Example 7
Identifying a TDR & Measuring Impairment: Fair Value Method
(Operation of Collateral)

Management makes a commercial loan for $3,000,000 bearing a contractual interest rate of 8% and secured by a multi-tenant retail building. The loan is amortizing over 20 years and is due in 5 years. The monthly payment amount is $25,093. At origination, an appraisal of the collateral reflected an "as is" MV of $4,000,000.

After 18 months, the borrower is 60 days delinquent on the loan. Vacancy increased to 55%, and rent concessions were granted to some tenants, resulting in a decreased cash flow. The guarantor has limited liquidity. There are no other available and reliable repayment sources other than the collateral's cash flow. The current appraisal notes a prospective "as stabilized" MV of only $2,600,000 and an "as is" MV of $2,030,000 due to a significantly higher vacancy rate and a decline in rental rates. An appraisal review found the assumptions and conclusions to be reasonable. After carefully analyzing the borrower's personal and business financial information and credit reports, and after discussions with the borrower, management determines that the collateral is able to generate cash flow of $18,000 per month to service the loan.

Management determines that a prudent workout would be in the best interest of the bank. In order to collect as much of the loan as reasonably possible, management negotiates a reduced payment amount the borrower can meet and both parties agree to the restructure. The economy is beginning to improve, and management reasonably believes that the property will reach the "as stabilized" MV within the next 2 years. The workout plan provides management with reasonable assurance that the cash flow will be sufficient to pay all principal and interest.

Management decides to extend the amortization period of the remaining principal balance of $2,900,000 to 25 years from the restructuring date, with the balance due in 5 years, although the bank's loan policy limits the amortization period for new loans of this type to 20 years. Based on the borrower's expected cash flow from the collateral, management lowers the contractual interest rate to 5%, which is below market for a new loan with similar risk characteristics. The new monthly payments under the modified loan terms are $16,953.

1. Is the loan a TDR?

Yes. The modification constitutes a TDR because it meets both prongs of the TDR test. The borrower is experiencing financial difficulties as evidenced by the debtor's payment default, negative equity, and significantly lower cash flow from the property. Foreclosure was imminent due to cash flow problems. Management also granted several significant concessions:

- The 5% interest rate is below market because it is less than the rate management would charge at the time of the restructuring for a new loan with similar risk characteristics (delinquency status, limited capacity to repay, collateral shortfall).
- The modified payments last for 5 years and are based on a longer amortization period than permitted under the bank's loan policy.
- Management did not require additional collateral or guarantors despite the collateral shortfall and the borrower's limited repayment capacity.

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

For regulatory reporting purposes, any collateral dependent TDR loan must be measured based on the fair value of the collateral method. In this example, the loan is collateral dependent because the sole source of repayment is the operating cash flow generated from the collateral; the borrower has no other available and reliable means of repayment outside of the retail building to contribute to the amortization of the loan.

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

Loan Amount	**$2,900,000**
Interest Rate	**5.00%**
Term	**5 Years**
Amortization	**25 Years**
New Monthly Payment	**16,953**
Balloon Payment	**$2,585,779**
Default Probability	**10%**
"As Stabilized" MV	**$2,600,000**
"As Is" MV	**$2,030,000**
Costs to Sell	**8.00%**

A.	"As Stabilized" MV net of Costs to Sell	$2,392,000
	Less: Loan Amount	2,900,000
	Impairment Amount	$508,000
B.	"As Is" MV (Fair Value)	$2,030,000
	Less: Loan Amount	2,900,000
	Impairment Amount	$870,000
C.	Discounted Cash Flow Analysis	
	Payment Less 10% default assumption	$15,258
	Discount Rate (Original Rate)	8.00%
	Term	5 Years
	PV of Payments	$752,000
	PV of Terminal Cash Flow	$1,562,000
	("As Stabilized" MV net of Costs to Sell)	
	Total PV of Cash Flows	$2,304,000
	Less: Loan Amount	2,900,000
	Impairment Amount	$596,000

The best answer is B.

Answer B is the best answer. The impairment measurement for an impaired collateral dependent loan for which repayment is from the operation of the collateral is always the difference between the collateral's fair value and the loan balance. The "as is" MV is most reflective of fair value. Costs to sell are not deducted from the fair value because the sale of the collateral is not part of the workout strategy.

Answer A incorrectly uses the "as stabilized" MV. The "as stabilized" MV should not be used to measure impairment because it is a prospective value. Rather, the fair value of the collateral as of the measurement date should be used. Additionally, as noted above, costs to sell are not deducted when determining the impairment amount for impaired collateral dependent loans for which repayment is from the operation of the collateral.

Answer C incorrectly uses the present value of expected future cash flows method to calculate impairment. The regulatory agencies require banks to use the fair value of the collateral method for calculating impairment on all impaired collateral dependent loans.

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

The impairment amount stays in the ALLL. The modification is reasonably structured, and management reasonably believes that the property will reach the "as stabilized" MV within the next 2 years. The workout plan provides management with reasonable assurance that the cash flow will be sufficient to pay all principal and interest at the below-market rate. Based on all of these factors, no charge-off is required at present; however, the impairment amount will need to be reviewed quarterly and adjusted, if necessary, based on ongoing performance and conditions. In addition, the loan would need to be evaluated quarterly to determine whether a charge-off should be taken. When available information confirms that the loan, or a portion thereof, is uncollectible, this amount should be promptly charged off against the ALLL.

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

A. Substandard - $2,900,000

B. Substandard - $2,600,000; Loss - $300,000

C. Substandard - $2,030,000; Loss - $870,000

The best answer is A.

The loan has well-defined weaknesses, such as delinquency, reduced cash flow, and a collateral shortfall, which warrant a Substandard classification. However, as noted in the answer to question #4, no charge-off is required since the property is stabilizing and management expects that cash flows will be sufficient to liquidate the debt according to its modified terms. Since no confirmed loss has been identified at the time of the restructuring, Answers B and C are not the best answer.

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

Yes. If the loan was not already on nonaccrual prior to the restructuring, it should be placed on nonaccrual at the time of the restructuring. The general rule for nonaccrual status in the Call Report instructions includes placing a loan on nonaccrual when "payment in full of principal or interest is not expected." Management's analysis of the borrower's financial information when the loan is 60 days past due reveals that, due to the borrower's decreased cash flow, the borrower cannot service the loan with its $25,100 monthly payment and 8% interest rate. Thus, management's credit analysis in conjunction with the modification indicates that full collection of principal and interest is not expected according to the original contractual terms, which supports placing the loan in nonaccrual status not later than at the time of the restructuring. A loan cannot be modified as a way to avoid placing the loan on nonaccrual when such treatment would otherwise be warranted.

A loan that is on nonaccrual at the time it undergoes a TDR need not be maintained for its remaining life in nonaccrual status. The loan can be restored to accrual status if it subsequently meets the return-to-accrual conditions set forth in the Call Report instructions.

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

No. The loan would continue to be reported as a TDR because the 5% modified interest rate was below the market rate for new debt with similar risk characteristics at the date of restructuring.