Call Report Preparation:
Advanced Lending Schedules and Issues:
OREO, Participations, TDRs, Commitments, Insiders

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Course Topics

- Loan classification for call report purposes
- Troubled debt restructurings (TDRs)
- Other real estate owned (OREO)
- Lines and letters of credit and other commitments
- Loan participations
- Insider loans and commitments

Loan Coding and Classification – Overview

Regulator's basic objectives for loan coding:

- Comparison to peers
- Analyze changes in portfolio over time
- Calculate accurate yields on loans
- Calculate consistent ratios for concentrations, past due loans, and the allowance for loan loss

Loan Coding and Classification

Loan coding carryovers to:

- Schedule RI – Loan interest and fee income
- Schedule RI-B – Charge-offs and recoveries
- Schedule RC-C Part II – Loans to small businesses and small farms
- Schedule RC-K – Quarterly averages for loans
- Schedule RC-L – Unused commitments
- Schedule RC-N – Past due and nonaccrual loans
- Schedule RC-P – Mortgage banking activities
- Schedule RC-R – Risk weighted assets for loans
- Schedule RC-S – Loan servicing

Loan Coding Hierarchy

- First – Loan Type
  - Line 10 – Lease Financing Receivables
  - Line 8 – Obligations of States and Political Subdivision
- Second – Loan Collateral
  - Line 1 – Loans secured by real estate
    - ◊ 1.a – Construction and Land Development
      - 1.a.1 or 1.a.2- 1-4 Family Residential Construction or Other Construction
    - ◊ 1.b – Farmland
    - ◊ 1.c – 1-4 Family Residential
      - 1.c.1- HELOCs
      - 1.c.2.a or 1.c.2.b- Closed- First Liens or Closed- 2nd Liens
    - ◊ 1.d – Multifamily
    - ◊ 1.e – Nonfarm, nonresidential
      - 1.e.1 or 1.e.2 – Owner Occupied or Non-owner Occupied

Loan Coding Hierarchy – Continued

- Third – Borrower
  - Line 2 – Loans to depository institutions
  - Line 3 – Loans to farmers (non-real estate)
  - Line 9.a – Loans to non-depository institutions
- Fourth – Loan Purpose
  - Line 4 – Commercial and industrial loans
  - Line 6 – Consumer loans- various types
  - Line 9.b.1 – Loans to purchase or hold securities
  - Line 9.b.2 – All other loans- including overdrafts

Real Estate Loans – Definition

Loans Secured by Real Estate: A loan secured by real estate is a loan that, at origination, is secured wholly or substantially by a lien(s) on real property for which the lien(s) are central to the extension of credit. That is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien(s) on the real property. To be considered wholly or substantially secured by a lien(s) on real property, the estimated value of the real estate collateral at origination (after deducting any more senior liens held by others) must be greater than 50% of the principal amount of the loan at origination.

- Coding challenges
  - Loans with multiple pieces of collateral
  - Cross collateralized loans
  - Previous liens on collateral

Real Estate Loans – Example 1

- Bank makes a $1,000,000 loan to a corporation to finance the purchase of a new building and equipment. Loan is secured by real estate appraised at $800,000 and equipment valued at $500,000.

  – Is this a loan secured by real estate?

Real Estate Loans – Example 1

- Answer:
  - Yes. The appraised value of the real estate exceeds 50% of the loan amount.

Real Estate Loans – Example 2

- Bank makes two loans to a corporation. First loan is $1,000,000 for a new building. Second loan is $300,000 to buy equipment and finance working capital. The loans are cross collateralized and secured by real estate appraised at $1,200,000 and $400,000 in equipment.
  - Should the loans above be classified as real estate loans?

Real Estate Loans – Example 2

- Answer:

  – Yes. Total combined loan amount is $1,300,000. Total value of real estate collateral is $1,200,000, which is over 50%. Both loans are classified as real estate loans.

Real Estate Loans – Example 3

- Bank makes a $30,000 home equity line of credit secured by a junior lien on the customer's home. The residence is appraised at $200,000 and the borrower has a first mortgage of $195,000.
  - Is the new loan a real estate loan?

Real Estate Loans – Example 3

- Answer:
  - It depends:
    - ◊ If the same bank made the first and second lien, it is a real estate loan. Total loans outstanding = $225,000. Total collateral value = $200,000. Collateral exceeds 50% so it is a real estate loan.
    - ◊ If a different bank made the first lien, it is not a real estate loan. Total loans outstanding = $30,000. Total collateral value = $5,000 ($200,000 less first lien of $195,000). Collateral is less than 50% so this is a consumer loan rather than a real estate loan.

Construction Loans

- Construction loans include not only construction of new structures, but also additions or alterations to existing structures
- Can also include:
  - Loans secured by vacant land except land known to be used or usable for agriculture (farmland)
  - Loans secured by real estate the proceeds of which are to be used to acquire and improve developed or undeveloped property
- Loans should continue to be reported as construction loans after completion until the loan is refinanced into a new permanent loan
- Combination construction-permanent loans should be reported as construction loans until completed or principal amortization payments begin, whichever comes first

Residential Real Estate

- In addition to single family homes, the definition of 1-4 family residential real estate includes:
  - Duplexes, triplexes, quads
  - Row houses, townhouses, etc., even if there are more than four connected units if each is separated by dividing walls that extend from ground to roof
  - Mobile homes, in states where laws define the purchase and holding as real property
  - Individual condominium units even if there are more than 4 units in a building
  - Mixed use properties containing commercial and 1-4 family residential units if the use is primarily residential
- Proper classification of 1-4 family residential real estate is critical since closed end 1-4 family loans generally receive 50% risk weighting for capital purposes

Owner vs. Non-Owner Occupied – Definition

Owner-occupied nonfarm, nonresidential property: Nonfarm, nonresidential property for which the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or an affiliate of the party, who owns the property. The primary source of repayment is not derived from third party rental income (i.e. any rental income from third parties is less than 50% of the source of repayment) or the proceeds of the sale, refinancing, or permanent financing of the property.

- Coding challenges
  - Multiple tenants or changing income streams
  - Exceptions:
    - ◊ All hospitals, golf courses, recreational facilities, and car washes are considered owner occupied unless owned by an investor who leases the property to an operator.
    - ◊ All hotels, motels, dormitories, nursing homes, assisted living facilities, mini-storage warehouse facilities, and similar properties are considered non-owner occupied regardless of management.

Owner vs. Non-Owner Occupied – Example

- Bank makes a loan for a strip mall with three units. Unit 1 produces monthly rent of $5,000. Unit 2 produces monthly rent of $10,000. Unit 3 is occupied by the building's owner who can not cover the debt service without the other tenants. Total monthly debt service payments are $25,000.
  - Is this loan owner occupied?

Owner vs. Non-Owner Occupied – Example

- Answer:
  - No. Total monthly debt service is $25,000. Third-party tenants pay $15,000 per month, which is more than 50%.

Other Definitions

- **Farmland:** Includes all land known to be used or usable for agricultural purposes, such as crop and livestock production. Farmland includes grazing and pasture land, whether tillable or not and whether wooded or not.

- **Depository financial institutions:** Includes all commercial banks, credit unions, savings and loan associations, mutual or stock savings banks, cooperative banks, and other similar institutions that take deposits from customers/members.

- **Nondepository financial institutions:** Includes real estate investment trusts, mortgage companies, bank holding companies, insurance companies, finance companies, financial intermediaries, investment banks, loans or advances made to the bank's own trust department, and similar institutions.

Troubled Debt Restructurings (TDRs)

- A bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider.
- Concession can include the following:
  - Reduction of the stated interest rate
  - Extension of maturity date at a stated rate lower than the current market rate for new debt with similar risk
  - Reduction of the face amount or maturity amount of the debt
  - Reduction of accrued interest

TDR – Example 1

- Borrower's earnings have declined from prior years. The borrower is still current, however cash flow is tight. Borrower approaches the bank to request a lower interest rate that is in line with current market rates and the bank agrees. Due to the decrease in real estate values the current loan-to-value is 100%.

  – Is this a TDR?

TDR – Example 1

- Answer:
  - No. New rate is at market rate and borrower can still service the payments for the existing debt.

TDR – Example 2

- Borrower has a home mortgage. Borrower lost his job and has had some late payments on the mortgage and is currently paying one month behind. Borrower requests reduced payments and extended amortization to accommodate the reduced income. There was no request for a change in interest rate. Bank agrees. Loan amortization is permanently extended by 5 years.

  – Is this a TDR?

TDR – Example 2

- Answer:

  – Yes. Financial difficulty (lost job and inadequate cash flow) and concession (reduced payments and extended amortization).

TDR – Example 3

- A borrower is having financial difficulty and the bank agrees to reduce the borrower's required payment for a period of 3 months by reducing the payment to interest-only payments. After the first 3 months, the loan will go back to regular payments under the original agreement.

  – Is this a TDR?

TDR – Example 3

- Answer:
  - It depends. There is financial difficulty and the bank is granting a concession; but, would this qualify as an insignificant payment delay? It depends on the length of the original loan.
    - ◊ If the loan was a 12-month loan – this would probably be a significant payment delay and should be classified as a troubled debt restructuring.
    - ◊ If the loan was a 30-year mortgage – this would probably not be a significant payment delay and then would not have to be classified as a troubled debt restructuring.
    - ◊ Determination of what is significant depends on the bank's judgment.

Reporting Troubled Debt Restructurings

- Report on Schedule RC-C, Memorandum Line 1
  - All loans that have undergone troubled debt restructurings and that are performing in compliance with their modified terms.
  - TDRs in compliance with modified terms <u>and</u> yielding a market rate of interest do not need to be reported in calendar years after the year in which the restructuring took place.
  - TDRs not yielding a market rate continue to be reported on Schedule RC-C as TDRs until they are paid off.
- Report on Schedule RC-N, Memorandum Line 1
  - All loans that have undergone troubled debt restructurings and are past due 30 days or more or on nonaccrual.

Other Real Estate Owned

- Real property received in foreclosure or in lieu of foreclosure in the full or partial satisfaction of a loan.
- Initially recorded at fair value less estimated costs to sell based on an appraisal or other valuation at the time the property is received.
  - Transfer from loans to other assets on the balance sheet
  - Report on Schedule RC, Line 7
- Initial loss on the property when transferred to OREO is charged off through the allowance for loan and lease losses as long as the charge off occurs within as reasonable time period (perhaps 90 days or less) of initial transfer.

OREO Initial Recording – Example

- A bank has a $1,000,000 loan that is secured by real estate. The borrower is unable to pay the loan and signs a deed in lieu of foreclosure to transfer the property to the bank in satisfaction of all debt. An appraisal near the time of transfer shows the current value of the property is $800,000 and the bank estimates $50,000 in costs to sell the property.

  – How does this get reported on the call report?

OREO Initial Recording – Example

- Answer
  - The bank records a charge-off through the allowance for loan losses of $250,000 and records OREO with an initial carrying value of $750,000.
  - The OREO of $750,000 is reported on Schedule RC Line 7.
  - The charge-off is reported on Schedule RI-B.

OREO – Subsequent Writedowns or Expenses

- Subsequent writedowns are recorded directly to the income statement.
  - Report on Schedule RI, Line 5j – Net gain/loss on sales of other real estate
- Any gain or loss on sale is also recorded directly to the income statement.
  - Report on Schedule RI, Line 5j – Net gain/loss on sales of other real estate
- Any expenses related to the property (real estate taxes, insurance, utilities, maintenance, etc.) should be expensed as incurred.
  - Report on Schedule RI, Line 5j – Other noninterest expense
- Accrue at quarter end any necessary expenses such as real estate taxes that have been incurred, but not yet paid.

Loan Participations

- Groups of loans or portions of individual loans are frequently sold in order to reduce credit concentrations and/or comply with legal lending limit requirements.
- To qualify as a sale of an asset, recipient must have the right to pledge or exchange (resell) the asset it acquires.
  - Seller can not retain effective control of the asset.
- Failure to hand over effective control results in the transaction not qualifying for sale treatment.
  - Treated as a secured borrowing arrangement

Loan Participation Accounting

- If the transaction qualifies as a sale:
  - The amount of the loan sold is removed from the bank's balance sheet and is not reported on Schedule RC-C or elsewhere on the call report
    - ◊ Even if servicing is retained
- If the transaction does not qualify as a sale:
  - Loan remains on the bank's balance sheet and is reported on Schedule RC-C
  - The bank has new debt outstanding (secured by the loan(s))
  - Bank has additional assets, which decreases bank's capital ratios
  - Bank may need to consider compliance with legal lending limits

Loan Commitments

- Unused Commitments – broadly defined set of obligations the bank has entered into with customers or third parties. Examples include:
  - Available balances on lines of credit
  - Commitments to extend credit or make loans that are not yet closed, but where the bank has extended terms, the borrower has accepted the terms, and the extension and acceptance are:
    - ◊ In writing – regardless of whether they are legally binding to the bank or borrower
    - ◊ Not in writing – but are still legally binding on the bank and the borrower
  - Any loan commitment for which the bank has charged a commitment fee or other consideration
  - Overdraft protection on depositor's accounts offered under a program where the bank advises the account holders of the amount of the protection
  - Any other commitments that are legally binding

Letters of Credit

- Financial standby
  - Irrevocably obligates the bank to pay a third-party beneficiary when a customer fails to pay an outstanding loan or debt instrument.
- Performance standby
  - Irrevocably obligates the bank to pay a third-party beneficiary when a customer fails to perform some contractual non-financial obligation
- Commercial letter of credit
  - Specifically used to facilitate trade or commerce. Under the terms of a commercial letter of credit, as a general rule, drafts will be drawn when the underlying transaction is consummated as intended.

Insider Lending

- Insiders are defined under Federal Reserve Regulation O as:
  - Executive officers – officer with authority to participate in major policymaking functions of the bank, holding company, or any related subsidiary
  - Director – director of the bank, holding company, or related subsidiary
  - Principal shareholder – directly or indirectly owns, controls, or has power to vote over 10% of the stock of the bank or holding company
  - Related interest – company that is controlled by an executive officer, director, or principal shareholder

Insider Lending – Reporting

- Aggregate amount of all extensions of credit to insiders must be reported on Schedule RC-M Line 1.a
  - Includes all balances outstanding on loans
  - Any overdrafts
  - All unused commitments on lines and letters of credit

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