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Regulators Ready and Willing to Flag Banks for Troubled-Debt Miscues

Rachel Witkowski

Want more clarity on restructuring troubled loans? Regulators are happy to oblige.

The rub is that guidance is increasingly coming in the form of more-onerous enforcement actions. A handful of recent orders have gone beyond general directives to fix credit quality, pointing to recently updated accounting standards. The biggest worry for regulators involves banks that fail to correctly report troubled debt restructurings - often a sore subject between bankers and examiners, especially when it involves real estate values.

"The OCC is going after banks that have not appropriately identified loans as TDRs and, therefore, have not recorded a sufficient allowance in accordance with Generally Accepted Accounting Principles," says an accounting executive at a bank regulated by the Office of the Comptroller of the Currency, who asked not to be named. "The OCC has established the identification and allowance accounting for TDRs as a primary focus in their bank examinations."

Bill Massey, an accountant and consultant at Saltmarsh, Cleaveland & Gund, said regulators have become more outspoken in the past year after the Financial Accounting Standards Board clarified guidance on the topic.

On particular FASB guidance, which became effective in the third quarter, requires banks to apply a market rate to modified loans. FASB stated that extending a payoff date, if not at market rates, would be subject to TDR classification.

Most regulatory orders citing accounting issues tied to troubled debt restructurings were issued since June 30. Now that amended rules are in effect, industry observers say regulators will start enforcing those standards.

This likely means higher TDRs and classified assets in 2012 as more banks are required to reevaluate loan portfolios.

"The new accounting rules probably make it so banks have to classify more loan modifications as troubled," says Julie Hill, a law professor at the University of Houston.

TDRs at banks with less than \$20 billion in assets have been rising. In the fourth quarter, they increased 27% from a year earlier, to \$40.1 billion, or 2.1% of total loans, according to Trepp LLC.

Industry observers say even a single miscue can cause regulators to scour a bank's entire credit metrics, especially with loan-loss allowances. For instance, an allowance for a residential mortgage that is not considered a TDR only covers expected losses on principal for the next one-year period. If the same loan is considered a TDR, the allowance must be increased to cover all future losses for the life of the loan, including interest.

Community West Bancshares in Goleta, Calif., received an order from the OCC last month over accounting concerns for TDRs, the allowance and other real estate owned. The company lost \$8.6 million in the fourth quarter after, among other things, its loan-loss provision jumped 354% from a year earlier, to \$6 million.

Martin Plourd, the \$633 million-asset company's new president and CEO, declined to comment. Robert Bartlein, the company's chairman, said in a press release Wednesday that they had already addressed "many of the prudent actions required" in the order.

Some thrifts that fell under the OCC's oversight last summer were later issued new orders to address accounting for TDRs.

Universal Bank in West Covina Calif. received a replacement order from the OCC on Oct. 20, which took into account updated FASB standards, required the bank to reevaluate its loan classifications and troubled debt.

In a Dec. 19 order against Lincoln Federal Savings Bank of Nebraska, the OCC cited accounting standards for establishing a "tickler system" to track updated appraisals to properly impair loans. That order also mentioned accounting properly for TDRs.

The details baffled some observers who say regulators usually zero in on credit quality in orders. Accounting standards are usually brought up by the Securities and Exchange Commission.

"It is surprising that the bank regulators are focused on accounting issues" to this specificity, said Chip MacDonald, a partner at Jones Day. He said that, if the accounting changes required by regulators are material enough at the bank level, it could cause the parent to adjust or even restate prior financials, which could hurt their public perception.

Massey says exam reports typically "go into detail on the accounting side" but consent orders "have been so generic."

Perhaps regulators have been pressed to clarify their views on credit quality as banks and examiners sought guidance to the new standards. Massey says regulators addressed TDRs heavily during regional meetings with examiners last year. At the same time, he says his firm's banking clients are being questioned.

"The rules definitely clarify things more, but I can tell you, there are still a lot of questions," Massey says.