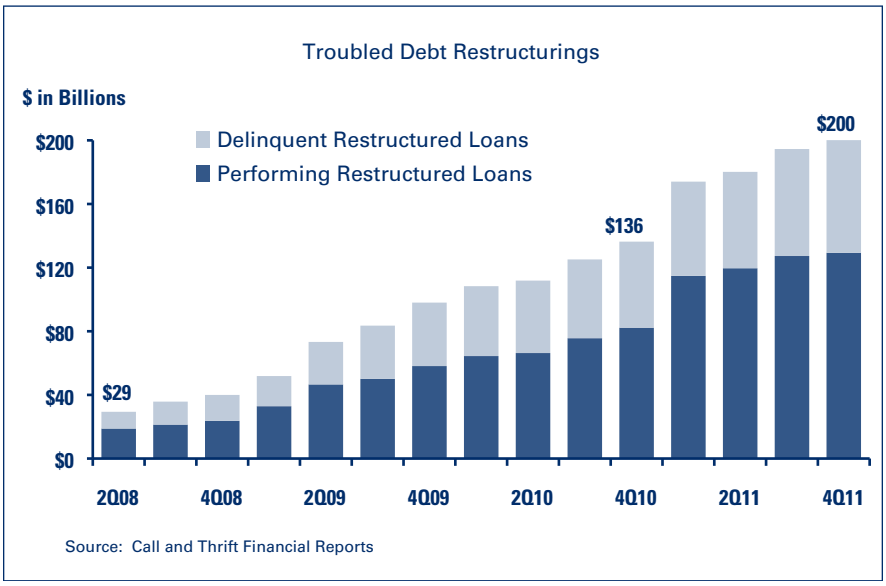
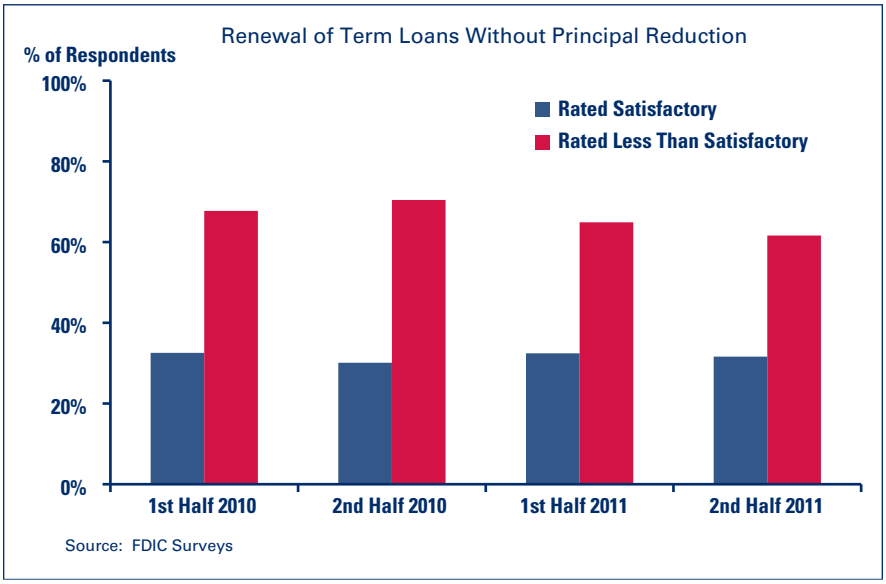


Chart 5: Banks Rated Less Than Satisfactory Tend to Renew More Term Loans without Material Reductions in Principal



Loan Workouts on the Rise

Increased use of loan workouts by insured depository institutions shows that lenders are actively working with borrowers who have been adversely affected by weak economic and real estate market conditions. Interagency supervisory guidance[6] encourages lenders to work with borrowers having difficulty making payments but who have the willingness and capacity to repay their debts. As reflected in Chart 4, greater use of workouts has resulted in an increase in the volume of troubled debt restructurings (as required by financial reporting standards), including past-due troubled debt restructurings, since the start of the economic downturn.

Similar to Survey findings in 2010, Surveys completed in 2011 found that when examiners had concerns with loan workouts, their concerns often focused on situations where loans were renewed without a material reduction in principal. For example, nearly half of the Survey respondents noted that lenders are renewing term loans without requiring a material principal reduction. For institutions with a less than satisfactory[7] UFIRS composite rating, the percentage is closer to 60 percent (see Chart 5).

When working with a troubled borrower, renewal of a term loan can in some instances be the best way to obtain recoveries for the lender. Interagency guidance states that the workout should be part of an overall

[6] FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts,* October 30, 2009. http://www.fdic.gov/news/news/financial/2009/fil09061.html.

[7] Less than satisfactory refers to a CAMELS composite rating of "3," "4," or "5."

repayment program. As discussed in the *Policy Statement on Prudent Commercial Real Estate Loan Workouts*[8] (*Policy Statement*), workouts including loan renewals are appropriate when used to improve the lender's prospects for repayment of principal and interest and are consistent with sound banking, supervisory, and accounting practices. The *Policy Statement* also emphasizes that in loan workout situations, the lender should develop a workout plan after analyzing the borrower's repayment capacity, evaluating the support provided by guarantors, and assessing the collateral pledged before granting a renewal.

Modest Recovery in Loan Growth

Aggregate loan balances for all insured institutions displayed a "boom-bust" pattern during the past decade. Outstanding loans grew steadily from 2001 to a peak in mid-2008, and then began to fall as a result of the financial crisis (see Chart 6).[9] Fueled by rapid expansion of the housing market, ADC loans along with residential mortgage loans were largely responsible for the rapid growth in loan balances from 2005 to 2008. Overall strength in the U.S. economy also led to expanded C&I loan balances during this period. The trend quickly reversed from late 2008 through 2010 as the collapse of the credit and housing markets halted residential mortgage originations and ADC lending. In particular, ADC loan balances have declined approximately 60 percent from the peak in first quarter 2008 due to a lack of new construction activity combined with write-downs and transfer of problem ADC loans to other real estate (ORE).

Banking industry data indicate a gradual turnaround in lending activity during the past several quarters.[10] Although a majority of insured depository institutions continued to report shrinking loan balances in their Call and Thrift Financial Reports during 2011, more than 40 percent expanded their loan portfolios. In contrast, during the three-year pre-crisis period of 2004 to 2006, approximately 80 percent of institutions were growing their loan portfolios.

Chart 6: Modest Recovery in Outstanding Loan Balances

Source: Call and Thrift Financial Reports *Refer to footnote 9 for details regarding 2010 data.

[8] See footnote 6.

[9] FASB Statements 166 and 167 resulted in the consolidation of large amounts of securitized loan balances back onto banks' balance sheets in the first quarter of 2010. Although the total amount consolidated cannot be precisely quantified, the industry would have reported a decline in loan balances for the quarter absent this change in accounting standards.

[10] FDIC. ***Quarterly Banking Profile***, Fourth Quarter 2011, http://www2.fdic.gov/qbp/2011dec/qbp.pdf.

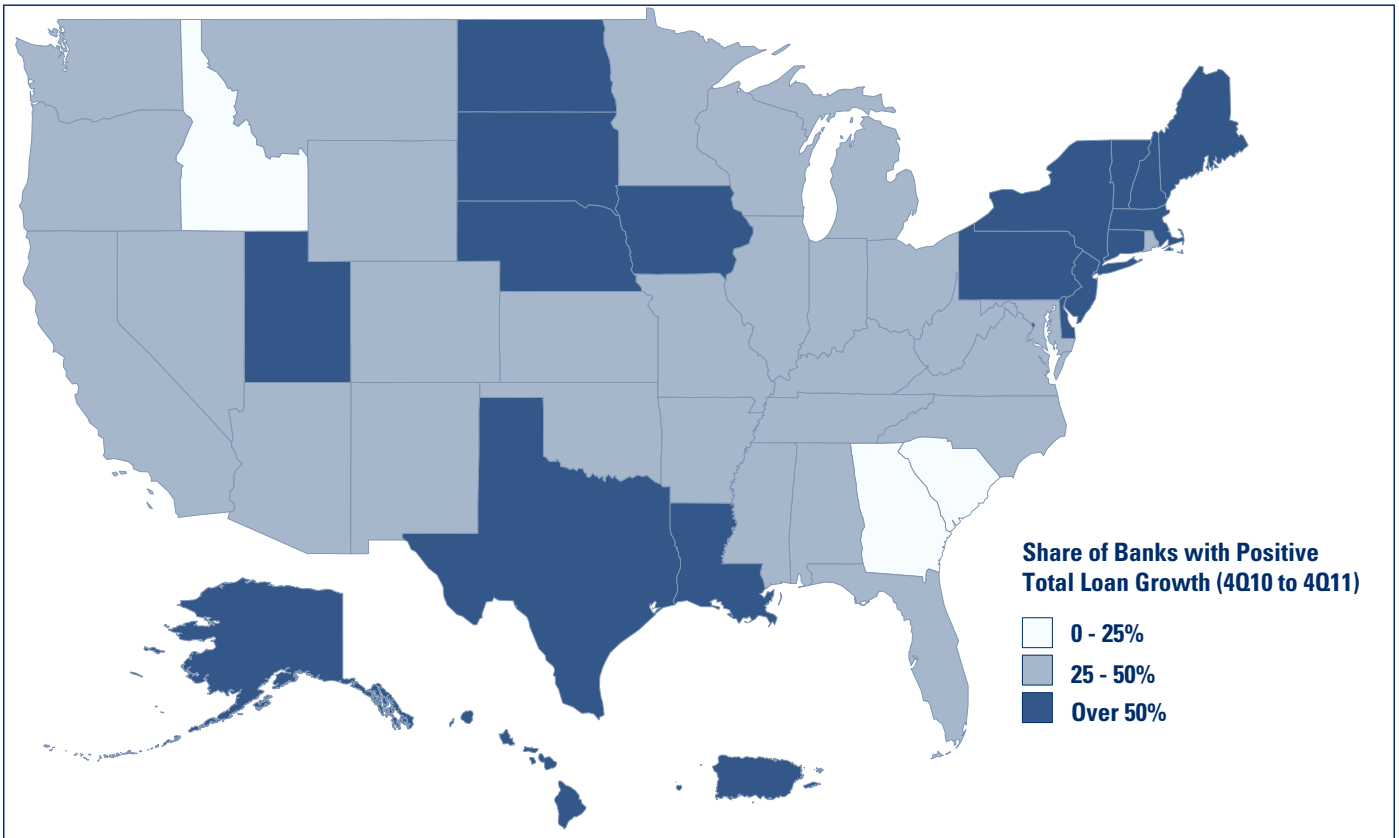
Credit and Consumer Products/Services Survey

continued from pg. 21

As reflected in the FDIC's fourth quarter 2011 *Quarterly Banking Profile*, C&I lending is largely responsible for recent aggregate loan growth. During 2011, C&I loans grew $161 billion, or nearly 14 percent, followed by growth in Other Loans of $55 billion or 21 percent. For some types of lending, growth did not occur until the second half of 2011. For example, although 1-4 family residential mortgage balances declined nearly $22 billion in 2011, they grew $49 billion or 2.7 percent during the last six months of the year. Consumer loans also expanded during the same period, up $18 billion or 1.4 percent.

Again, based on Call and Thrift Financial Report data, loan growth has a pronounced geographic component. Some sections of the country appear to be having more success with loan growth than other areas. During 2011, more than half the institutions in several energy-producing states, along with those in the Great Plains and Northeast, reported loan growth while the remaining states had less than 50 percent of their institutions expanding loan balances during the year (see Map 1).

Map 1: Percentage of Banks with Loan Growth in 2011 Varies by State



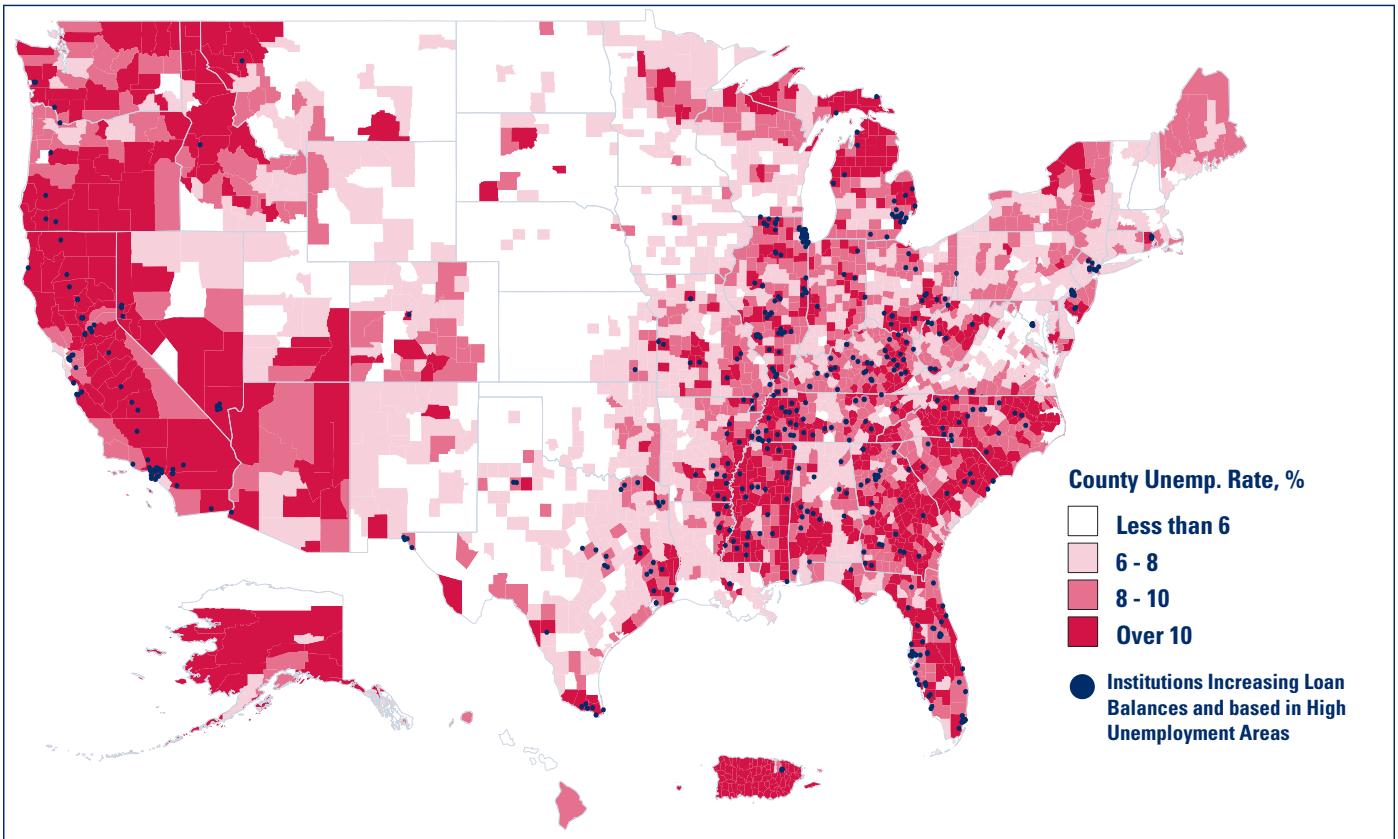
Source: FDIC; Merger-adjusted loan growth data.

Overall Survey findings indicate that most institutions materially growing their portfolios are doing so in a prudent manner. Specifically, for banks generating loan growth of at least 10 percent during 2011, the associated risk was characterized by Survey respondents as "high" at only 5 percent of the institutions. Examiners characterized the risk as "low" in approximately one-third of the Surveys and "medium" in more than 40 percent of the Surveys. The remaining institutions had not made significant changes in lending activity since the previous examination.

Factors Affecting Lending Activity

As noted earlier in this article, economic conditions tend to have the greatest impact on lending activity, both for commercial- and consumer-related lending. We have witnessed the effect of the recent economic crisis on loan portfolios, particularly ADC portfolios, as they declined substantially at many banks from 2008 to 2010. As the Survey results from 2010 and 2011 indicate, when underwriting practices for C&I, CRE,

Map 2: Some Banks Are Increasing Lending in Markets with High Unemployment



Source: Bureau of Labor Statistics, FDIC. Unemployment data are non-seasonally adjusted data as of December 2011. Merger-adjusted loan growth data.

continued from pg. 23

and ADC lending were adjusted, the changes were made in response to economic conditions at approximately one-third of the institutions, while about one-fifth of the institutions modified their residential mortgage and consumer lending practices.

As expected, loan growth is most commonly found at institutions operating in markets that are growing economically. However, one possible indicator of a broader recovery in lending is that some banks currently operating in markets experiencing weak economic conditions are also expanding their loan portfolios. For example, there are banks reporting loan growth in areas that have high levels of unemployment. Specifically, more than one-third of banks headquartered in counties with a December 2011 unemployment rate of at least 10 percent grew loan balances during 2011. As illustrated in Map 2 on page 23, these institutions have been generating loan growth in many distressed markets, including states such as Florida, Georgia, Michigan, and California. For the most part, these banks have been growing their CRE, C&I, and/or residential mortgage portfolios using various methods including in-market originations, bank/branch acquisitions, and hiring established lenders who bring loan relationships with them. Survey results indicate that few of these institutions are using out-of-area lending to generate loan growth.

A weakened financial condition characterized by shrinking capital, poor earnings, tight liquidity, and elevated level of problem assets also is a significant obstacle to some financial institutions' efforts to lend. Approximately 16 percent of Surveys completed during 2010 and 2011 reported that as a result of a change in financial condition, lending activity was modified through C&I, CRE, and ADC underwriting changes.

And finally, examination findings, UFIRS ratings, and enforcement actions also may prompt changes in an institution's underwriting practices, although such situations tend to be closely associated with institutions whose financial condition is deteriorating. For those banks with a less than satisfactory CAMELS composite rating of "3," "4," or "5," approximately 29 percent of Surveys completed in 2011 indicate that lending activity was modified through changes to C&I, CRE, and ADC underwriting practices in response to bank regulatory findings/actions. This percentage is closer to 13 percent for banks satisfactorily rated "1" or "2."

Conclusion

Survey results from 2010 and 2011 indicate that insured institutions were generally reducing their credit risk profiles, especially in their ADC, C&I, and CRE portfolios, and that a greater number of institutions were tightening rather than loosening underwriting practices. However, recent informal observations from examiners and industry participants suggest that the trend toward tighter loan underwriting may be nearing an end. We will continue to review and analyze Survey results to see if the trend in 2010 and 2011 has begun to shift toward a greater number of institutions easing their credit standards.

Lenders also are addressing credit risk through increased use of loan workouts for distressed borrowers. Supervisory guidance encourages prudent workouts as a way for lenders to work with borrowers. In some instances, however, examiners have had a concern with banks that are addressing problem term loans through renewals without material principal reduction or a plan for repayment.

Against a backdrop of generally more prudent loan underwriting, overall lending activity increased slightly during 2011. Although more than half the insured institutions reported a decline in loan balances for the year, a substantial number grew their loan portfolios. Led by an increase in C&I lending, there is evidence of loan growth in many markets across the country, including some areas hardest hit by the financial downturn. The same factors - economic conditions, financial health of the institution, and responses to regulatory observations - appear to have influenced changes in underwriting as well as overall lending activity at most institutions captured in the Survey during 2011.

Analysis of results from the *Credit and Consumer Products/Services Survey*, in tandem with other financial and economic data, will enable the FDIC to continue effective monitoring of the overall financial condition of insured financial institutions, particularly changes in their lending activity and credit risk profiles.

Jeffrey A. Forbes
Senior Examination Specialist
jforbes@fdic.gov

Margaret M. Hanrahan
Senior Examination Specialist
mhanrahan@fdic.gov

Andrea N. Plante
Senior Quantitative Risk Analyst
aplante@fdic.gov

Paul S. Vigil
Senior Management Analyst
pvigil@fdic.gov

Accounting News: Troubled Debt Restructurings

This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to SupervisoryJournal@fdic.gov.

Over the last several years, many parts of the United States experienced declining real estate values and high rates of unemployment. This economic environment has rendered some borrowers unable to repay their debt according to the original terms of their loans. Interagency guidance encourages bankers to work with borrowers who may be facing financial difficulties.[1] Prudent loan modifications are often in the best interest of financial institutions and borrowers, and in fact many financial institutions are restructuring or modifying loan terms to provide payment relief for borrowers whose financial condition has deteriorated. These loan modifications may meet the definition of a troubled debt restructuring (TDR) found in the accounting standards.

FDIC examiners and supervisors frequently receive questions from bankers about TDRs. Often the answers to these questions can be found in the framework for TDRs established by the accounting standards, a framework which governs the identification of TDRs, the impairment analysis that banks must perform, and the required disclosures. Other important guidance is found in the banking agencies' published instructions for the Consolidated Reports of Condition and Income (Call Report) and selected policy statements of the federal banking agencies. This article summarizes and distills the aspects of these standards and guidance that are most relevant to identifying and accounting for TDRs and complying with the associated regulatory reporting requirements.[2]

Accounting Guidance

A modification of the terms of a loan is a TDR when a borrower is troubled (i.e., experiencing financial difficulties) and a financial institution grants a concession to the borrower that it would not otherwise consider. The following discussion will focus on the generally accepted accounting principles (GAAP) that provide relevant guidance for the financial reporting of TDRs. The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 310 provides the basis for identifying TDRs and treating TDRs as impaired loans when estimating allocations to the allowance for loan and lease losses (ALLL).[3] In this regard, ASC

[1] FIL-35-2007, *Statement on Working with Mortgage Borrowers*, April 17, 2007, www.fdic.gov/news/news/financial/2007/fil07035.html; FIL-128-2008, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, November 12, 2008, www.fdic.gov/news/news/financial/2008/fil08128.html; FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, www.fdic.gov/news/news/financial/2009/fil09061.html; and FIL-5-2010, *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers*, February 12, 2010, www.fdic.gov/news/news/financial/2010/fil10005.html.

[2] Additional guidance on accounting for TDRs is included in the transcript from the FDIC's Seminar on Commercial Real Estate Loan Workouts and Related Accounting Issues, December 15, 2011, www.fdic.gov/news/conferences/2011-12-15-transcript.html.

[3] ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*), and ASC Subtopic 310-10, Receivables – Overall (formerly Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*), respectively.

Subtopic 310-40 addresses receivables that are TDRs from the lending institution's standpoint. Other GAAP guidance addresses the accounting for TDRs from the borrower's standpoint, a discussion of which is beyond the scope of this article.[4] Finally, this article incorporates the new guidance in the FASB's Accounting Standards Update No. 2011-02 (ASU 2011-02) that, among other clarifications of TDR issues, discusses whether a delay in payment as part of a loan modification is insignificant.[5] These resources along with complementary regulatory guidance provide the foundation for discussing TDRs.

Identification of a TDR

A TDR involves a troubled borrower and a concession by the creditor. ASU 2011-02 identifies several indicators a creditor must consider in determining whether a borrower is experiencing financial difficulties. These indicators include, for example, whether the borrower is currently in payment default on any of its debt and whether it is probable the borrower would be in payment default on any debts in the foreseeable future without the modification. Thus, a borrower does not have to be in payment default at the time of the modification to be experiencing financial difficulties. Types of loan modifications that may be concessions that result in a TDR include, but are not limited to:

- A reduction of the stated interest rate for the remaining original life of the debt,
- An extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk,
- A reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement, or
- A reduction of accrued interest.

The lending institution's concession to a troubled borrower may include a restructuring of the loan terms to alleviate the burden of the borrower's near-term cash requirements, such as a modification of terms to reduce or defer cash payments to help the borrower attempt to improve its financial condition. An institution may restructure a loan to a borrower experiencing financial difficulties at a contractual interest rate below a current market interest rate, which normally is considered to be a concession resulting in a TDR. However, a change in the interest rate on a loan does not necessarily mean that the modification is a TDR. For example, an institution may lower the interest rate to maintain a relationship with a borrower that can readily obtain funds from other sources. In this scenario, extending or renewing the borrower's loan at the current market interest rate for new debt with similar risk is not a TDR. To be designated a TDR, both borrower financial difficulties and a lender concession must be present at the time of restructuring.

Determining whether a modification is at a current market rate of interest at the time of the restructuring can be challenging. The following scenarios

[4] ASC Subtopic 470-60, Debt – Troubled Debt Restructurings by Debtors (formerly Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*).

[5] Accounting Standards Update No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring.*

continued from pg. 27

regarding interest rates on modified loans are often encountered:

- *Rate for a troubled versus nontroubled borrower* – The stated interest rate charged to a troubled borrower in a loan restructuring may be greater than or equal to interest rates available in the marketplace for similar types of new loans to nontroubled borrowers at the time of the restructuring. Some institutions have concluded these restructurings are not TDRs, which may not be the case. These institutions may not have considered all the facts and circumstances – other than the interest rate – associated with the loan modification. An interest rate on a modified loan greater than or equal to those available in the marketplace for similar new loans to nontroubled borrowers does not preclude a modification from being designated as a TDR when the borrower is troubled.
- *Market rate for a troubled borrower* – Generally, the contractual interest rate on a modified loan is a current market interest rate if the restructuring agreement specifies an interest rate greater than or equal to the rate the institution was willing to accept at the time of the restructuring for a new loan with comparable risk, i.e., comparable to the risk on the modified loan. The contractual interest rate on a modified loan is not a market interest rate simply because the interest rate charged under the restructuring agreement has not been reduced.
- *Below-market rate* – According to ASU 2011-02, if a borrower does not have access to funds at a market interest rate for debt with similar risk characteristics as the restructured debt, the rate on the modified loan is considered a below-market rate and may indicate the institution has granted a concession to the borrower.
- *Increased rate* – When a modification results in either a temporary or permanent increase in the contractual interest rate, the increased interest rate does not preclude the modification from being considered a concession. As noted in ASU 2011-02, the new contractual rate on the modified loan could still be a below market interest rate for new debt with similar risk characteristics.

When evaluating a loan modification to a borrower experiencing financial difficulties, all relevant facts and circumstances must be considered in determining whether the institution has made a concession to the troubled borrower with respect to the market interest rate or has made some other type of concession that could trigger TDR accounting and disclosure. This determination requires the use of judgment and should include an analysis of credit history and scores, loan-to-value ratios or other collateral protection, the borrower's ability to generate cash flow sufficient to meet the repayment terms, and other factors normally considered when underwriting and pricing loans. If the terms or conditions related to a restructured loan to a borrower experiencing financial difficulties are outside the institution's policies or common market practices, then the restructuring may be a TDR. Financial institutions must exercise judgment and carefully document their conclusions about market interest rates and other terms and conditions under restructuring agreements and whether the restructurings are TDRs.

A modification of a loan to a borrower experiencing financial difficulties involving only a delay in payment also needs to be evaluated for TDR status. According to ASU 2011-02, lenders

must consider many factors, including, but not limited to the following:

- 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 of the loan, and
- the original expected duration of the loan.

If an institution determines that a restructuring results in only a delay in payment that is insignificant, then the institution has not granted a concession to the borrower. This determination may lead to the conclusion that a particular modification to a troubled borrower is not a TDR.

Impairment

All held-for-investment loans whose terms have been modified in a TDR are impaired loans that must be measured for impairment under ASC Subtopic 310-10. This guidance applies even if the loan that has undergone a TDR is not otherwise individually evaluated for impairment under ASC Subtopic 310-10, as in the case of residential mortgages and other smaller-balance homogeneous loans that are collectively evaluated for impairment. ASC Subtopic 310-10 specifies that an institution should measure impairment (and, hence, the amount of any allocation to the ALLL for an impaired loan) based on:

- the present value of expected future cash flows discounted at the loan's effective interest rate,
- the loan's observable market price, or
- the fair value of the collateral if the loan is collateral dependent.

The fair value of collateral and present value of expected future cash flows methods warrant further discussion. When an impaired loan is collateral dependent, the banking agencies' regulatory reporting guidance requires that the fair value of collateral method be used to measure impairment.[6] In contrast, the fair value of collateral method may not be used when an impaired loan is not collateral dependent, even if the loan is collateralized. An impaired loan, including a TDR, is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. According to ASC Subtopic 310-10, if an institution uses the fair value of the collateral to measure impairment of an impaired collateral dependent loan, and repayment or satisfaction of the loan is dependent only on the operation, rather than the sale, of the collateral, estimated costs to sell should not be incorporated into the impairment measurement. In contrast, an institution should adjust the fair value of the collateral to consider estimated costs to sell when measuring the impairment of an impaired collateral dependent loan if repayment or satisfaction of the loan is dependent on the sale of the collateral. According to the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, any portion of the recorded investment in an impaired collateral dependent loan in excess of the fair value of the collateral (less estimated costs to sell, if appropriate) that can be identified as uncollectible (i.e., a confirmed loss) should be promptly charged off against

[6] GAAP permits impairment on an impaired collateral dependent loan to be measured based on the fair value of the collateral, but requires the use of this impairment measurement method only when foreclosure is probable.

continued from pg. 29

Fair Value of Collateral Method
Questions and Answers

Q) Is the definition of collateral dependent for regulatory reporting purposes the same as under GAAP, which includes loans for which the cash flow from the operation of the collateral is the only source of repayment? Or is a loan collateral dependent only when repayment is dependent on the sale of the collateral?

A) Collateral dependent is defined in ASC Subtopic 310-10, which is the same definition used in the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses:* A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral.[7] The instructions for the Call Report elaborate on this definition, noting that it applies to situations where there are no other available and reliable sources of repayment other than the underlying collateral. Thus, the definition of collateral dependent includes cases where repayment of the loan is dependent on the sale of the collateral as well as cases where repayment is dependent only on the operation of the collateral.

Q) Impairment measurement on an impaired collateral dependent loan for which repayment is dependent only on the operation of the collateral should not reflect costs to sell. What is the reference for this guidance?

A) FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, was the original source. This guidance is now in ASC paragraph 310-10-35-23, which states "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 the collateral."

Q) When is an allocation to the ALLL appropriate for a collateral dependent TDR and when is a charge-off needed?

A) The December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* and the Glossary section of the Call Report instructions provide guidance on measuring impairment relevant to TDRs. Each institution must maintain an ALLL at a level appropriate to cover estimated credit losses associated with the loan and lease portfolio in accordance with GAAP.[8] Additions to, or reductions of, the ALLL are to be made through charges or credits to the "provision for loan and lease losses" in the Call Report income statement.[9] When available information confirms that specific loans or portions thereof are uncollectible, including loans that are TDRs, these amounts should be promptly charged off against the ALLL.[10]

[7] FIL-105-2006, *Allowance for Loan and Lease Losses Revised Policy Statement and Frequently Asked Questions*, December 13, 2006, www.fdic.gov/news/news/financial/2006/fil06105.html.

[8] Ibid.

[9] *Instructions for the Preparation of Consolidated Reports of Condition and Income*, Glossary, "Allowance for Loan and Lease Losses," page A-3 (9-10), http://www.fdic.gov/regulations/resources/call/crinst/2012-03/312Gloss_033112.pdf.

[10] Furthermore, the *Uniform Retail Credit Classification and Account Management Policy* calls for charge-offs of retail loans, including TDRs, in certain circumstances. See FIL-40-2000, June 29, 2000, www.fdic.gov/news/news/financial/2000/fil0040.html.

For an individually evaluated impaired collateral dependent loan, including a TDR, the banking agencies require that impairment be measured using the fair value of collateral method in ASC Subtopic 310-10. In this situation, as discussed in the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, if the recorded amount of the loan exceeds the fair value of the collateral (less costs to sell if repayment of the loan is dependent on the sale of the collateral), this excess represents the measurement of impairment on the loan and is the amount to be included for this loan in the overall ALLL. However, determining the portion of this difference that represents a confirmed loss, if any, which should be charged against the ALLL in a timely manner, is based on whether repayment is dependent on the sale or only on the operation of the collateral.[11]

Q) Are institutions required to evaluate impairment using the present value of expected future cash flows method when an impaired loan, including a TDR, is not collateral dependent? Can an institution use the fair value of collateral method to measure impairment on an impaired non-collateral dependent loan?

A) A TDR is not collateral dependent when there are available and reliable sources of repayment other than the sale or operation of the collateral. ASC Subtopic 310-10 acknowledges that a loan's observable market price may be used as a practical expedient to measure impairment. However, such a price is not usually available for individual impaired loans, including TDRs. Therefore, the present value of expected future cash flows method normally would be used when a TDR is not collateral dependent.

The fair value of collateral method may only be used when an impaired loan, including a TDR, is collateral dependent. It would be inappropriate under GAAP to measure impairment using the fair value of collateral method when an impaired loan or TDR is not collateral dependent.

the ALLL.[12] Institutions must apply the fair value of collateral method appropriately to TDRs.

With regard to the present value of cash flows method, an institution's estimate of the expected future cash flows on a TDR should be its best estimate based on reasonable and supportable assumptions (including default and prepayment assumptions) and projections. GAAP also specifies the effective interest rate to be used for discounting. Under ASC Subtopic 310-10, when measuring impairment on a TDR using the present value of expected future cash flows method, the cash flows should be discounted at the effective interest rate of the original loan, not the rate after the restructuring. For a restructured residential mortgage loan that originally had a "teaser" or starter rate less than the loan's fully indexed rate, the starter rate is not the original effective interest rate. In this case, the effective interest rate should be a blend of the "teaser" rate and the fully indexed rate. If the results are not materially different from using the blended rate, the fully indexed rate may be used as the effective interest rate. Using the proper effective interest rate is critical to allocating the appropriate amount to the ALLL when measuring impairment on a TDR under the present value method.

[11] FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, www.fdic.gov/news/news/financial/2009/fil09061.html.

[12] FIL-105-2006, *Allowance for Loan and Lease Losses Revised Policy Statement and Frequently Asked Questions*, December 13, 2006, www.fdic.gov/news/news/financial/2006/fil06105.html.

continued from pg. 31

Applying the Appropriate Impairment Measurement Method

Example 1: Discounted Cash Flow Method

FACTS: A banker makes a commercial loan to a small wholesale business, which has a market interest rate at origination. The loan matures in five years and is secured by a first lien on the business's warehouse.

- After 24 months, the local economy has weakened, adversely affecting the borrower's wholesale business. The borrower has fallen delinquent on several loans including this commercial loan, which is 90 days past due. After carefully analyzing the borrower's personal and business financial statements and credit reports, the banker determines that it is likely the borrower's business will be able to generate only enough cash flow to partially service this commercial loan. The borrower plans to operate the business for five more years and expects economic conditions to improve by the end of this period, enabling the borrower to sell the business at that time, including remaining inventory and the warehouse.
- The banker decides to restructure the remaining principal balance of this commercial loan to mature in five years. Based on the borrower's expected cash flows from the business, the banker lowers the contractual interest rate to a below market rate (i.e., to an interest rate that is less than the rate the banker would charge at the time of the restructuring for a new loan with comparable risk). The required monthly payments are reduced, with these payments expected to come from business operations. A balloon payment is scheduled at the end of five years.
- Based on reasonable and supportable assumptions and projections, which take default probability into account, the banker develops an estimate of the expected monthly cash flows over the five year loan term. The banker also concludes that the current "as is" appraised value of the warehouse is not likely to increase over this period. Considering the borrower's current inventory levels and other information, the banker estimates that the sale of the borrower's warehouse and other available business assets at the end of five years would generate additional funds to satisfy the debt.
- Considering all available evidence, including the borrower's current financial difficulties, the banker's best estimate is that 90 percent of the contractual loan payments under the modified terms will be collected.

IMPAIRMENT MEASUREMENT METHOD: This restructured commercial loan is a TDR subject to impairment measurement in accordance with ASC Subtopic 310-10. Because the available and reliable sources of repayment include cash flow from the borrower's business operations, this commercial loan is not collateral dependent. The banker will use the discounted cash flow method to determine the impairment amount.[13]

[13] The commercial loan does not have an observable market price.

Example 2: Fair Value of Collateral Method

FACTS: A banker makes a commercial real estate loan, the collateral for which is an apartment building. The collateral at origination has normal occupancy and rental rates and its value provides sufficient collateral coverage.

- The borrower subsequently experiences financial difficulties. The banker obtains a current appraisal, which shows that the prospective "as stabilized" and the "as is" market values have declined in comparison to market values in the original appraisal as a result of a significantly increased vacancy rate and a decline in rental rates. The banker has reviewed the current appraisal and found the assumptions and conclusions to be reasonable.
- The banker also concludes that the current "as is" market value conclusion is an appropriate estimate of the fair value of the collateral for financial reporting purposes.
- Available evidence indicates that the local economy is beginning to improve. Thus, the banker reasonably expects that the property will reach the current appraisal's prospective "as stabilized" value within two years.
- The borrower has no other assets and his ability to service the debt from other sources is nonexistent.
- After a thorough analysis of the borrower's financial condition and the operating statements for the apartment building, the banker concludes that the loan can be repaid only through the operation of the collateral. Liquidation of the collateral is not anticipated.
- The banker determines that a prudent loan workout would be in the best interest of the bank and the borrower. In order to recover as much of the loan as reasonably possible, the banker negotiates reduced monthly payments that the cash flow from the apartment building is expected to be sufficient to service at an interest rate below a current market interest rate for a new loan with comparable risk.

IMPAIRMENT MEASUREMENT METHOD: This restructured commercial real estate loan is a TDR subject to impairment measurement in accordance with ASC Subtopic 310-10. This commercial real estate loan is collateral dependent. The banker must use the fair value of collateral method to determine the impairment amount. Only the operation of the collateral is expected to repay this loan; therefore, the measurement of impairment shall not incorporate estimated costs to sell the collateral.

continued from pg. 33

Example 3: Fair Value of Collateral Method

FACTS: Same as Example 2 except that a thorough analysis of the borrower's financial condition, the operating statements for the apartment building, and the borrower's inability to increase rental rates, leads the banker to conclude that the apartment building provides insufficient collateral coverage. Local economic conditions are not expected to improve in the near term and the banker is not confident that the current appraisal's "as stabilized" market value can be achieved within a reasonable time period.

- As a consequence, the banker determines that repayment of the loan is dependent on the liquidation of the collateral by the borrower or by the bank through foreclosure. As an interim measure to recognize the apartment building's reduced cash flow until collateral liquidation, the banker modifies the loan terms to lower the monthly payments at an interest rate below a current market interest rate for a new loan with comparable risk.
- Under either scenario, the banker has determined that the well supported current appraisal's "as is" market value conclusion is an appropriate estimate of the fair value of the collateral.
- Costs to sell the property are estimated.

IMPAIRMENT MEASUREMENT METHOD: This restructured commercial real estate loan is a TDR subject to impairment measurement in accordance with ASC Subtopic 310-10. This commercial real estate loan is collateral dependent. The banker must use the fair value of collateral method to determine the impairment amount. Liquidation of the collateral is expected to repay this loan; therefore, the measurement of impairment must incorporate estimated costs to sell the collateral.

The appropriate impairment measurement method, determined as discussed above, is applied to TDRs and other impaired loans on a loan-by-loan basis. However, ASC Subtopic 310-10 permits an institution to aggregate impaired loans that share risk characteristics in common with other impaired loans. For example, modified residential mortgage loans that represent TDRs and have common risk characteristics may be aggregated for impairment measurement purposes. In this scenario, an institution uses historical statistics along with a composite effective interest rate to measure impairment of this pool of impaired loans. Institutions may aggregate TDRs to measure impairment in accordance with GAAP and regulatory guidance.

Accrual Status

The Glossary section of the Call Report instructions provides guidance for nonaccrual status, which is consistent with GAAP and applies to loans that have undergone TDRs. The general rule is that institutions shall not accrue interest on any loan:

- which is maintained on a cash basis because of deterioration in the financial condition of the borrower,
- for which payment in full of principal or interest is not expected, or
- upon which principal or interest has been in default for a period of 90 days or more unless the loan is both "well secured" and "in the process of collection."[14]

Assuming the accrual of interest has not already been discontinued on a loan undergoing a TDR, this Call Report general rule should be considered when evaluating whether the loan should be placed in nonaccrual status.

However, the general rule need not be applied to consumer loans and loans secured by one-to-four family residential properties on which principal or interest is due and unpaid for at least 90 days. If not placed in nonaccrual status, these loans should be subject to alternative methods of evaluation to assure the institution's net income is not materially overstated. When such consumer and residential loans are treated as nonaccrual by the institution, these loans must be reported as nonaccrual in the Call Report. The exception from the general rule for nonaccrual status and related guidance also apply to consumer and residential loans that are TDRs.

- A loan is "well secured" if it is secured by collateral in the form of liens on or pledges of real or personal property, including securities, with a realizable value sufficient to discharge the debt (including accrued interest) in full, or by the guarantee of a financially responsible party.
- A loan is "in the process of collection" if collection of the loan is proceeding in due course through either legal action or other collection efforts which are reasonably expected to result in repayment of the loan or in its restoration to a current status in the near future.[15]

[14] *Instructions for the Preparation of Consolidated Reports of Condition and Income*, Glossary, "Nonaccrual Status," page A-59 (9-10), http://www.fdic.gov/regulations/resources/call/crinst/2012-03/312Gloss_033112.pdf.

[15] Ibid.

continued from pg. 35

A nonaccrual loan may be restored to accrual status:

- when none of its principal and interest is due and unpaid, and the institution expects repayment of the remaining contractual principal and interest, or
- when it becomes "well secured" and "in the process of collection" as previously defined.

With regard to satisfying the first parameter, the institution must have received repayment of the past-due principal and interest unless the loan has been formally restructured in a TDR and qualifies for accrual status. Thus, a nonaccrual loan that has been formally restructured and is reasonably assured of repayment (of principal and interest) and performance according to the modified terms may be returned to accrual status even though amounts past due under the original contractual terms have not been repaid. In this scenario, the restructuring and any charge-off taken on the loan must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. Otherwise, the restructured loan must remain in nonaccrual status. The credit evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period before the date the loan is returned to accrual status. A sustained period of repayment performance is generally a minimum of six months and involves payments of cash or cash equivalents. In returning a nonaccrual TDR to accrual status, sustained historical repayment performance for a reasonable time before the restructuring may be considered. Such a restructuring must improve the collectability of the loan in accordance with a reasonable repayment schedule and does not relieve the institution from the responsibility to promptly charge off identified losses. Returning a nonaccrual TDR to accrual status must be carefully documented and supported.

The structure of a modified loan that is a TDR may influence whether the loan is reported in nonaccrual or accrual status. A formal restructuring may involve a multiple note structure in which a troubled loan is divided into two notes. In accordance with the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*[16] and the Call Report instructions, institutions may separate the portion of an outstanding troubled loan into a new legally enforceable note (i.e., the first note) that is reasonably assured of repayment (of principal and interest) and performance according to prudently modified terms. The second note represents the portion of the original loan that is unlikely to be collected and has been charged off at or before the restructuring. The first note may be placed in accrual status provided the conditions in the preceding paragraph are met and the restructuring has economic substance and qualifies as a TDR under GAAP.

In contrast, a loan that undergoes a TDR should remain or be placed in nonaccrual status if the modification does not include the splitting of the troubled loan into multiple notes, but the institution instead internally

[16] FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, www.fdic.gov/news/news/financial/2009/fil09061.html.

recognizes a partial charge-off for the identified loss on the loan before or at the time of its restructuring as a single note. A partial charge-off would indicate the institution does not expect full repayment of the amounts contractually due under the loan's original terms. After the restructuring, the remaining balance of the TDR may be returned to accrual status without having to first recover the charged-off amount if the conditions for returning a nonaccrual TDR to accrual status discussed above are met. The charged-off amount may not be reversed or re-booked when the loan is returned to accrual status.

If a loan appropriately in accrual status has its terms modified in a TDR, the loan may not meet the criteria for placement in nonaccrual status at the time of the restructuring. The TDR can remain in accrual status provided the borrower's sustained historical repayment performance for a reasonable time prior to the TDR (generally a minimum of six months) is consistent with the loan's modified terms and the loan is reasonably assured of repayment (of principal and interest) and of performance in accordance with its modified terms. This determination must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms.

Income on nonaccrual TDRs should be reported in accordance with the Call Report instructions and GAAP. For a nonaccrual TDR, some or all of the cash interest payments received may be recognized as interest income on a cash basis provided the remaining recorded investment in the loan (i.e., after charge-off of identified losses, if any) is deemed fully collectible. If a nonaccrual TDR that has been returned to accrual status subsequently meets the criteria for placement in nonaccrual status as a result of past-due payments based on its modified terms or for any other reason, the TDR must again be placed in nonaccrual status.

Regulatory Reporting

Properly applying the accounting and Call Report requirements for TDRs provides useful financial information about the quality of the loan portfolio and an institution's efforts to work with troubled borrowers. Two Call Report schedules specifically disclose information on TDRs by loan category:

- Schedule RC-C, Part I, "Loans and Leases," Memorandum item 1, if the TDR is in compliance with its modified terms, and
- Schedule RC-N, "Past Due and Nonaccrual Loans, Leases, and Other Assets," Memorandum item 1, if the TDR is not in compliance with its modified terms.

To be considered in compliance with its modified terms, a loan that is a TDR must be in accrual status and must be current or less than 30 days past due on its contractual principal and interest payments under the modified terms. A TDR that meets these conditions must be reported as a restructured loan in Schedule RC-C, Part I, Memorandum item 1. In the calendar year after the year in which

continued from pg. 37

the restructuring took place a TDR may be removed from being reported in this memorandum item if:

- the TDR is in compliance with its modified terms, and
- the restructuring agreement specifies an interest rate that at the time of the restructuring is greater than or equal to the rate that the bank was willing to accept for a new loan with comparable risk, i.e., a market interest rate.[17]

When a loan has been restructured in a TDR, it continues to be considered a TDR for purposes of measuring impairment until paid in full or otherwise settled, sold, or charged off, even if disclosure of the loan as a TDR is no longer required. The loan remains an impaired loan for accounting purposes because impairment is evaluated in relation to the contractual terms specified by the original loan agreement, not the restructured terms. Thus, the impairment measurement requirements for impaired loans in ASC Subtopic 310-10, discussed above, continue to be applicable for all TDRs, even if they are no longer subject to disclosure as TDRs.

Conclusion

Regulators support institutions proactively working with borrowers in the current economic environment to restructure loans with reasonable modified terms and expect these modifications to be properly reflected in Call Reports. Although borrowers may experience deterioration in their financial condition and other challenges, many continue to be creditworthy customers with the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work together to improve the borrower's repayment prospects. Accurate Call Reports allow regulators and the public to monitor the extent and status of modifications that represent TDRs.

Shannon M. Beattie, CPA
Regional Accountant, New York Region
sbeattie@fdic.gov

The author acknowledges the valuable contributions of Robert F. Storch, CPA, Chief Accountant and Robert B. Coleman, CPA, Regional Accountant to the writing of this article.

[17] *Instructions for the Preparation of Consolidated Reports of Condition and Income*, Schedule RC-C, Part I, "Loans and Leases," page RC-C-21 (3-11), www.fdic.gov/regulations/resources/call/crinst/2011-09/911RC-C1_093011.pdf.

Overview of Selected Regulations and Supervisory Guidance

This section provides an overview of recently released regulations and supervisory guidance, arranged in reverse chronological order. Press Release (PR) and Financial Institution Letter (FIL) designations are included so the reader can obtain more information.

ACRONYMS and DEFINITIONS	
CFPB	Consumer Financial Protection Bureau
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FRB	Federal Reserve Board
NCUA	National Credit Union Administration
OCC	Office of the Comptroller of the Currency
Federal bank regulatory agencies	FDIC, FRB, and OCC
Federal financial institution regulatory agencies	CFPB, FDIC, FRB, NCUA, and OCC

Subject	Summary
Agencies Clarify Supervisory Expectations for Stress Testing by Community Banks (PR-54-2012, May 14, 2012)	The federal bank regulatory agencies clarified that financial institutions with $10 billion or less in total assets are not required or expected to conduct enterprise-wide stress testing required of larger organizations. See http://www.fdic.gov/news/news/press/2012/pr12054.html
Agencies Finalize Large Bank Stress Testing Guidance (PR-53-2012, May 14, 2012)	The federal bank regulatory agencies issued final supervisory guidance regarding stress-testing practices at banking organizations with total consolidated assets of more than $10 billion. The guidance outlines general principles for a satisfactory stress-testing framework and describes various stress-testing approaches and how stress testing should be used at various levels within an organization. The guidance does not implement the stress-testing requirements in the *Dodd-Frank Wall Street Reform and Consumer Protection Act* or in the FRB's capital plan rule that apply to certain companies, as those requirements have been or are being implemented through separate proposals by the respective agencies. See http://www.fdic.gov/news/news/press/2012/pr12053.html
FDIC and SBA to Offer Financial Education Support for New and Aspiring Entrepreneurs (PR-44-2012, April 24, 2012)	The FDIC and U.S. Small Business Administration (SBA) released *Money Smart for Small Businesses*, a free training curriculum for new and aspiring business owners. The training provides an introduction to day-to-day business organization and planning and is written for entrepreneurs with limited or no formal business training. It offers practical information that can be applied immediately, while also preparing participants for more advanced training. See http://www.fdic.gov/news/news/press/2012/pr12044.html

Regulatory and Supervisory Roundup

continued from pg. 39

Subject	Summary
Volcker Rule Conformance Period Clarified (PR-41-2012, April 19, 2012)	The FRB announced a rule providing entities covered by Section 619 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* until July 21, 2014, to fully conform their activities and investments to the requirements of Section 619, unless that period is extended by the FRB Board. Section 619 generally requires banking entities to conform their activities and investments to the prohibitions and restrictions included in the statute on proprietary trading activities and on hedge fund and private equity fund activities and investments. See http://www.fdic.gov/news/news/press/2012/pr12041.html
FDIC Statement on Payments to Loan Originators Based on Mortgage Transaction Terms or Conditions (FIL-20-2012, April 17, 2012)	The FDIC issued a statement on CFPB Bulletin 2012-02 dated April 2, 2012, which provides additional guidance on permissible forms of compensation to loan originators under the Truth in Lending Act (Regulation Z's Compensation Rules). The Bulletin addresses whether and how the rules apply to qualified plans. FDIC-supervised institutions should ensure their policies and practices related to compensation programs are consistent with the rules and applicable CFPB guidance. FDIC compliance examiners will review institution compensation programs in light of these rules, and consider the specific facts of the institution's compensation program, the totality of the circumstances at each financial institution, and the institution's efforts to comply with the Compensation Rules. See http://www.fdic.gov/news/news/financial/2012/fil12020.html
Agencies Clarify Effective Date for Section 716 of the Dodd-Frank Act (PR-37-2012, March 30, 2012)	The federal bank regulatory agencies issued guidance clarifying that the effective date of Section 716, the Swaps Pushout provision of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, is July 16, 2013. Section 716 prohibits the provision of federal assistance (such as discount window lending and deposit insurance) to any entity defined under that Section to be a swaps entity. See http://www.fdic.gov/news/news/press/2012/pr12037.html
Agencies Propose Revisions to Leveraged Finance Guidance (PR-34-2012, March 26, 2012, *Federal Register*, Vol. 77, No. 62, p. 19417, March 30, 2012)	The federal bank regulatory agencies have proposed revisions to the interagency leveraged finance guidance issued in 2001. The proposed guidance outlines principles related to safe-and-sound leveraged lending activities. This proposed guidance would apply to all insured institutions substantively engaged in leveraged lending activities. The number of community banking organizations with substantial exposure to leveraged lending is very small; therefore, the agencies generally expect that community banking organizations largely would be unaffected by this guidance. Comments on the proposed guidance were due June 8, 2012. See http://www.fdic.gov/news/news/press/2012/pr12034.html

Subject	Summary
Proposed Rule on Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company (PR-30-2012, March 20, 2012, *Federal Register*, Vol. 77, No. 59, p. 18127, March 27, 2012)	The FDIC issued a Notice of Proposed Rulemaking which permits the FDIC, as receiver of a financial company whose failure would pose a significant risk to the financial stability of the United States, to enforce and prevent termination of the contracts of the institution's subsidiaries or affiliates. This proposal implements Section 210(c)(16) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*. Comments were due May 29, 2012. See http://www.fdic.gov/news/board/2012/2012-03-20_notice_no6.pdf
Proposed Revisions in Assessment Rate Definitions for Large and Highly Complex Institutions (FIL-15-2012, March 20, 2012, *Federal Register*, Vol. 77, No. 59, p. 18109, March 27, 2012)	The FDIC issued a Notice of Proposed Rulemaking which would amend and clarify some definitions related to higher-risk assets as used in the deposit insurance pricing scorecards for large and highly complex insured depository institutions. Comments were due May 29, 2012. See http://www.fdic.gov/news/news/financial/2012/fil12015.html
Guidelines Regarding the Copying and Removal of Confidential Financial Institution Information (FIL-14-2012, March 19, 2012)	The FDIC is reminding directors and officers that copying and removing financial institution and supervisory records from an institution in anticipation of litigation or enforcement activity against them personally is a breach of their fiduciary duty to the institution and an unsafe-and- unsound banking practice, which also may violate applicable laws and regulations and contravene the financial institution's information security program. Attorneys who represent an insured depository institution also are reminded that their fiduciary duty obligates them to act in the best interests of the institution. See http://www.fdic.gov/news/news/financial/2012/fil12014.html
Consolidated Reports of Condition and Income (Call Reports, FIL-10-2012, March 2, 2012)	The Call Report revisions implemented as of March 31, 2012, relate to the initial filing of Call Reports by savings associations as of that report date and also include certain instructional changes. The new data items to be added to the Call Report effective June 30, 2012, will help the banking agencies and state supervisors better understand institutions' risk exposures and address insurance assessment data needs. See http://www.fdic.gov/news/news/financial/2012/fil12010.html
FDIC Announces a Quick Guide for Consumers on Credit, Debit and Prepaid Cards (PR-27-2012, March 5, 2012)	The FDIC issued a guide to help consumers understand the differences among debit, credit, and prepaid cards as well as the applicable consumer protections. The guide is available at http://www.fdic.gov/consumers/consumer/information/ncpw/index.html. See http://www.fdic.gov/news/news/press/2012/pr12027.html

Regulatory and Supervisory Roundup

continued from pg. 41

Subject	Summary
Extension of Community Reinvestment Act (CRA) Consideration for Gulf Coast Disaster Area (FIL-9-2012, February 22, 2012)	The areas designated major disaster areas by the Federal Emergency Management Agency in 2005 following Hurricanes Katrina and Rita continue to demonstrate significant revitalization and recovery needs. To support community development, the federal banking agencies are extending CRA consideration for community development loans, investments, and services that help revitalize or stabilize those disaster areas through 2014. See http://www.fdic.gov/news/news/financial/2012/fil12009.html
FDIC Announces Series of Teleconferences Providing Information and Insights Regarding Compliance and Consumer Protection (FIL-6-2012, February 2, 2012)	The FDIC is holding teleconferences during 2012 to maintain communication, provide transparency, and update FDIC-supervised institutions on compliance and consumer protection-related rulemakings, guidance, and emerging issues. The first teleconference was held on February 21 and discussed the Truth in Lending Mortgage Loan Originator (MLO) Compensation Rule and the impact on a bank's ability to compensate MLOs based on profitability. A second teleconference focusing on third-party risk is scheduled for June 5. Additional teleconferences are scheduled for September 27 and November 15, 2012. See http://www.fdic.gov/news/news/financial/2012/fil12006.html
Free Telephone Seminars on Deposit Insurance for Bank Officers and Employees (FIL-5-2012, February 2, 2012)	The FDIC is holding 15 free telephone seminars for bank officers and employees between February 15, 2012, and December 6, 2012, to provide an overview of the rules for determining deposit insurance coverage for all account ownership categories. Participants must register in advance for the seminars. See http://www.fdic.gov/news/news/financial/2012/fil12005.html
FDIC Hosts Conference on "The Future of Community Banking" (PR-14-2012, January 31, 2012)	The FDIC hosted a national conference on "The Future of Community Banking" on February 16, 2012. The conference provided a forum for community bank stakeholders to explore the unique role community banks play in the nation's economy and the challenges and opportunities this segment of the banking industry faces. Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, and FDIC Director Thomas J. Curry delivered the keynote addresses. See http://www.fdic.gov/news/news/press/2012/pr12014.html
Guidance on Junior Lien Loan Loss Allowances (FIL-4-2012, January 31, 2012)	The federal financial institution regulatory agencies issued guidance on allowance for loan and lease losses (ALLL) estimation practices associated with loans and lines of credit secured by junior liens on one-to-four family residential properties. This guidance reiterates key concepts included in generally accepted accounting principles and existing supervisory guidance related to the ALLL and loss estimation practices. Institutions also are reminded to follow appropriate risk management principles in managing junior lien loans and lines of credit. See http://www.fdic.gov/news/news/financial/2012/fil12004.html

Subject	Summary
Revised Guidance on Payment Processor Relationships (FIL-3-2012, January 31, 2012)	The FDIC announced revised guidance describing potential risks associated with relationships with third-party entities that process payments for telemarketers, on-line businesses, and other merchants. These relationships can pose increased risk to institutions and require careful due diligence and monitoring. This guidance outlines certain risk mitigation principles for this type activity. See http://www.fdic.gov/news/news/financial/2012/fil12003.html
FDIC Board Proposes Stress-Testing Regulation for Large Banks (FIL-7-2012, February 3, 2012, *Federal Register*, Vol. 77, No. 14, p. 3166, January 23, 2012)	The FDIC issued a notice of proposed rulemaking that would require certain large insured depository institutions to conduct annual capital-adequacy stress tests. The proposal, which implements Section 165(i)(2) of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*, would apply to FDIC-insured state nonmember banks and FDIC-insured state-chartered savings associations with total consolidated assets of more than $10 billion. The stress tests would provide forward-looking information that would assist the FDIC in assessing the capital adequacy of the banks covered by the rule. See http://www.fdic.gov/news/news/financial/2012/fil12007.html
FDIC Board Approves Final Rule Requiring Resolution Plans for Insured Depository Institutions Over $50 Billion (PR-3-2012, January 17, 2012, *Federal Register*, Vol. 77, No. 14, p. 3075, January 23, 2012)	The FDIC approved a final rule requiring an insured depository institution with at least $50 billion in total assets to submit to the FDIC periodic contingency plans for resolution in the event of the institution's failure. The final rule requires the largest insured depository institutions to engage in extensive planning that, in cooperation with the FDIC, will enhance the FDIC's ability to reduce losses to the Deposit Insurance Fund and resolve the institutions in a manner that limits any disruption from their insolvency. See http://www.fdic.gov/news/news/press/2012/pr12003.html
Frequently Asked Questions Regarding Interagency Advisory on Interest Rate Risk Management (FIL-2-2012, January 12, 2012)	The federal financial institution regulatory agencies and the FFIEC issued responses to questions received following the issuance of the *Interagency Advisory on Interest Rate Risk (IRR) Management* in October 2010. The responses clarify points addressing IRR exposure measurement and reporting, model risk management, stress testing, assumption development, and model and systems validation. Financial institution management should consider the responses in the context of their institution's complexity, risk profile, business model, and scope of operations. See http://www.fdic.gov/news/news/financial/2012/fil12002.html

Regulatory and Supervisory Roundup

continued from pg. 43

Subject	Summary
Adjustment to the Community Reinvestment Act (CRA) Annual Asset-Size Threshold (FIL-76-2011, December 19, 2011, *Federal Register*, Vol. 76, No. 246, p. 79529, December 22, 2011)	The federal bank regulatory agencies have amended their CRA regulations to increase the asset-size threshold used to define "small bank" and "intermediate small bank" under the Act. "Small bank" or "small savings association" means a bank that, as of December 31 of either of the prior two calendar years, had assets of less than $1.160 billion. "Intermediate small bank" or "intermediate small savings association" means a small bank with assets of at least $290 million as of December 31 of both of the prior two calendar years, and less than $1.160 billion as of December 31 of either of the prior two calendar years. These asset-size threshold adjustments took effect January 1, 2012. See http://www.fdic.gov/news/news/financial/2011/fil11076.html
Proposed Rule on Risk-Based Capital Standards: Alternatives to Credit Ratings (FIL-75-2011, December 16, 2011, *Federal Register*, Vol. 76, No. 245, p. 79360, December 21, 2011)	The federal bank regulatory agencies are requesting comment on possible modifications to risk-based capital standards for market risk. The agencies are proposing to incorporate certain alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings. Comments on the proposed rule were due February 3, 2012. See http://www.fdic.gov/news/news/financial/2011/fil11075.html
Proposed Revisions to Consolidated Reports of Condition and Income (Call Reports) for 2012 (FIL-72-2011, December 7, 2011)	The federal bank regulatory agencies are requesting comment on proposed revisions to the Call Report that would take effect in 2012. The proposed new data items would be added to the Call Report as of the June 30, 2012 report date, except for two proposed revisions that would take effect March 31, 2012, in connection with the initial filing of Call Reports by savings associations. Comments on the proposed rule were due January 20, 2012. See http://www.fdic.gov/news/news/financial/2011/fil11072.html
FDIC Hosts Seminar on Commercial Real Estate Loan Workouts and Related Accounting Issues (FIL-71-2011, November 23, 2011)	The FDIC held a free telephone seminar on December 15, 2011, to discuss prudent commercial real estate loan workouts and related accounting issues, including the treatment for troubled debt restructurings. Employees of all FDIC-supervised institutions were invited to participate. See http://www.fdic.gov/news/news/financial/2011/fil11071.html

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429-9990

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE, $300

FIRST CLASS MAIL

Postage &
Fees Paid
FDIC
Permit No. G-36

Subscription Form

To obtain a subscription to ***Supervisory Insights***, please print or type the following information:

Institution Name _____

Contact Person _____

Telephone _____

Street Address _____

City, State, Zip Code _____

Please fax or mail this order form to: FDIC Public Information Center
3501 North Fairfax Drive, Room E-1022
Arlington, VA 22226
Fax Number (703) 562-2296

Subscription requests also may be placed by calling 1-877-ASK-FDIC or 1-877-275-3342
or go to https://service.govdelivery.com/service/multi_subscribe.html?code=USFDIC