Department of
Financial Institutions

Memo

To: North Dakota State Chartered Credit Unions

From: North Dakota Department of Financial Institutions

Date: 10/10/2017

Re: Guidance on Loan Workouts and Loan Modifications

During periods of economic stress, the need arises from time to time to modify existing loans to improve their collectability. Common examples are the terming out of agricultural operating loans following a drought or depressed commodity prices, rewriting credits under government guarantee or participation programs, and temporary interest only payments on distressed commercial real estate.

As you review your options for these credits, please be aware that regulatory changes have mandated certain documentation standards for restructures and workouts. Additionally, care should be taken to ensure accurate loan portfolio risk monitoring. Finally, government programs are available to reduce the risk including, the Bank of North Dakota's recently introduced program to assist producers impacted by drought conditions.

State and Federal rules establish the framework for documenting a workout credit. First off, they establish what constitutes a workout, which is somewhat encompassing. Any credit extended, restructured, or re-aged due to financial difficulty is a workout credit per the regulation. This would capture in part any agricultural or commercial term credits where, for financial reasons, full payment was not made and any operating loan restructured into term financing. Even if the operation is still viable and you are not actively trying to exit the lending relationship, the credit still needs to be identified as a workout and comply with rule requirements.

The rules require loan files to reflect the borrowers' continued willingness and ability to repay the loan, it must consider the balanced interests of the borrower and the credit union, and the institution must be able to validate that the credit's modification improved collectability. What this means is somewhat unclear if only reading the regulations, so the following are some things examiners will be looking for and that must be documented in a credit presentation to meet this standard:

- Evaluate and explain what went wrong that resulted in a need for a restructure. Take the prior years' projections and evaluate which income and expense lines were materially inconsistent with actual results. Evaluate how the problem will impact the accuracy of the next years' projections.
- Stress test the credit. The loan officer and the borrower should both understand how far key income and expense lines can vary from the projection (or historical performance in the case of some commercial accounts) before they no longer can meet their obligations.
- Calculate and share with the borrowers their working capital burn rate and their equity burn rate. This is a relatively new risk measurement tool, but is extremely useful for the credit union and the borrower to evaluate if a restructure is in either of your best interests. This calculation

should be documented in the file. Many economists have discussed this concept including Dr. David Kohl who has published extensively on the subject. An internet search will produce many articles explaining the subject, some of which are included below:
    - http://www.cornandsoybeandigest.com/blog/its-time-stress-test-your-farm-business-financials
    - http://www.cornandsoybeandigest.com/blog/land-equity-shock-test
    - http://www.cornandsoybeandigest.com/blog/agriculture-financial-management-working-capital-burn-rate
    - http://www.northlandfbm-moorhead.com/Old%20Website/Web%20Documents/Kohl%2063.pdf
- Inspect and update the value of collateral. Stress testing and equity burn rates will not be a useful tool unless collateral values have been updated. Files should document:
    - That previous appraisals are still valid. If the appraisal was performed using comparables from the peak prices or is extremely dated, an updated appraisal may be warranted. Updating the income approach is one way to check and document an appraisal's continued validity (see next bullet for explanation).
    - Estimate real estate value changes as part of the annual review, renewal, or restructure process. A simple way of doing this is to update the income analysis within the existing appraisal to reflect current net operating income, and utilized stated capitalization rates (assuming original rates were reasonable). This is a quick and easy check and may be more reasonable for use in loan to value analysis for risk rating purposes.
    - Inspect the collateral. Inspected inventory notes generally can be rated a pass. Document the existence and condition of major collateral items. If it is a classified credit, consider more frequent inspections. Update the values in your analysis based on conditions noted and current auction/book values. Explain the process for and results of the valuations in the credit presentation.
- If the credit is relying on the guarantors for payment, verify the guarantors' liquidity position. Calculate how long the guarantors are able to support the credit based upon their liquidity position. Consideration should also be given to other direct or contingent obligations and their potential impact on this liquidity position. The inability to sustain these payments over time could impact the reasonableness of a loan modification or classification decision.
- Track all workout credits, and establish policy limits on the frequency in which they can be modified, as well as a portfolio limit on the number and volume of modified credits. A report which captures all credits that have been modified and meet the definition of a loan workout will be necessary. This will also help track the success rates of modifications, which will be useful in validating that the modifications improved collectability of the credit.
- Modified credits may result in policy exceptions. For example, a policy loan to value exception may need to be granted for real estate with a current appraised value less than the note amount if the borrower has the capacity to service the debt under modified terms. Be sure your system has the capacity to track and produce a report on all policy exceptions granted.

Consider ways to reduce the risk to the institution for difficult credits which are still viable. FSA, USDA, and the Bank of North Dakota all have programs to assist lenders and borrowers. This includes a new program introduced by the Bank of North Dakota to assist ag produces impacted by the drought. More on this can be found at https://bnd.nd.gov/ag/.