

Challenges with Troubled Debt Restructuring: Accounting and Reporting



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Troubled Debt Restructurings (TDR) Agenda

Guidance

- TDR identification
- Accrual, impairment, and reporting

Considerations in TDR accounting and reporting

- Trial modifications
- Revenue recognition – accrual/nonaccrual
- A/B note splits
- TDR reporting
- Identifying whether a rate is a market rate
- Loss measurement methods

Questions and answers

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TDR Identification and GAAP Guidance

Primary source of TDR GAAP guidance

- FASB Accounting Standards Codification 310-40

A TDR is defined as:

- A loan restructuring or modification of terms is 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.”

A TDR determination requires judgment to assess if:

- A borrower is experiencing financial difficulties and
- An institution has granted a concession that it would not have otherwise considered if not for the borrower’s financial difficulties.

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TDR Identification

Two-Step Process:

Step 1:

Determine whether the borrower is experiencing financial difficulties.

Indicators include the following:

- Current or probable default in foreseeable future on any debt
- Headed toward, or is in, bankruptcy
- Doubt about ability to remain a going concern
- Unable to service debt based on current capabilities for the foreseeable future
- Inability to obtain takeout financing
- Debt-specific weakness (inability to maintain tenants, rents, or loss of key leadership)

Step 2:

Determine whether modification is a concession.

Examples include the following:

- Forgiving principal or interest
- Modifying interest rate to a below-market rate
- Deferring principal payments (e.g., interest only)
- Extending the maturity date

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TDR Identification: New Guidance

FASB Issued Accounting Standards Update 2011-02 in April 2011

- Provides clarifying guidance intended to narrow diversity in practice of TDR identification
- Did not change the TDR definition

Key Points

- An increase in a borrower's interest rate does not preclude a restructuring from being considered a TDR (increase in rate might represent a concession)
- In assessing financial difficulty, consider whether borrower might default in the foreseeable future
- An insignificant delay in payment is not a concession
- Adding collateral or guarantees in exchange for a modification may be a concession if not adequate compensation

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TDR Identification: Insignificant Delay

Modifications or restructurings that result in an insignificant delay in payment are not concessions

Concept of insignificant delay in impairment guidance added to TDR guidance

Insignificant delay concept requires an assessment of both the amount and timing of cash flows

- Amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal balance or collateral value of the debt and will result in an insignificant shortfall
- The delay in timing of the restructured payments is insignificant relative to any one of the following:
 - Frequency of payments due,
 - Debt's original contractual maturity, or
 - Debt's original expected duration.

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Applying the Guidance: Collateral/Guarantees

A bank may restructure a debt in exchange for additional collateral or guarantees. In that situation, a bank has granted a concession when the nature and amount of that additional collateral or guarantees received as part of a restructuring do not serve as adequate compensation for other terms of the restructuring.

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Accrual, Impairment, and Reporting

Implications for Interest Accrual

- Bank should not materially overstate income.
- Decision to return a loan to accrual status should be based on a sustained period of performance at the revised terms (e.g., six months).
- All amounts due (both principal and interest) are reasonably assured of collection.

Allowance for Loan and Lease Losses (ALLL)

- Loans that are reported as TDRs are deemed to be impaired and should generally be evaluated based on the present value of expected cash flows.
- However, if the loan is collateral dependent, the impairment should be measured based upon the fair value of the collateral less costs to sell.

Call Report (Schedule RC-C Part I memoranda item 1b)

- Restructured loans are reported as restructured until paid in full. However, a restructured loan that is in compliance with its modified terms *and yields a market rate* need not continue to be reported as a troubled debt restructuring after the year in which the restructuring took place.

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Considerations in TDR Accounting and Reporting

Applying the guidance requires judgment

- Qualitative and quantitative
- No bright lines

Policy elections

- Insignificant delay evaluations
- Sufficiently granular (e.g. by product type)
- Consistent application

TDR assessment process should be reasonable, documented, and well supported

Applying the Guidance: Trial Modifications

- There may be diversity in practice with respect to the identification of a trial modification as a restructuring that would be within the scope of TDR accounting.
- Trial modifications are not automatically scoped out of TDR accounting.
- Several large banks are currently discussing this issue with the Securities and Exchange Commission (SEC).

Applying the Guidance: A/B Note Structures

A formal restructuring may involve a multiple note structure in which, for example, a troubled loan is restructured into two notes.

- The first, or "A" note, represents the portion of the original loan principal amount that is expected to be fully collected along with contractual interest.
- The second, or "B" note, represents the portion of the original loan that has been charged off.

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Applying the Guidance: A/B Note Structures

The "A" note may be returned to accrual status provided the conditions in the preceding section on returning TDRs to accrual status are met and:

- There is economic substance to the restructuring,
- The portion of the original loan represented by the "B" note has been charged off before or at the time of the restructuring, and
- The "A" note is reasonably assured of repayment.

The "A" note must be reported as a TDR for the remainder of the calendar year but need not be reported as a TDR in subsequent years.

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Applying the Guidance: TDR Reporting Issues

Generally, once a TDR, always a TDR

Narrow TDR reporting exception

- For a TDR with an interest rate at or greater than a market rate of interest for that borrower at the time of the modification and that is performing in compliance with the restructured terms
 - The loan is not required to be reported in calendar years after the restructuring if both conditions are present

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Applying the Guidance: When Markets Contract

If a borrower does not otherwise have access to funds at a market rate for loans with similar risk characteristics as the restructured loan because no bank is offering that loan product in the market, the restructuring would be considered to be at a below-market rate, which would likely indicate that the bank has granted a concession.

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Applying the Guidance: Market Rate of Interest Evaluation

- *Call Report Supplemental Instructions* indicate that in determining whether a loan has been modified at a market interest rate, an institution should:
 - Analyze the borrower’s current financial condition and
 - Compare the rate on the modified loan to rates the institution would charge customers with similar financial characteristics on similar types of loans.
- This determination requires the use of judgment and should include an analysis of credit history and scores, loan-to-value ratios or other collateral protection, the borrower’s ability to generate cash flow sufficient to meet the repayment terms, and other factors normally considered when underwriting and pricing loans.

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Applying the Guidance: Loss Measurement

- A loan restructured in a TDR is an impaired loan.
- All TDRs must be measured for impairment in accordance with ASC Subtopic 310-10, Receivables – Overall (formerly FAS 114, “Accounting by Creditors for Impairment of a Loan,” as amended).
- TDRs that are modifications of terms, where repayment is expected from the borrower, are generally measured for loss based upon the present value of cash flows, discounted at the loan’s original effective interest rate.

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Applying the Guidance: Loss Measurement

- Regulatory reporting instructions require that TDRs that are collateral dependent be measured for loss, based on the fair value of the collateral, less costs to sell.
 - Loans that are collateral dependent are defined in ASC 310-30 as loans “for which the repayment is expected to be provided solely by the underlying collateral.”
 - If a loan is repaid through operation or sale of the collateral, that loan is collateral dependent and should be measured for loss, based upon the fair value (FV) of the collateral.

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Question and Answer

Is a concession granted if the bank restructures the loan from an amortizing loan to an interest-only loan?

- Unless the deferral of principal payment is considered an insignificant delay, yes, it is a concession.

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Question and Answer

A lender renews a commercial real estate (CRE) loan (land acquisition and development) in a market where no lenders are originating that type of loan. Is this a TDR?

- It depends on facts and circumstances.
- Is the loan being renewed because the original exit strategy has failed and the borrower cannot pay the loan?
- How do operations compare to original expectations?
- Based upon current forecasts, will the borrower's cash flows be sufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future?

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Question and Answer

A 5-year balloon loan with payments based upon a 20-year amortization was restructured at maturity to a 3-year balloon loan with payments based upon a 20-year amortization and a 75 bp increase in the interest rate. Is the new interest rate a concession?

- To determine whether the modification is a concession, the bank should perform a credit review of the borrower.
- Is the rate a market rate of interest?
 - Is the new rate commensurate with the risk profile of the borrower?
 - Just because the rate was increased does not mean it is not a concession.

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Question and Answer

Should a loan be removed from TDR reporting if the borrower defaults under the modified terms?

- As noted above, the only exception for TDR reporting is when the TDR had a market rate of interest at the time of the restructuring and is performing in compliance with the restructured terms.
- A TDR in default would not meet that exception and would therefore continue to be reported as a TDR. (Past due TDRs should be reported on RC-N Memoranda).

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Question and Answer

A CRE loan is renewed with an interest rate concession. The borrower performs under the new terms for a year. The modified rate is now a market rate of interest (market rates have declined). The loan is fully secured, based upon a recent appraisal. While the property doesn't service the debt, the borrower's and guarantor's global cash flows provide 1.1x debt service coverage. Can this loan be removed from TDR status and returned to accrual status?

- The loan doesn't meet the exception and cannot be removed from TDR reporting because it was not at a market rate of interest at the time of the modification.
- The loan can be returned to accrual status once the borrower has demonstrated sustained payment performance (generally considered to be 6 months).

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Question and Answer

A loan has been restructured (i.e. partial forgiveness of debt, reduced interest rate, extended maturity) with the borrower paying the recorded balance according to the modified terms, with no indication of inherent loss. At what time would it be reasonable to consider upgrading the loan classification?

- Need to consider:
 - Any uncertainty surrounding the collection of the remaining balance
 - Expectations of the borrower's ability to continue to make contractual payments (profitability and debt service coverage)
 - Length of time borrower has complied with modified terms
 - Compliance with bank's underwriting standards (A/B note split)

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Questions?

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