High-Risk Asset Accounting and Reporting

This Farm Credit Administration (FCA) document is an extension of the EM-22.2 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 A, 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. Performance categories include nonaccrual loans, formally restructured loans, and loans 90 days past due still accruing interest. 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. A loan cannot be put into more than one performance category, and loans meeting the criteria for both nonaccrual and another performance category shall be classified as nonaccrual. 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 defines a loan as nonaccrual if it meets any of the following conditions:

- Collection of any amount of outstanding principal and all past and future interest accruals, considered over the full term of the asset, is not expected.
- Any portion of the loan has been charged off, except in cases where the prior chargeoff was taken as part of a formal restructuring of the loan.
- The loan is 90 days past due and is not both adequately secured and in process of collection.

Repayment of loans categorized as nonaccrual is in such doubt that interest accrual is no longer appropriate. Loans should not be transferred to nonaccrual if full collection of principal and interest, including further accruals of interest, is expected within a reasonable time frame consistent with the definition of *in process of collection* (see below). Conversely, a loan that is severely past due should not be carried in accrual status solely because the loan is adequately secured.

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. Generally, loans in this program will remain in accrual status as long as the institution services the loan in accordance with program terms. However, if a government guaranteed loan or a loan included in the program becomes 90 days past due, it must be disclosed in the loans 90 days past due still accruing interest performance category (see below). If a risk of loss becomes evident and the loan is no longer fully collectible despite the existence of a guarantee or program commitment, the loan must be transferred to nonaccrual as prescribed by FCA Regulation 621.6(a). Furthermore, if the enforceability of the guarantee or purchase commitment is in doubt, the loan should be classified, accounted for, and reported in a manner consistent with its own unique risks without reliance upon the guarantee or purchase commitment. Additional guidance 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.

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

Adequately Secured: FCA Regulation 621.6(a)(3)(i) defines *adequately secured* as a loan that is secured by real or personal property having a net realizable value sufficient to discharge the debt in full, or guaranteed by a financially responsible party in an amount sufficient to discharge the debt in full. FCA Regulation 621.2(k) 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 loans 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.

In Process of Collection: FCA Regulation 621.6(a)(3)(ii) states that a loan is considered *in process of collection* only if collection efforts are proceeding in due course and, based on a probable and specific event, are expected to result in the prompt repayment of the debt or its restoration to current status. There must be documented evidence that collection in full of amounts due and unpaid is expected to occur within a reasonable time period, not to exceed 180 days from the date the payment was due. The commencement of collection efforts through legal action, including bankruptcy or foreclosure, or through other collection efforts such as ongoing workouts and reamortizations, do not, in and of themselves, provide sufficient cause to keep a loan out of nonaccrual status. If full collection of the debt or restoration to current status is dependent upon borrower actions, the institution must also obtain the borrower's written agreement to complete all such actions by specific dates set forth in the agreement.

When evaluating if the regulatory requirements for *in process of collection* have been met, examiners should primarily focus on the borrower's ability to restore the loan to current status through normal operations or other recurring and reliable sources of repayment. However, nonrecurring sources such as voluntary liquidation may constitute a repayment source if such liquidation plan is documented in a borrower-signed written agreement. Bankruptcy may also fulfill the criteria for *in process of collection* if the court terminates jurisdiction or grants relief from the automatic stay that permits collection to proceed fully. Similarly, foreclosure may be considered *in process of collection* if the institution has documented evidence the proceedings will result in prompt repayment of all principal and interest within 180 days from the date that payment was due. In most instances, it is rare that an institution can show documented evidence that would result in satisfying the 180 day criteria when bankruptcy or foreclosure processes are involved.

Rule of Aggregation: FCA Regulation 621.7 requires that when a loan is placed in nonaccrual, an institution must immediately evaluate whether other loans to that borrower, or related borrowers, should also be placed in nonaccrual. 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. 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. Refer to the regulation for specific guidance on what constitutes an independent credit risk. In addition, when the institution becomes aware that a borrower has a nonaccrual loan with any other lender, the institution must reevaluate its loan(s) to that borrower to determine if an independent credit risk exists.

Debtor-In-Possession (DIP) financing may be viewed as an independent credit risk under FCA Regulation 621.7. The bankruptcy court approves these loans and treats the post-bankruptcy petition DIP as a separate entity apart from the pre-petition debtor. The court's involvement essentially results in a different obligor for the purpose of applying the regulatory criteria for an independent credit risk. These loans are also generally structured with super-priority status over other creditors. This superior claim may be on the same cash flow or collateral securing other loans. However, the additional legal protections provided to lenders under this loan structure typically are sufficient to separate the primary sources of repayment and collateral from those of the pre-bankruptcy loan obligations—thus, creating a separate and non-aggregated credit risk. Nonetheless, FCA examiners can require an institution to apply the rule of aggregation if the institution has not sufficiently protected its position with regard to the DIP financing arrangement. Examiners should expect to see a documented analysis of the DIP financing decision and application of the rule of aggregation.

Earned but Uncollected Interest: FCA Regulation 621.8(c) requires accrued interest to be reversed or charged off on loans that are determined not to be fully collectible, as outlined below:

- Uncollectible accrued interest receivable that was earned in the current year should be reversed from interest income.

- Any uncollectible accrued interest receivable that was earned in prior years should generally be charged off against the allowance for loan 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. It is not necessary to reverse any interest income that has been collected. In addition, if a nonaccrual loan is adequately secured, the interest receivable may be considered collectible and support not reversing or charging off accrued interest. However, the accrual of additional interest must end on the date the loan is transferred to nonaccrual regardless of the accounting treatment for past accrued interest.

Application of Payments and Income Recognition: FCA Regulation 621.8(a) requires that recognition of interest income on nonaccrual loans is not appropriate if the ultimate collectibility of the recorded investment[1], in whole or in part, is in doubt. Any cash payments received on such loans shall be applied

[1] Recorded Investment – The remaining contractual borrower indebtedness (including uncollected penalty interest, collection expenses, and other items due from the borrower) reduced by interest not accrued (memo interest), previous chargeoffs, and other nonrefundable fees and costs. The contractual obligation may not be reduced by any valuation accounts (allowances or specific reserves) for purposes of determining the recorded investment in the loan.

to reduce 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). However, all the following conditions must be met at the time the payment is received:

- The loan does not have a remaining unrecovered prior chargeoff associated with it, except in cases where the prior chargeoff was taken as part of a formal restructuring of the loan.

- 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. However, the underlying loan characteristics should support that collectibility of the recorded investment is beyond reasonable doubt and the loan is not expected to become severely past due. In evaluating these loans, institutions should complete appropriate analyses of repayment capacity, the borrower's overall financial condition, repayment history, and other pertinent factors. These determinations should focus on the expected adequacy of repayment sources to meet the required contractual payments over the term of the loan. For example, interest income recognition on a nonaccrual loan would not be appropriate in situations where partial liquidation of essential assets was the repayment source and hindered the borrower's future repayment capacity. In contrast, payments originated from the non-routine conversion of a lender's collateral to cash could be eligible for cash basis income recognition provided the collection of the recorded investment in the loan continues to be fully expected.

Per FCA Regulation 621.8(b)(1), 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 collectability of the recorded investment is no longer in doubt. Once the chargeoff is fully recovered, payments may then be applied to interest income.

Individual payments on nonaccrual loans qualifying for cash basis income recognition should generally be applied in accordance with the contractual terms of the loan. The interest portion should be recorded as interest income upon receipt, while the portion which relates to principal should reduce the principal loan balance. An exception applies in the case of a nonaccrual loan on which interest has been previously received and applied to principal (resulting in a difference between the contractual indebtedness of the borrower and the recorded investment). In this situation, the portion of the payment which would otherwise be applied to principal may be recognized as interest income until the difference between the contractual balance and the recorded principal balance has been eliminated. Interest payments previously applied to principal under the cost recovery method may not be reversed.

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 states that a loan may be reinstated to accrual status when each of the following criteria is met:

- All contractual principal and interest due on the loan is paid and the loan is current.
- Prior chargeoffs are recovered, except for formally restructured loans.
- No reasonable doubt remains regarding the willingness and ability of the borrower to perform in accordance with the contractual terms of the loan agreement.
- Reinstatement is supported by a period of sustained performance in accordance with the contractual terms of the note or loan agreement. Sustained performance will generally be demonstrated by 6 consecutive monthly payments, 4 consecutive quarterly payments, 3 consecutive semiannual payments, or 2 consecutive annual payments.

Institutions need to determine the borrower's ability to perform in accordance with the loan agreement. This determination should consider the factors that caused the loan to be transferred to nonaccrual and whether those factors still exist. If the factors still exist, a reasonable doubt may remain regarding the borrower's ability to perform in accordance with the contractual terms of the loan agreement. This can be true regardless of the period of sustained performance demonstrated by the borrower. However, the longer repayment performance is sustained, the more likely the borrower's ability to perform has been restored and reinstatement to accrual status can be supported.

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 restructuring must provide reasonable assurance the borrower will be able and willing to service the restructured debt through ongoing cash payments. 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 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.

Formally Restructured Loans (Troubled Debt Restructurings)

FCA Regulation 621.6(b) defines formally restructured loans as a loan that meets the troubled debt restructuring (TDR) definition set forth in Accounting Standards Codification (ASC) 310-40, Troubled Debt Restructurings by Creditors *(link requires login to FASB website)*. ASC 310-40 states that a debt restructuring constitutes a TDR if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. FCA's Informational Memorandum on Accounting and Disclosure of Troubled Debt Restructurings, as required under GAAP dated March 14, 2011, provides specific guidance on TDRs. Institutions should have policies, procedures, or other guidance that are consistent with FCA guidance, GAAP, and System guidelines for identifying and reporting TDRs. Some primary considerations when examining TDR identification and reporting include:

- In evaluating loan modifications and restructurings, two conditions must be present: the borrower is having financial difficulty, and the lender grants a concession.

- A modification to a loan classified Substandard or worse (or Probability of Default of 11 or higher) should typically be evaluated for TDR status. A Special Mention loan (Probability of Default of 10) that previously demonstrated adverse financial and repayment trends and is now or has previously been 30 days or more past due should also be evaluated to determine if a modification to the loan is a TDR.

- Loans identified as a TDR are required to be disclosed in the institution's shareholder reports in accordance with ASC 310-40. As of the date of each balance sheet presented, a creditor shall disclose the amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in a TDR. This disclosure can be made in either the body of the financial statements or in the accompanying notes.

- ASC 310-40 states that information about an impaired loan that had a modification of terms as part of a TDR need not be included in years after the restructuring if both of the following conditions exist:

    - The restructuring agreement specifies an interest rate equal to or greater than the rate the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk.

    - The loan is no longer impaired based on the terms specified by the restructuring agreement.

Loans 90-Days Past Due Still Accruing Interest

FCA Regulation 621.6(c) defines this category as loans 90 days or more contractually past due that are both adequately secured and in process of collection. A loan is considered contractually past due when any principal or interest payment required by the loan instrument is not received on or before the due date. It continues to be considered contractually past due until it is formally restructured or until the entire past due amount, including principal, accrued interest, and any penalty interest, is collected or otherwise discharged in full. 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 must be 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. The property may have been acquired through foreclosure, deed in lieu of foreclosure, or other 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 stated in the following ASCs *(links require login to FASB website)*:

- ASC 310-40 – Troubled Debt Restructurings by Creditors
- ASC 360-10-35 – Overall – Subsequent Measurement
- ASC 360-20 – Real Estate Sales
- ASC 835-30 – Imputation of Interest

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 310-40 on troubled debt restructurings 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). Therefore, 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 utilize a present value calculation of forecasted cash flows to determine fair value, but more frequently look to an appraisal to establish fair value. However, an appraisal is just one factor used in determining fair value and should not be used in isolation. Circumstances may exist that indicate the appraised value is not an accurate measurement of the OPO's current fair value. For example, if the borrower had the property on the market for a considerable time at a value near the appraised value, this could indicate an overly optimistic appraised value given the current market. Economic conditions may have changed since the last appraisal, or in the case of specialized assets, the opinion of value assigned was 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 (e.g., market value or liquidation value)
- 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

FCA does not consider an appraisal, by itself, as a confirming event or a basis for recognizing a gain on OPO when received. While ASC 310-40 allows booking a gain on OPO based on fair value, in practicality, it should be a rare occurrence as most borrowers would not forego equity that existed above the loan amount. 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 would relinquish the equity in the asset if it was worth more than the loan amount.

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. As such, subsequent declines in the fair value less costs to sell below the existing cost basis are recorded through a direct write-off. 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 written back up to a value that exceeds the value established at the date of acquisition. 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 360-20 on real estate sales provides guidance as to what constitutes a consummation of a sale. It also covers when and how profit or loss should be recognized when the institution is financing the sale of OPO. The following conditions must be met for an OPO real estate sale to be considered consummated under the full accrual method:

- The parties are bound by the terms of a contract.
- All consideration has been exchanged.
- Any permanent financing for which the seller is responsible has been arranged.
- All conditions precedent to closing have been performed.

Usually, these conditions are met at the time of closing or after closing, not when an agreement to sell is signed or at a pre-closing. Once the sale is consummated, a profit or loss on the sale can be recognized. Generally speaking, a loss should be recognized immediately after the sale while profits may be recognized via various accounting methods, including full accrual, installment, cost recovery, and deposit methods (see ASC 360-20 for accounting guidance on these methods).

Accounting for Loan Losses (Chargeoffs and Recoveries)

FCA Regulation 621.5 addresses accounting for the allowance for loan losses and chargeoffs. The allowance for loan losses is a valuation account established to reflect estimated incurred losses in the loan and lease portfolio. It is a contra account recorded as an offset (reduction) to loan volume 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. While the guidance provided below addresses chargeoffs, it should be read and applied in conjunction with the closely related guidance provided in the EM-21.2 *Allowance for Losses* Examination Manual topic. The EM-21.2 guidance also addresses the related requirements for identifying and evaluating impaired loans, which is another aspect of properly accounting for high-risk assets.

FCA Regulation 621.5(c) requires System 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(k). 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 and 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 off the loan down to the expected fair value of the collateral less selling costs. However, establishing a specific allowance in addition to the chargeoff may be a reasonable approach to reflect the additional 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 loss should generally be applied in the following sequence:

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 loan 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 which 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. Additionally, recoveries should not be recognized based solely on the receipt of additional collateral or a market value increase in the underlying collateral.