

District Banks' Exposure to Modified Loans Limited

By Kory Killgo

The current experience with loan restructurings in the district appears to be less a cause for alarm and more a helpful response to some borrowers' difficulties.

Banks in the Eleventh Federal Reserve District are performing better than their peers.¹ However, signs of strain are still evident—with loan delinquencies a prime example—following the recession and financial market crisis. Some banks that restructure troubled loans by granting borrowers easier terms subsequently find the loans delinquent again.

While the number of restructured loans has grown dramatically, these loans remain a small part of the average bank's balance sheet, a review of district data shows. Lenders here are less likely to carry restructured loans than banks around the country, and when they do hold such assets, problems don't appear to be out of line with historical tendencies.

These findings indicate that the current experience with loan restructurings in the district is less a cause for alarm and more a helpful response to some borrowers' difficulties.

How Restructured Loans Work

A restructured loan is one in which a lender makes a repayment concession because the borrower's financial condition has changed, making it unlikely or impossible for the original terms to be met. Concessions include reductions of interest or principal payments. A loan isn't considered restructured if it's extended or renewed under the same terms that a similar borrower would receive on a new transaction.

Banks renegotiate loans when they believe more favorable terms will increase the prospects of repayment. Supervisory guidelines expect such changes to be prudent and infrequent. Regulators encourage bank boards of directors to approve proposed restructurings and require board notification of any that are implemented.

If restructurings are not done prudently, a borrowing that should be classified as nonperforming or declared a loss could masquerade as a sound loan, deferring recognition of problems. In practice, many

restructured loans encounter repayment difficulties, despite the concessions made to borrowers. Some industry observers have suggested that the poor performance of restructurings points to an ineffective process that only delays loss recognition.

Assessing whether banks are properly handling problem loans requires detailed knowledge of the banks' restructuring process—the type of in-depth insight supervisory personnel gain during onsite bank examinations. It also requires exam-level data to determine an institution's indirect exposure to restructured loans, often through securities based on them. Even without this internal information, publicly available data provide some clues.

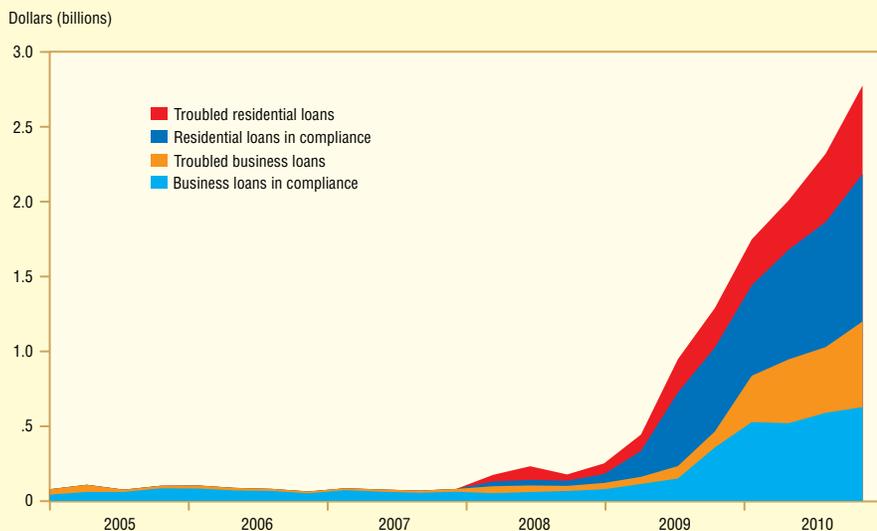
Growth of Restructured Loans

Banks traditionally reported restructured business loans but not consumer loans and borrowings secured by one- to four-family residential properties. In 2008, they began reporting restructured loans secured by these residential holdings.

At year-end 2005, before the financial crisis, restructured business loans at Eleventh District banks totaled just over \$100 million, with about \$18 million (18 percent) failing to comply with their modified terms (*Chart 1*). In 2008, the dollar volume of restructured business loans began growing and their performance deteriorated—a trend that accelerated in 2009. As of Sept. 30, 2010, district banks reported just over \$1.2 billion in restructured business loans, with \$573 million (48 percent) in repayment trouble.²

One- to four-family residential real estate loans added to the concern. At the beginning of 2008, district banks reported \$76 million in restructured residential loans, with \$45 million (59 percent) in trouble. By Sept. 30, the figure had soared to \$1.6 billion, with \$592 million (37 percent) in difficulty. While some of this growth can probably be attributed to government initiatives such as the Home Affordable

Chart 1
Recession Leads to Restructured Loan Surge in Eleventh District



NOTE: Cumulative total depicted. Troubled loans are defined as those 30 days or more past due on their modified terms.
 SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

As of Sept. 30, district banks held a total of \$2.8 billion in restructured loans, with \$1.2 billion (43 percent) at least 30 days past due on their modified terms.

Modification Program that were implemented to help avoid foreclosures, reporting requirements don't capture the data that would document that impact.

As of Sept. 30, district banks held a total of \$2.8 billion in restructured loans, with almost \$1.2 billion (43 percent) at least 30 days past due on their modified terms.

Modified Loan Share

Watching a dramatic increase in any troubled asset category can be unsettling for bankers and regulators. However, it's important to put such an upsurge in context.

It's particularly useful to look at the relative size of restructured loans on banks' balance sheets.

Restructured business loans accounted for 0.9 percent of total district business lending as of Sept. 30. Also, restructured loans accounted for only 10.1 percent of all troubled business loans. Relative to the overall portfolio, the level of restructured business loans appears manageable.³

Figures are slightly higher for restructured one- to four-family residential property loans. As of Sept. 30, restructured loans accounted for 2.6 percent of overall residential lending at district banks. Restructured loans accounted for 17.4 percent of total troubled residential loans.

Across the country, restructured business loans rose to \$30.8 billion as of Sept. 30 from \$1.3 billion at year-end 2005 (*Chart 2*). Such

business loans accounted for almost 1 percent of total business lending nationwide as of Sept. 30, slightly higher than the district's 0.9 percent.

Reflecting the deterioration of the housing market nationwide, U.S. banks held about \$83 billion in restructured loans secured by one- to four-family residential properties on Sept. 30, up from \$19 billion two years earlier. About \$31 billion of these were at least 30 days past due. Total restructured residential loans accounted for 4 percent of all residential lending. By comparison in the district, restructured residential loans were 2.6 percent of total residential loans, largely reflecting the relatively moderate decline in Texas housing prices.

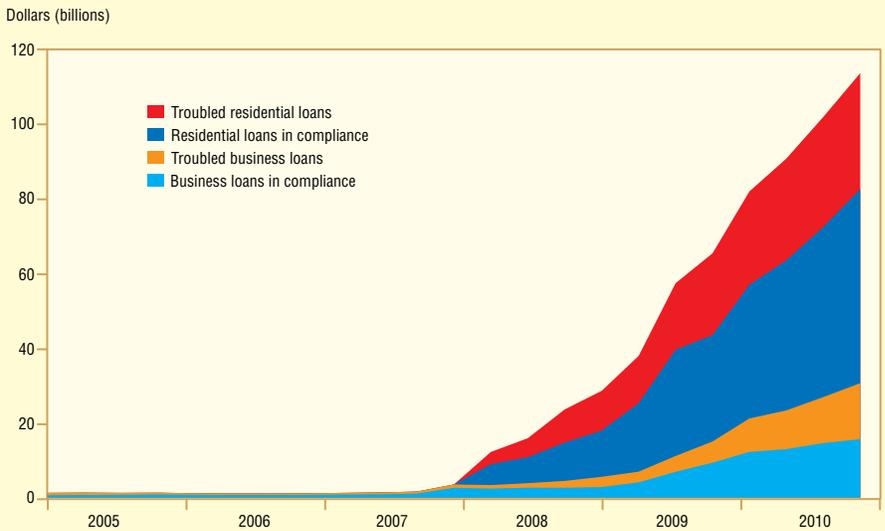
It's also useful to see how widespread restructured loans are in the banking industry.

In the three years leading up to the recession, about 15 percent of banks in the district and the nation held restructured loans. That percentage has trended upward since first quarter 2008, with the rate of increase nationwide outpacing the rate at area banks (*Chart 3*). Thirty-one percent of district banks held restructured loans as of Sept. 30, compared with 51 percent nationwide.

Put another way, despite the jump in restructurings, about 70 percent of banks in the district and half of banks across the country reported no such loans.

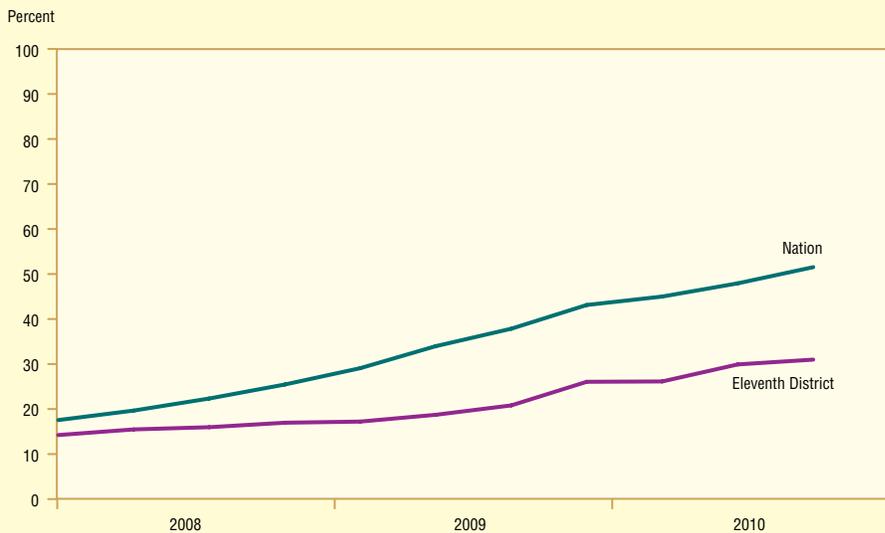
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Chart 2
Restructured Loans Rise at U.S. Banks at Recession's Onset



NOTE: Cumulative total depicted. Troubled loans are defined as those 30 days or more past due on their modified terms.
 SOURCE: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council.

Chart 3
Fewer Than One-Third of District Banks Hold Restructured Loans



SOURCES: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council; author's calculations.

In Line with History

Even with the assistance of beneficially revised terms, many restructured loans fall behind. Could it be a sign that banks have become desperate under the weight of the financial crisis and are imprudently modifying loans to delay loan-loss recognition or hide from regulators the full extent of their credit difficulties?

If bankers became less discerning in

pursuing restructurings, proceeding with deals even when the likelihood of repayment was lower than usual, we might expect the restructured loan delinquency rate to exceed historical norms. That doesn't appear to be the case.

The percentage of total restructured business loans failing to comply with modified terms in the district and the nation appears

Chart 4
Restructured Loan Delinquency Rates Remain in Normal Range



SOURCES: Quarterly Reports of Condition and Income, Federal Financial Institutions Examination Council; author's calculations.

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within the usual range going back to 2001 (*Chart 4*).⁴ While the delinquency rate is high, it has reached similar levels before, even when restructuring activity was low, consistent with the view that banks are not restructuring loans less carefully.

Broader Economic Impact

While loan restructuring calls for careful oversight by lenders, borrowers and regulators, it is an important acknowledgment of the uncertainties that are a normal part of doing business. In a tough economic climate, the benefits of loan restructuring can increase for borrowers and lenders and may extend to the broader economy.

Successful residential mortgage loan modifications, for example, help reduce foreclosures and moderate the speed at which these properties come to market. This could lessen both the disruptive impact on borrowers' families and the downward pressure on neighboring property values. Giving borrowers another chance also helps minimize the negative impact on financial markets by averting foreclosure costs. In these ways, prudent attempts at loan restructuring may provide macroeconomic benefits beyond the relief experienced by individual borrowers.

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Notes

¹ The Eleventh Federal Reserve District is headquartered in Dallas and includes Texas, northern Louisiana and southern New Mexico.

² District bank data are adjusted for merger and relocation activity.

³ For a broader view of district bank conditions, see "Eleventh District Banking Industry Weathers Financial Storms," by Kenneth J. Robinson, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter 2010.

⁴ This delinquency rate is equal to troubled restructured business loans divided by the sum of troubled restructured business loans and restructured business loans in compliance with modified terms.