High-Risk Asset Accounting and Reporting

This Farm Credit Administration (FCA) document is an extension of the Risk Identification Examination Manual section. It provides additional supporting information and examination guidance.

Properly accounting for and reporting high-risk assets are essential elements of a Farm Credit System (System) institution's risk identification process and overall loan portfolio management. Institutions must properly account for high-risk assets to ensure the board, shareholders, investors, and FCA are apprised of credit risk that has, or could, adversely impact loan portfolio performance. FCA Regulations in Part 621, Subparts B and C, identify several high-risk asset accounting and reporting requirements. This includes FCA Regulation 621.3(b), which requires institutions to prepare financial statements and reports in accordance with generally accepted accounting principles (GAAP), except as otherwise directed by statutory and regulatory requirements.

FCA Regulation 621.6 requires institutions to use performance categories and other property owned (OPO) to categorize high-risk loans and loan-related assets. The regulatory performance categories for high-risk loans are nonaccrual loans and loans 90-days past due still accruing interest. A loan must not be put into more than one performance category. FCA Regulation 621.10 provides related direction on monitoring of performance categories and OPO. Among other things, this regulation requires institutions to have policies and procedures in this area and to review the loan portfolio at least quarterly to ensure all high-risk loans have been assigned the appropriate performance category and reassess the collectability of accrued but uncollected income. A general description and application of each performance category, OPO, and related accounting issues is provided below. Refer also to FCA's FAQs About Risk Identification for additional guidance and clarifications.

Nonaccrual Loans

FCA Regulation 621.6(a) requires categorizing a loan as nonaccrual if there is a known risk to the continued collection of principal and interest. Although several factors may be used to identify a known collection risk, this regulation also establishes the following three conditions as always presenting a known risk to collection:

- The loan may or may not be past due, but the institution has determined collection of the outstanding principal and interest, plus future interest accruals, over the full term of the loan is not expected because of a documented deterioration in the financial condition of the borrower.

- The loan is 90 days or more past due and is not otherwise eligible to be categorized as a *loan 90-days past due still accruing interest*. (This alternate category requires the loan to be 90-days or more past due, adequately secured, and in the process of collection.)

- Legal action, including foreclosure or other forms of collateral conveyance, has been initiated to collect the outstanding principal and interest.

Loans carrying a Farm Service Agency or other U.S. government guarantee can remain in accrual status even though repayment problems or other credit weaknesses may exist, assuming there is a valid, enforceable guarantee and no apparent loss exposure. Loans covered by the Federal Agricultural Mortgage Corporation's (Farmer Mac) Long-Term Standby Purchase Commitment program (program) are treated similarly. Additional guidance for guaranteed loans can be found in FCA Informational

Memorandums on Examination of Loans Guaranteed by Federal and Local Government Agencies dated July 10, 1998, and Long-Term Standby Purchase Commitments dated May 2, 2012.

Identifying collectibility: The requirements of FCA Regulation 621.6(a)(1) are not dependent upon whether a loan is past due. Instead, the focus is on the lender determining if collection of the loan is unlikely – over the full term of the loan contract – based on a deterioration of the borrower's financial condition. Institutions should be proactive in identifying problem loans while the loans are still current. If a borrower is experiencing financial difficulties, we expect the lender to have documented evidence supporting whether collection of the loan is likely considering all potential sources (e.g., farm and off-farm income, other revenue, or liquidation of collateral). For example, insufficient cashflow or earnings could merit nonaccrual consideration. Similarly, if the servicing plan includes partial liquidation of collateral to bring the account current but results in insufficient collateral to secure the remaining debt and the borrower lacks other assets to pledge, then nonaccrual status may be warranted.

When evaluating the collectibility of a loan, many risks can affect current or future payments on the loan, including, but not limited to, the following:

- A primary obligor filing a voluntary petition in bankruptcy or an involuntary petition in bankruptcy has been filed against a primary obligor.
- Substantial collateral has been abandoned, is in danger of disappearing, or losing its value.
- Loss of off-farm income serving as a primary income source for loan payments.
- A lawsuit against a primary obligor adversely affecting repayment of the borrower's loan with the institution.
- Illness or injury to a primary operator of the farm, significantly hindering the continued long-term operation of the farm business.
- The cessation of farming operations where the primary obligors have not made other arrangements to repay the loan.

We also expect the institution to consider the likelihood of current or future loan servicing actions improving collectibility of the loan.

The following sections address several key points examiners should consider in applying the nonaccrual performance category and related accounting requirements.

Adequately Secured: FCA Regulation 621.2 defines *adequately secured* as a loan that is secured by either or both of the following:

- Collateral in the form of perfected security interests in, or pledges of, real and/or personal property (including securities with an estimable value) having a net realizable value sufficient to repay the loan's outstanding principal and accrued interest. (FCA Regulation 621.2 defines *net realizable value* as the net amount the lender would expect to be realized from the acquisition and subsequent sale or disposition of a loan's underlying collateral. Generally, net realizable value is equal to the estimated selling price in the ordinary course of business, less estimated costs of acquisition, completion, and disposal.)

- The guarantee of a financially responsible party in an amount sufficient to repay the loan's outstanding principal and accrued interest.

In the Process of Collection: FCA Regulation 621.2 explains that *in the process of collection* means debt collection or loan servicing efforts are proceeding in due course and are reasonably expected to result in the recovery of the loan's principal balance, accrued interest, and penalties or reinstatement of the loan to current status within a reasonable time period. For example, we would not expect loans that are 90-days or more past due to be transferred to nonaccrual if full collection of principal and interest, including further accruals of interest, is expected within a reasonable timeframe consistent with the definition of *in the process of collection*.

Rule of Aggregation: FCA Regulation 621.7 requires that when one loan of a borrower is placed in nonaccrual status, an institution must immediately evaluate whether any other loans to that borrower, or related borrowers, should also be placed in nonaccrual status. Specifically:

- All loans on which a borrowing entity, or a component of a borrowing entity, is primarily obligated to the reporting institution shall be considered as one loan unless a review of all pertinent facts supports a reasonable determination that a particular loan constitutes an independent credit risk. This determination must be adequately documented in the loan file. Refer to FCA Regulations 621.7(a)(1) and (2) for specific guidance on what constitutes an independent credit risk. (FCA Regulation 621.7(a))

- If it is determined that the borrower's other loans with the institution do not represent an independent credit risk and full collection of such loans is not expected, then all the borrower's loans must be aggregated and classified as nonaccrual. (FCA Regulation 621.7(b))

- When the institution becomes aware that a borrower has a nonaccrual loan with any other lender, the institution must reevaluate the credit risk in its loan(s) to that borrower and determine if an independent credit risk exists. (FCA Regulation 621.7(c))

Earned but Uncollected Interest: Under FCA Regulation 621.8(c), institutions shall employ the following practices with respect to earned but uncollected interest income on loans, leases, contracts, and similar assets that are determined not to be fully collectible:

- Earned but uncollected interest income that was accrued in the current fiscal year and is determined to be uncollectible shall be reversed from interest income; and

- Earned but uncollected interest income that was accrued in prior fiscal years and is determined to be uncollectible shall be charged off against the allowance for credit losses.

Reversal of interest (and fees, if applicable) may be limited to the amount accrued and deemed uncollectible at the time of transfer to nonaccrual status.

Application of Payments and Income Recognition: FCA Regulation 621.8(a) explains that any cash payments received on nonaccrual loans where the ultimate collectibility of the recorded investment is in doubt shall be applied in a manner that reduces the recorded investment to the extent necessary to eliminate such doubt. Once the ultimate collectibility of the recorded investment is no longer in doubt, payments received in cash may qualify for recognition of interest income under FCA Regulation 621.8(b), but only if all the following conditions are met at the time the payment is received:

- The loan does not have a remaining unrecovered prior chargeoff associated with it.

- The payment received has come from a source of repayment detailed in the plan of collection.

- After considering the payment, the loan is not contractually past due more than 90 days and is not expected to become 90-days past due, or a repayment pattern has been established that reasonably demonstrates future repayment capacity.

Nonaccrual loans meeting all these conditions qualify for cash basis income recognition and reporting as cash basis nonaccrual loans under FCA Call Report Schedule RC-F, line 3a.

FCA Regulation 621.8(b)(1) states that a nonaccrual loan with a remaining unrecovered prior chargeoff associated with it (except for prior chargeoffs taken as part of a formal restructure) does not qualify for cash basis income recognition. In these instances, any cash payments received should be applied as a recovery of that prior chargeoff after the collectibility of the recorded investment is no longer in doubt. Once the chargeoff is fully recovered, payments may then be applied to interest income, in accordance with GAAP.

When recognition of interest income on a cash basis is appropriate, it should be handled in accordance with GAAP. Some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining recorded investment in or the amortized cost basis of the asset, as applicable (i.e., after charge-off of identified losses, if any), is deemed to be fully collectible. An institution's determination as to the ultimate collectibility of the asset's remaining recorded investment, or amortized cost basis, as applicable, must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

Legal and Other Related Expenses: Legal and other related expenses on nonaccrual loans should generally be expensed in the period incurred. An exception is allowed when an institution is required to capitalize these expenses to ensure collection under bankruptcy proceedings involving a potential write-down to the recorded investment. In this situation, an institution can capitalize these expenses if appropriately covered through a specific allowance. In addition, if the institution has a participation agreement with a second party that affirms it will pay its share of expenses at the end of the collection period, that party's pro rata share of expenses can be shown as a receivable.

Reinstatement to Accrual Status: FCA Regulation 621.9(a) states that before a loan may be reinstated to accrual status, it must be current on contractual payments and the borrower must be offered servicing in accordance with the institution's policies maintained under either FCA Regulation 614.4170 or Part 617 (distressed loan servicing), whichever is applicable. Servicing a loan is a key element of addressing risk to collectibility and assessing the loan's readiness to be reinstated to accrual status. Loans that receive effective and constructive loan servicing have a much greater likelihood of remaining current over time. Further, loan servicing is a critical process for institutions because working with borrowers to address the underlying cause of the borrower's financial and repayment weaknesses that caused the loan's original nonaccrual designation often reveals valuable information on the future collectibility of the loan. Additional reinstatement eligibility requirements are dependent upon certain characteristics of the loan under review and include:

- A loan that was current when placed in nonaccrual status pursuant to FCA Regulation 621.6(a)(1) may be reinstated to accrual status if the known risks to the continued collection of principal or interest have been mitigated. If the loan was past due when placed in nonaccrual status, it may only be reinstated under either paragraph (a)(2) or (a)(3) of FCA Regulation 621.9, as applicable. (FCA Regulation 621.9(a)(1))

- A loan placed in nonaccrual status when past due and *not* adequately secured must remain current on contractual payments for a period of sustained performance before it may be reinstated. (FCA Regulation 621.9(a)(2))

- A loan placed in nonaccrual status when past due and *adequately* secured must have a recent repayment pattern demonstrating future repayment capacity to make on-time payments before it may be reinstated. The repayment pattern is established in one of two ways: (FCA Regulation 621.9(a)(3))

    - Sustained performance in making on-time contractual payments, or
    - A recent history of making on-time partial payments in amounts the same or greater than newly restructured payment amounts.

FCA Regulation 621.2 defines *sustained performance* as a borrower that has resumed on-time payment of the full amount of scheduled contractual loan payments over a sustained period. In accordance with the contractual payment schedule, the sustained on-time repayment period is demonstrated by making six consecutive monthly payments, four consecutive quarterly payments, three consecutive semiannual payments, or two consecutive annual payments. The payments considered are those listed in the loan contract as due during the sustained performance period, regardless of whether scheduled payments are interest-only, unequally amortized principal and interest, equally amortized principal and interest, or a combination of payment amounts.

FCA Regulation 621.9 also explains that nothing in this section prevents a current loan from being reinstated to accrual status in response to a Credit Review Committee (CRC) decision issued under Section 4.14D(d) of the Farm Credit Act of 1971, as amended (the Act), when that decision was made in compliance with applicable laws, regulations, and in accordance with GAAP. The Act provides borrowers with current loans in nonaccrual status certain rights when the nonaccrual status results in adverse actions toward the borrower. These borrower rights include written notice of the loan being moved to nonaccrual status and, if the loan is current, the opportunity to request the lender restore the loan to accrual status. If the lender denies such a request, the borrower may seek a CRC review of the decision. FCA Regulation 617.7310(e) provides that CRC decisions are the final decision of the institution when made in compliance with applicable laws and regulations.

Additional considerations apply when a formal restructure or routine loan servicing action, such as a renewal or reamortization, is the basis for transferring a loan back to accrual status. The receipt of additional collateral alone does not constitute a sufficient basis to return a loan to accrual status. The borrower must exhibit a period of sustained performance or a recent history of making on-time partial payments in amounts the same or greater than newly restructured payment amounts as described above. Otherwise, the loan should remain in nonaccrual status until such performance has been demonstrated. The new terms and conditions of the restructured loan should be used as the basis for determining whether the loan is current.

<u>Loans 90-Days Past Due Still Accruing Interest</u>

FCA Regulation 621.6(c) requires categorizing a loan as 90-days past due still accruing interest when it is 90-days or more contractually past due, adequately secured, and in the process of collection. If the loan is not adequately secured, it cannot be categorized under this category unless there is evidence to suggest repayment within a reasonable time period of either the past due amount or the remaining principal and interest. U.S. government-guaranteed loans and loans covered by the Farmer Mac Long-Term Standby Purchase Commitment program that become 90-days past due but are well-secured with no risk of loss, are generally disclosed as loans 90-days past due still accruing interest under this regulation. See additional guidance on this topic in FCA Informational Memorandums on Examination of Loans Guaranteed by Federal and Local Government Agencies dated July 10, 1998, and Long-Term Standby Purchase Commitments dated May 2, 2012.

Other Property Owned

FCA Regulation 621.6(d) defines OPO as any real or personal property, other than an interest-earning asset, that has been acquired as a result of full or partial liquidation of a loan, through foreclosure, deed in lieu of foreclosure, or other legal means. OPO is a non-interest earning asset and considered an adverse asset when evaluating an institution's risk-bearing capacity. As such, management should routinely monitor and report to the board these loan-related assets and their effect on the institution's financial condition.

Several accounting standards apply to OPO. As a result, institutions should have well-documented procedures and staff expertise to ensure adherence with all applicable accounting standards. Primary standards regarding OPO accounting issues are in the following Accounting Standards Codification (ASC):

- ASC 310-20 – Nonrefundable Fees and Other Costs
- ASC 820-10 – Fair Value Measurement
- ASC 360-10 – Property, Plant, and Equipment
- ASC 606-10 – Revenue from Contracts with Customers
- ASC 610-20 – Gains and Losses from the Derecognition of Nonfinancial Assets

Two of the more common issues examiners may address when examining OPO accounting include establishing the fair value of OPO and handling real estate sales.

The following sections provide more specific guidance on these issues.

Fair Value: ASC 310-20 addresses a creditor receiving long-lived assets from a debtor that will be sold in full satisfaction of a receivable. It states the creditor should account for those assets at their fair value less costs to sell (commonly referred to as the net realizable value). Upon receiving an OPO, the institution should record it at the fair value less costs to sell. The fair value less costs to sell becomes the new cost basis or carrying amount for the OPO. The amount by which the recorded investment in the loan exceeds the fair value less costs to sell of the OPO is a loss. For purposes of this paragraph, losses, to the extent they are not offset against allowances for uncollectible amounts or other valuation accounts, shall be included in measuring net income for the period. In the rare instance that the fair value less costs to sell is greater than the recorded investment in the loan, a gain would be recognized in the income statement in accordance with GAAP.

GAAP defines fair value as the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. It is the value the lender could reasonably expect to receive in a current sale between a willing buyer and a willing seller, rather than a forced liquidation or distressed sale value. Institutions may use a present value calculation of forecasted cash flows to determine fair value, but more frequently look to an appraisal or evaluation to establish fair value. An appraisal or evaluation is just one factor used in determining the present fair value, and should not be used in isolation. For example, economic conditions may have changed since the last appraisal or evaluation, or, in the case of specialized assets, the opinion of value assigned may be highly subjective and based on limited market data or may have excluded the results of recent distressed sales. As such, institutions should consider other factors in determining fair value, including:

- Type of appraisal or evaluation (e.g., market value or liquidation value) and whether the final value assigned was done by an appraisal professional.
- Age of appraisal or evaluation.
- The use of the facility, if applicable.
- Disposition strategies, such as discounting.
- Disposition time frame.
- Historical experience with similar property.
- Liquidation costs.
- Current economic environment.

ASC 820-10, Fair Value Measurement, provides further guidance on measuring fair value.

While ASC 310-20 allows booking a gain on OPO based on fair value, a gain at the time the collateral is taken in satisfaction of the loan is very rare and collateral valuations should be closely scrutinized. FCA does not consider a non-current appraisal or evaluation as a basis for recognizing a gain on OPO when acquired. If an institution recognizes a gain on OPO upon acquisition, management should clearly document the appropriateness of recognizing the gain. This should include reasons why the borrower relinquished equity in the asset if it was worth more than the obligation owed.

ASC 360-10 states that OPO held for sale should be carried at the lower of the existing cost basis or the current fair value less costs to sell. Subsequent declines in the fair value less costs to sell below the existing cost basis are recorded through a direct write-off or losses on OPO. Changes in fair value less costs to sell must be determined on a property-by-property basis. Subsequent increases in value are reflected as a gain. However, the asset may not be reinstated to a value that exceeds the value established at the date of acquisition. In other words, any subsequent gains cannot exceed previously recorded losses. The fair value less costs to sell should be evaluated at least quarterly.

Seller-Financed Sales of Real Estate: A significant portion of OPO typically consists of real estate. ASC 606-10-25 establishes criteria for the occurrence of a sale, including the existence of a contract and the likelihood of collectibility of payment under the contract.

For the institution to recognize a sale, a contract and probability of repayment per ASC 606-10-25 must be established. Once the transaction is recognized as a sale, the entire gain or loss, if any, is recognized and derecognition of OPO takes place per ASC 610-20. If the transaction does not meet the contract criteria, the institution generally will record any payments received as a deposit liability to the buyer and continue to record the OPO as an asset until the criteria is met. If the transaction does not meet the contract criteria, the institution should reassess the transaction until a sale is recognized.

Accounting for Credit Losses (Chargeoffs and Recoveries)

FCA Regulation [621.5]() addresses accounting for the allowance for credit losses and chargeoffs. The allowance for credit losses is a valuation account established to reflect the current expected credit losses in the loan and lease portfolio. It is a contra-asset account recorded as an offset (reduction) to loan value on the balance sheet. Conversely, chargeoffs are recorded to reflect known losses and are accounted for through a direct reduction or write-down of the asset value. While the guidance provided below addresses chargeoffs, it should be read and applied in conjunction with the closely related guidance provided in the *Allowance for Losses* Examination Manual topic. This Examination Manual topic also addresses the related requirements for identifying and evaluating assets evaluated individually for expected credit losses, which is another aspect of properly accounting for high-risk assets.

FCA Regulation 621.5(c) requires institutions to charge off loans, wholly or partially, as appropriate, at the time they are determined to be uncollectible. In addition, FCA Regulation 621.5(d) requires institutions to charge off such amounts as directed by FCA if the amount determined to be uncollectible by the institution differs from the amount determined by FCA. Generally, FCA determines loan amounts to be uncollectible when repayment is dependent on the liquidation of collateral and the loan amounts exceed the net realizable value of collateral, as defined by FCA Regulation 621.2. Initiating foreclosure, agreeing to accept a deed in lieu of foreclosure, or approving a plan of liquidation would be clear examples where repayment is dependent on collateral. These would also be confirming events that make losses known if the net realizable value of collateral is insufficient to discharge the debt in full. Less apparent examples where losses may become known and recognized include situations where loan servicing or restructuring is not proceeding in due course or is highly unlikely to return the borrower's operation to viability. As previously mentioned, the net realizable value is essentially the same as the fair value less costs to sell. It is important to note that selling costs should not include future holding costs because these costs should be recognized as expenses when incurred. Also, future declines in the fair value of collateral should be recognized as chargeoffs in the period identified.

When substantial uncertainty exists regarding the fair value of collateral, which is common on highly specialized assets, institutions are still required to determine the fair value of the assets and charge the loan down to the expected fair value of the collateral less selling costs. However, establishing an allowance to reflect expected (but not known or confirmed) losses in addition to the chargeoff of known losses may be a reasonable approach to reflect the uncertainty in the value of the collateral and related probable losses. In such cases, and in similar situations where uncertainty exists regarding the institution's collateral position (e.g., lien perfection issues), the onus is on the institution to document the rationale for the approach taken.

If a chargeoff is recorded, the transaction should generally be as follows:

1. Earned but uncollected interest income that was accrued during the current fiscal year and is determined to be uncollectible should be reversed from interest income.

2. Earned but uncollected interest income that was accrued in prior fiscal years and is determined to be uncollectible should be charged off against the allowance for credit losses.

3. Principal and other related amounts (which include accounts receivable, additional advances, etc.) determined to be uncollectible should be charged off.

Recoveries of previous chargeoffs should only be recorded when any of the following occur:

- The chargeoff was recorded in error and the error was not detected until a subsequent accounting period. (The chargeoff would be reversed if the error was detected in the same accounting period.)

- Cash payments on a nonaccrual loan reduce the recorded investment below zero.
- Cash payments are received on a loan that would qualify for cash basis accounting treatment were it not for the existence of an unrecovered chargeoff.
- Collateral is acquired with a value greater than the loan balance outstanding.

Loan recoveries should never be recorded at the time of a loan restructuring. In addition, recoveries should not be recognized based solely on the receipt of additional collateral or a market value increase in the underlying collateral.