BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Troubled Loan Workouts and Loans to Borrowers in Troubled Industries

To: Chief Executive Officers of all National Banks, Deputy Comptrollers, District Administrators, Directors and all Examining Personnel

PURPOSE

This issuance provides a summary of supervisory and reporting guidance to help banks deal with troubled borrowers or non- troubled borrowers operating in troubled industries. The issuance addresses: 1) refinancing medium-term commercial real estate loans; 2) loan concentrations; 3) troubled debt restructurings; 4) returning a loan with a partial charge-off to accrual status; 5) recognition of interest income on a cash basis; and, 6) enhanced disclosure of nonaccrual loans. Some of these matters were previously discussed in the joint agency supervisory release of March 1, 1991, which was distributed as Banking Bulletin 91-07.

BACKGROUND

Many national bank customers are experiencing financial difficulties, particularly those involved in industries such as real estate. Periods of economic uncertainty for a major industry provide significant challenges for banks. In commercial real estate markets, overcapacity, declines in value of financed projects, and more cautious lending practices and less availability of financing from traditional non-bank sources (such as insurance companies, pension funds, etc.) have made bank loan portfolios riskier.

In this environment, it is important that bankers understand supervisory and reporting requirements when assessing the options available to them in working with borrowers. Understanding these requirements will help institutions avoid unnecessarily restricting the availability of credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems. The OCC supports banks making loans on sound terms to creditworthy borrowers. Similarly, the OCC supports bankers' efforts to develop a strategy to minimize losses on troubled loans -- which frequently means working with the borrower. It is important that lack of understanding or misunderstandings about supervisory policies not adversely affect the availability of credit to sound borrowers or the prudent working out of loans to troubled borrowers.

Loan workouts can take a number of forms: simple renewal or extension of the loan terms; extension of additional credit; formal restructuring of the loan terms with or without concessions; or, in some cases, foreclosure on underlying collateral. Banks should choose the alternative that will maximize the recovery on each troubled loan. This circular presents supervisory considerations regarding these options.

Accurate reporting of troubled loans is also important. Banks' disclosures of troubled loans should enable analysts and other readers of the financial statements to understand fully the effects, both positive and negative, that such loans have on the bank's financial condition and results of operations. This issuance also clarifies certain reporting policies regarding troubled loans.

LOAN WORKOUTS

Refinancing of medium-term commercial real estate loans

Many commercial banks aggressively participated in the 1980's real estate boom by originating a large number of real estate construction and development loans. In today's market, commercial real estate borrowers are having difficulty obtaining planned post-construction refinancing and purchase financing for real estate development projects. In many cases, the usual sources for this financing, such as insurance companies and institutional investors, are currently not available. In other cases, projects that the bank financed are not performing in accordance with original projections. Consequently, banks are frequently faced with the choice of renewing a loan they had not planned to renew, restructuring the loan, or foreclosing on the collateral.

This environment presents significant challenges to banks in maintaining standards of asset quality and diversification. The OCC recognizes that,in many cases, the most effective way for banks to minimize their losses on existing loans may be to renew or extend loans beyond the original plan. In other cases it may make sense to restructure the loan terms. As with any commercial credit, these renewals, extensions, or restructurings must be based on sound underwriting standards and must be subject to normal loan classification rules. A bank will not be criticized for continuing to carry such loans as long as the bank has a well conceived and effective workout plan for the borrower, effective internal controls to manage the levels of these loans, has classified the loan in cases where weaknesses exist, and has properly considered these loans when determining the level of the allowance for loan and lease losses.

Concentration of credit

Banks and the OCC have long recognized portfolio diversification as an important element of an overall risk management strategy. Banks have been criticized by the OCC for having excessive concentrations in certain industries. In some cases, concentrations have been the subject of OCC enforcement actions. In recent months, fear of regulatory criticism for adding to, or not reducing, concentration levels has led some banks to hesitate to extend credit to new creditworthy borrowers or to renew existing sound loans.

However, concentration risk is only one consideration in managing the risks associated with troubled borrowers and industries. The OCC recognizes that it may be appropriate for a bank to make additional loans, on prudent terms, in an industry where the bank has a concentration, if it has effective internal systems and controls in place to manage concentration risk. When management believes the renewal, extension, or restructuring of credit is the best way to work out an existing troubled relationship and avoid further losses, the level of loans to a particular industry should not deter management from exercising its best judgment. The OCC will criticize a bank for failing to recognize the reality of a troubled loan but will not criticize a bank that manages a troubled loan using a well conceived and effective workout strategy.

Troubled debt restructurings (TDRs)

Some banks feel that TDRs implemented in accordance with Statement of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors For Troubled Debt Restructurings" (FAS 15) will not work in today's environment. Some of these banks believe that FAS 15 requires the lender to grant the borrower a large concession. Others believe the lender must wait a period of time after the restructuring before the loan can be returned to accrual status. Neither belief is always the case.

The OCC believes TDRs can be useful in meeting sound business and reporting objectives. Restructurings should be undertaken in a way that improves the likelihood that the loan will be repaid in full. Regulatory reporting policies and generally accepted accounting principles (GAAP) do not require banks to grant excessive concessions, forgive principal, or take other steps that are not commensurate with the borrower's ability to repay. The only concessions required are those needed to restore the expectation of full collectibility. The amount and size of those concessions depends on the nature of the loan and the financial condition of the borrower.

Regulatory reporting requirements and GAAP do not prevent banks from including contingent payment provisions in the restructured terms. For example, a bank may reduce the interest rate on a troubled loan but require the borrower to pay the bank a percentage of any gain realized if the collateral is sold. Or, the bank may require that the reduced rate will automatically revert to a market rate if the borrower meets certain profit levels. Thus, the bank can recover concessions granted during periods of economic troubles if the borrower's financial condition improves.

It is not always necessary for a bank to wait a period of time after the restructuring before returning a restructured loan to accrual status. Rather, in some situations, the loan can return to accrual status immediately after the restructuring if the return is supported by a well documented credit evaluation of the borrower's financial condition and the prospects for full repayment. Examples include 1) payment performance immediately prior to the restructuring or 2) other significant factors that preclude the need for demonstrated performance.

<u>Payment performance</u> in accordance with the newly restructured terms is one of the most important forms of evidence used to decide whether the borrower can fully meet the restructured terms. The performance to be assessed should not be limited to that occurring after the restructuring. Performance immediately prior to the restructuring should also be considered. Often the level of debt service on a restructured loan is less than the payment the borrower was making before the restructuring. If this is the case, and the borrower is expected to be able to continue this level of performance and fully repay the new contractual amounts due, the loan can immediately return to accrual status.

<u>Other significant factors</u> may constitute a preponderance of evidence that the loan will be repaid in full. Those factors may be sufficient to allow the loan to return immediately to accrual status without demonstrated performance under the restructured terms. Such factors include substantial and reliable new sales, lease or rental contracts, or other important developments that significantly increase the borrower's net cash flow and debt service capacity and strengthen the borrower's commitment to repay. If such factors are not enough to eliminate entirely the need for demonstrated performance, they may reduce the period of performance otherwise considered necessary.

The instructions to the Consolidated Reports of Condition and Income (Call Reports) were amended as of June 30, 1991, to permit the removal of restructurings that are in compliance with their modified terms and yielding a market rate of interest from restructured debt reporting after the year in which the restructuring occurs. In situations where a partial charge-off has been taken before the restructuring, an interest rate concession may still achieve an effective yield that approximates a market rate. This is because FAS 15 requires that the effective yield be computed based on the recorded loan balance instead of the contractual balance. This situation is even more frequent in today's environment given recent declines in interest rates.

Because many banks have taken charge-offs on troubled loans, the TDR can, in some cases, use a two-note structure to return one "good" note to accrual status, with the troubled note accounted for separately. The troubled note may represent the lender's contractual claim on the portion of the loan that has been charged-off. For example:

- Assume that a bank has a $10 million loan secured by real estate. The loan is on nonaccrual status and $1 million has been charged off. Cash flows are adequate to service only a $9 million loan at a market rate of interest. The bank formally restructures the loan by dividing it into two notes. The first is for $9 million and carries a market rate of interest. The second is for $1 million (the charged-off portion of the note to which the bank retains a claim) and carries a below market rate of interest. The bank forgives no principal. This restructuring meets the requirements of FAS 15, and assuming that full collection of the $9 million loan and the borrower's continued performance under the modified terms are expected, that loan can return to accrual status.

The return to accrual status must always be supported by well documented evidence of the borrower's financial condition and the expectation of complete repayment under the revised terms. The restructuring should improve the collectibility of the loan in accordance with a reasonable repayment schedule. The amount of charge-off must be based on a good faith evaluation of collectibility and cannot be calculated simply to achieve a specified rate of interest or avoid future troubled debt disclosures. In every TDR, the bank must make a good faith evaluation of the collectibility of the new contractual principal and interest, maintain the allowance for loan and lease losses at an appropriate level and charge off all identified losses in a timely manner.

REPORTING CONSIDERATIONS

Returning a loan with a partial charge-off to accrual status

On March 1, 1991, the four federal banking and thrift regulatory agencies jointly issued a statement clarifying certain supervisory and reporting policies. The release also announced the pending issuance of a request for comment on a proposed reporting standard that would permit certain partially charged-off nonaccrual loans to return to accrual status.

The proposal (sometimes called "loan splitting") was published for comment on March 18, 1991, with a 45-day comment period that ended May 2. Most of the comments received indicated concerns that the proposal was not in conformity with GAAP. A number of commenters expressed concern that such differences might diminish the integrity of bank financial reporting. While noting these concerns, the agencies also observed that in some respects where the proposal differed from GAAP, such as the areas of loss recognition and disclosure, the proposal was more conservative than GAAP. As a longstanding practice, however, the agencies have attempted to minimize differences between regulatory reporting requirements and GAAP.

For that reason, the agencies recently announced in the Federal Register that the proposal has been withdrawn. The agencies have agreed to participate in projects underway by the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) to attempt to resolve issues relating to recognizing income on nonaccrual loans and estimating credit losses on certain loans.

The federal banking agencies have included guidance on certain aspects of the March 1 policy statement in the instructions for the June 30, 1991 Call Report. This issuance reiterates those policies and is intended to encourage depository institutions to continue to work with borrowers who are experiencing difficulties and to avoid restricting the availability of credit to sound borrowers, particularly in areas of the economy that may be experiencing temporary problems.

Cash-basis interest recognition

For partially charged-off loans where the remaining recorded balance is considered fully collectible, recognition of interest income on a cash basis is an appropriate alternative to "loan splitting" when combined with increased disclosure of the contribution to income that nonaccrual loans provide.

While a loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis. This can occur only if the remaining book balance of the loan (i.e., the balance after charge-off of identified losses, if any) is deemed to be fully collectible. The amount of interest income that should be recognized is limited to that which would have been accrued on the asset's remaining book balance at the contractual rate. Any excess over that amount should be recorded as recoveries of amounts previously charged- off until the charge-off is fully recovered.

A bank's determination of the ultimate collectibility of a loan's remaining book balance must be supported by a current, well documented credit evaluation of the borrower's financial condition. Prospects for repayment must also be evaluated, including such factors as the borrower's historical repayment performance and other relevant factors.

Suggested increased nonaccrual disclosure

Many financial statement readers use banks' current nonaccrual loan disclosures as an important barometer of financial condition. Many analysts place heavy emphasis on the levels of nonaccrual loans in projecting future loan losses and earnings. Few banks take the opportunity to show that there are varying degrees of problems in the reported total of nonaccrual loans. Few indicate to the reader that many of these assets provide a contribution to earnings through cash basis interest income and loan loss recoveries.

In January 1991, the OCC suggested a format in Banking Bulletin 91-05 for voluntary disclosures relating to nonaccrual loans. In addition to the cash-basis interest income recorded on such loans, disclosure can include charge-offs taken and cash payments applied as loan loss recoveries. Banks may also segregate loans that are generating substantial cash flows relative to other nonaccrual loans to help distinguish those loans that are current but are in nonaccrual status due to concerns regarding the borrower's financial condition. The OCC suggested that this increased disclosure also might be extended to other real estate owned so that analysts can see the contribution those assets make to operating income.

Accrual status of partially charged-off loans

There may be circumstances when a partially charged-off loan can return to accrual status without first recovering the partial charge-off. In accordance with the Call Report instructions, this is permitted when the loan has been brought fully current with respect to principal and interest and the bank expects that the full contractual balance of the loan (including any amount charged-off) plus interest will be fully collected under the terms of the loan. (These instructions also provide that certain past due loans may return to accrual status if they are both well secured and in the process of collection.)

Ordinarily, a partial charge-off would indicate that the bank does not expect full repayment of the amounts contractually due and the loan would, therefore, remain on nonaccrual status. If, however, facts have changed since the charge-off was taken such that the full amounts contractually due, including the amounts charged-off, are expected to be collected and the loan is contractually current, the partially charged-off loan could return to accrual status. This determination must be supported by a well documented credit evaluation of the borrower's financial condition and the prospects for full repayment.

OTHER RELATED OCC RELEASES

The following recent banking and examining issuances contain additional guidance dealing with troubled loan situations and reporting troubled assets:

Banking Bulletin 91-05 -- "Public Disclosure on Nonaccrual Loans"
Banking Bulletin 91-07 -- "Joint Agency Policy Statements"
Banking Bulletin 91-19 -- "Nonaccrual Loan Issues"
Examining Bulletin 91-02 -- "Joint Agency Statements Clarifying Certain Regulatory Policies"

Questions about this Banking Circular, or any of the issuances listed above, should be directed to the Office of the Chief Accountant at (202) 874-5180.

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