



# Accounting for TDRs by Creditors

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Sources:

FASB, AICPA, PPC, McGladrey, The CB Journal  
DT, KPMG, PwC



# Agenda

- What are troubled debt restructurings?
- Recent guidance
  - ASU 2011-02 – *A creditor's determination of whether a restructuring is a TDR*
- Accounting
- Disclosures

# Definition

## ■ Troubled Debt Restructuring

- A restructuring of a debt constitutes a troubled debt restructuring 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 concession is typically granted by a creditor in an attempt to protect as much of its investment as possible.

# Background

- The accounting for restructured debt requires the application of judgment based on the specific facts and circumstances of the situation.
  - Should be based on the SUBSTANCE of the modifications.
  - Not the labels used to describe them.
- The basis for the resulting accounting should be well documented.

# Background

- Covered by FASB ASC 310-40, *Troubled Debt Restructurings by Creditors*
  - Accounting for troubled debt restructurings by debtors is located at ASC 470-60.
  - Debtor and creditor shall individually apply the tests for TDRs and may not result in symmetrical accounting by both parties
- This guidance applies to all creditors.
  - Pooled loans are scoped out.

# Pool of Multiple Loans

- ASC 310-30 allows a creditor to group two or more acquired loans (other than debt securities) with common risk characteristics into a pool and account for the pool as a single asset.
- ASC 310-30-40-1 requires the integrity of a pool to be maintained unless either of the following conditions are met:
  - Creditor sells, forecloses, or otherwise receives assets in satisfaction of the loan.
  - The loan is written off.

# Pool of Multiple Loans

- ASU 2010-18 clarifies that a refinancing or restructuring of a loan shall not result in the removal of a loan from a pool.
  - *Applicable even if the modification of those loans would otherwise be considered a TDR.*
- Heads Up:
  - The proposed ASU on accounting for financial instruments contains a requirement to remove modified loans that constitute TDRs from a pool of loans, contrary to ASU 2010-18.

# OTS Thrift Bulletin 85 (dated 8/28/2009)

- “During periods of market deterioration, loan modifications should be presumed to be TDRs, unless that presumption can be overcome by a preponderance of evidence to the contrary.”
- Documentation in the debtor’s loan file for each TDR decision should include:
  - An analysis of data considered when granting the TDR.
  - Evidence that the TDR has been properly authorized.



# ***ASU 2011-02***

## ***A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring***

# Background

- Several stakeholders raised concerns about needing additional guidance for purposes of determining whether a restructuring constitutes a TDR:
  - Whether a creditor has granted a concession.
  - Whether a debtor is experiencing financial difficulties.
- Intended to result in more consistent identification of TDRs by creditors.

# Applying New Guidance

- Historically there was not much guidance in the creditor's accounting literature to determine when a concession had been made.
- Therefore, many creditors relied on the debtor's accounting literature for guidance.
- ASU 2011-02 helps by further defining when a concession has been granted from a creditor's perspective.

# Applying New Guidance

- The ASU also explicitly prohibits creditors from applying the debtor's guidance for determining whether the creditor granted a concession.
- What does this mean?
  - Creditors can no longer apply the debtor's effective borrowing rate test prescribed in ASC 470-60-55-10.
  - Debtor's and creditor's evaluation of a TDR may now be asymmetrical.

# Applying New Guidance

- What does this mean? ...continued
  - Creditors have frequently applied the debtor's test since it is quantitative in nature and easier to apply across all modifications.
  - The FASB wants creditors to evaluate modifications on a more holistic basis, as opposed to applying rules-based criterion.
  - Creditors will now how to revisit how they evaluate whether they have granted a concession.

# Applying New Guidance

- A creditor determines if the debtor's effective borrowing rate was increased or lowered as a result of the modification.
  - Before ASU 2011-02:
    - If lowered, a concession was granted = TDR.
    - If increased, a concession was not granted  $\neq$  TDR.
  - After ASU 2011-02:
    - If lowered, a concession *may* have been granted = ?TDR
    - If increased, a concession *may* have been granted = ?TDR. Creditor can no longer presume  $\neq$  TDR.

# Applying New Guidance

- Example: a creditor modifies a loan with a teaser interest rate into a fixed interest rate so that the effective interest rate increases.
  - Before ASU 2011-02:
    - Conclude that no concession was granted ≠ TDR
  - After ASU 2011-02:
    - Conclude that a concession *may* have been granted = ?TDR
    - The creditor needs to consider all the terms of the modification before finalizing the determination.
    - May result in more modifications = TDR.

# Concession Granted

- A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate.
  - If principal due at original maturity is primarily dependent on the value of collateral, the creditor shall consider the current value of that collateral to determine the principal due for TDR calculation purposes.

# Concession Granted

- If the nature and amount of additional collateral or guarantees, received by the creditor, does not serve as adequate compensation for other terms of the restructuring.
  - Both the guarantor's ability *and* willingness to pay the balance owed should be evaluated.

# Concession Granted

- If a debtor does not have access to funds at a market rate for debt with similar risk characteristics, the restructuring is considered at a below-market rate.
  - This may indicate a concession was granted.
  - The creditor shall consider all aspects of the restructuring to determine if a concession was granted.

# Concession Granted

- If temporary or permanent increases in the contractual interest rate are made but the restructured rate is still below market interest rates for new debt with similar risk characteristics.
  - This may indicate a concession was granted.
  - The creditor shall consider all aspects of the restructuring to determine if a concession was granted.

# Concession NOT Granted

- A restructuring that results in only a delay in payment that is insignificant is not a concession.
  - Amount of restructured payments subject to the delay is insignificant relative to the unpaid principal balance and will result in an insignificant shortfall of contractual amounts due.
  - Delay in timing of restructured payment period is insignificant relative to any one of the following:
    - Frequency of payments due under the debt
    - The debt's original contractual maturity
    - The debt's original expected duration

# Concession NOT Granted

- A restructuring that results in only a delay in payment that is insignificant is not a concession.
  - If the debt has been previously restructured, an entity shall consider the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant.

# Financial Difficulties

- A creditor shall consider the following indicators when determining if the debtor is experiencing financial difficulties:
  - Debtor is currently in payment default on any of its debt.
  - Debtor is probable to default on any of its debt in the foreseeable future without the modification.
    - Therefore, debtor does not currently have to be in default to conclude they are experiencing financial difficulties.
  - Debtor has declared (or is in the process of declaring) bankruptcy.

# Financial Difficulties

## ■ Indicators...continued

- There is substantial doubt about the debtor's ability to continue as a going concern.
- Debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.
- Creditor forecasts the debtor's entity-specific cash flows will be insufficient to service any of its debt (P&I) in accordance with existing contract terms for the foreseeable future.
  - Creditor's estimates and projections can only encompass the debtor's current capabilities.

# Financial Difficulties

## ■ Indicators...continued

- Without the current modification, debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled debtor.
  - Absence of a market rate doesn't automatically result in TDR.
  - Need to look at broader markets to evaluate if debtor could access funds at a non-troubled market rate.
- The above list is not intended to include all indicators of a debtor's financial difficulties.
- Essentially the same indicators from the debtor's guidance at ASC 470-60.

# Financial Difficulties

- Questions are on how to apply this guidance when markets no longer exist or are severely hampered.
  - Some creditors concluded this principal didn't apply when a market no longer existed.
  - ASU 2011-02 clarifies that the principal does exist.
  - Also clarifies that the mere absence of a market rate does not automatically result in a TDR because credit markets occasionally contract severely.
  - Creditor should look at broader markets to evaluate whether the debtor could access funds at a non-troubled market rate.

# Insignificant Delay? Example 1

- Commercial RE debt w/balloon payment
  - Debtor is experiencing financial difficulties.
  - 7 year loan, fixed interest rate, collateralized by commercial real estate
    - Monthly interest payments
    - Balloon principal payment at maturity
  - At origination, the collateral is the primary source of principal repayment.
    - Refinancing
    - Sale of the property

# Insignificant Delay? Example 1

- Commercial RE debt w/balloon payment...cont
  - Prior to maturity, due to market conditions, the FV of the collateral was less than the principal due at maturity, therefore debtor can't refinance.
  - Debtor plans to sell the property to repay the debt and requests a 3 month extension of the maturity date to provide time to liquidate the property.
  - Creditor grants the 3 month extension.
  - At the time of extension, debtor had not yet identified a buyer for the property.

# Insignificant Delay? Example 1

- Commercial RE debt w/balloon payment...cont
  - Length of delay is insignificant in relation to the:
    - frequency of payments due.
    - debt's original contractual maturity.
    - debt's original expected duration.
  - **BUT**, when the property is sold, the creditor expects a significant shortfall in cash flows relative to the contractual amount due (property is the sole source or repayment).
  - The delay in payment as a result of restructuring **IS NOT insignificant**.
  - Therefore, a concession *has been* granted.

# Insignificant Delay? Example 2

- Residential mortgage debt, temporary payment deferral
  - Debtor is experiencing financial difficulties.
  - 30 year mortgage, monthly P&I payments.
  - In year 4 debtor misses 2 payments.
  - Based on debtor's financial hardship, a forbearance arrangement and repayment plan are agreed on:
    - Debtor will increase its next 4 monthly payments to include  $\frac{1}{4}$  of the delinquent amount plus interest.
    - Creditor won't take any foreclosure action.

# Insignificant Delay? Example 2

- Residential mortgage debt, temporary payment deferral...cont
  - Debtor will not be charged interest on past due interest.
  - At the end of the forbearance, debtor will:
    - Have repaid all past due amounts
    - Be considered current in relation to the debt's original terms
    - Have resumed making monthly payments set out under the debt's original terms.

# Insignificant Delay? Example 2

- Residential mortgage debt, temporary payment deferral...cont
  - At the time of forbearance, creditor expects to collect all amounts due for the periods of delay.
  - Length of delay is insignificant in relation to the:
    - frequency of payments due.
    - debt's original contractual maturity.
    - debt's original expected duration.
  - The delay in payment as a result of restructuring **IS insignificant**.
  - Therefore, a concession *has not been* granted.

# Insignificant Delay? Example 3

- Commercial LOC – ST extension before finalization of renegotiated terms
  - Debtor is experiencing financial difficulties.
  - 5 year revolving LOC, interest payments due every 90 days based on average daily balance.
  - Near maturity, debtor and creditor begin to renegotiate the terms for a new LOC:
    - Similar terms to current LOC.
    - Comparable to terms available to debtors with similar risk characteristics.

# Insignificant Delay? Example 3

- Commercial LOC – ST extension before finalization of renegotiated terms...cont
  - Debtor is unable to make final interest payment on old LOC due to delay in collections from 2 key customers.
  - Creditor expects debtor to recover quickly.
  - Creditor extends a 3 month payment deferral and adds the missed interest payment to the balance of the new LOC.
  - Debtor is required to make next interest payment 90 days after new LOC is finalized, which is 180 days after the due date of the missed interest payment.

# Insignificant Delay? Example 3

- Commercial LOC – ST extension before finalization of renegotiated terms...cont
  - Creditor still expects to collect all amounts due, including interest at the contractual rate.
  - Length of delay is insignificant in relation to the:
    - frequency of payments due.
    - debt's original contractual maturity.
    - debt's original expected duration.
  - The delay in payment as a result of restructuring **IS insignificant**.
  - Therefore, a concession *has not been* granted.

# Probable in the Foreseeable Future? Example 1

## ■ Facts and Circumstances:

- Interest-only mortgage for the first 5 years.
- After 5 year interest only period, principal balance is then repaid over 25 years.
- In year 4, debtor is not in default.
- Mortgage payments are going to significantly increase at the end of the 4<sup>th</sup> year to incorporate principal.

- Creditor determines that, absent any modification, the debtor's default is probable in the foreseeable future.

# Probable in the Foreseeable Future? Example 2

- Debtor enters into a loan to purchase residential property:
  - P&I payments based on a 1% rate for the first 3 years
  - After 3<sup>rd</sup> year, interest rate is reset to the prevailing market rate plus an additional 3%
    - At origination, debtor expected new rate to be 5%
- At the end of year 2:
  - Debtor asks for a modification of the loan
  - Debtor is not in default
  - Current market conditions indicate the interest rate after year 3 will reset to 12%

# Probable in the Foreseeable Future? Example 2

- Based on projected reset interest rate, mortgage payment will be adjusted to a significantly higher amount.
- Based on experience with similar debtors and circumstances, the creditor determines the debtor's default is probable.
- Creditor concludes the debtor is experiencing financial difficulties.

# Effective Date & Transition

- For nonpublic entities:
  - Annual periods ending after December 15, 2012.
  - If, as a result of adopting this ASU, a creditor identifies receivables that are newly considered impaired, the creditor shall disclose the following:
    - Total recorded investment in such receivables
    - And associated allowance for credit losses as of the end of the period of adoption.

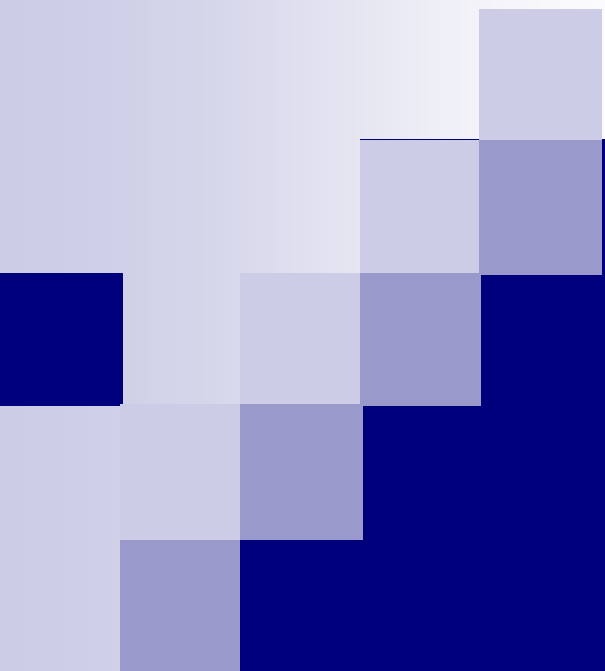
# Effective Date & Transition

- For nonpublic entities:
  - Early adoption is permitted, but the guidance needs to be applied to all restructurings from the beginning of the fiscal year of adoption.
    - Cost / benefit should be analyzed when determining whether or not to early adopt.
  - This guidance cannot be applied retroactively to prior periods because the information is not likely to be available, or would be difficult to obtain, and would require the use of hindsight.

# Effective Date & Transition

- Example adoption disclosure:

- As a result of adopting the amendments in Accounting Standards Update (ASU) No. 2011-02, the Bank reassessed all restructurings that occurred on or after the beginning of the current fiscal year for identification as troubled debt restructurings. The Bank identified as troubled debt restructurings certain receivables for which the allowance for credit losses had previously been measured under a general allowance for credit losses methodology. Upon identifying those receivables as troubled debt restructurings, the Bank identified them as impaired under the guidance in Section 310-10-35. The amendments in ASU 2011-02 require prospective application of the impairment measurement guidance in Section 310-10-35 for those receivables newly identified as impaired. At the end of the first period of adoption (mmmm dd, yyyy), the recorded investment in receivables for which the allowance for credit losses was previously measured under a general allowance for credit losses methodology and are now impaired under Section 310-10-35 was \$XX, and the allowance for credit losses associated with those receivables, on the basis of a current evaluation of loss, was \$XX.



# *Accounting*

# 5 Common Mistakes in TDRs

1. Not properly identifying a loan modification as a TDR.
2. Not considering a TDR an impaired loan under ASC 310-40-35-9 (FAS 114, par 9).
3. Not using the discounted cash flow method to determine the amount of the specific reserve.
4. Not properly identifying expected future cash flows when using the discounted cash flow (DCF) method of measuring impairment.
5. Not using the proper discount rate in the DCF calculation.

# 5 Common Mistakes in TDRs

1. **Not properly identifying a loan modification as a TDR.**
  - Loan modifications include:
    - Extending repayment terms
    - Reducing interest rates
    - Delaying or forgiving principal and/or interest payments
  - However, not all loan modifications qualify as TDRs
  - Must consider all facts and circumstances
    - No single characteristic or factor is determinative
  - Require the exercise of judgment
  - Recent guidance helps to clarify (ASU 2011-02)

# 5 Common Mistakes in TDRs

2. **Not considering a TDR an impaired loan under ASC 310-40-35-9 (FAS 114, par 9).**
  - All TDRs are considered impaired loans
    - All TDRs must be *individually* measured for impairment by comparing the recorded investment in the loan to the present value of cash flows expected to be collected (original contractual rate should be used in DCF calc).
      - Creditor cannot use methods applicable to non-impaired loans, such as an estimated loss factor.
    - The loan should be moved from the general reserve section of the allowance to the specific reserve section.
    - Specific disclosures are required.

# 5 Common Mistakes in TDRs

## 3. Not using the discounted cash flow method to determine the amount of the specific reserve.

- Three methods are provided for measuring impairment of an individual loan.
  - i. Observable market price
    - Observable market prices are usually not available on individual loans, making this method rarely used.
  - ii. Collateral fair value if loan is collateral dependent
    - Can only be used when repayment of a loan is *solely* dependent on the underlying collateral, making use of this method limited.
  - iii. Discounted cash flow method
    - Most TDR modifications will be forced to use this method as they contemplate additional loan payments (making collateral the fair value not applicable, even if collateral is involved).

# 5 Common Mistakes in TDRs

4. **Not properly identifying expected future cash flows when using the DCF method of measuring impairment.**
  - Creditor is required to consider all available information when projecting expected future cash flows of a TDR.
    - This can be a difficult exercise due to lack of good info.
  - Generally, the projected cash flows should be based on current financial information provided by the debtor.
    - Creditors should not try to short-cut the process by just discounting the modified loan payments.
  - It's very important to fully document the various assumptions used to determine the future cash flows.

# 5 Common Mistakes in TDRs

- 5. **Not using the proper discount rate in the DCF calculation.**
  - Purpose of impairment measurement is to identify the deterioration in the credit quality of a loan.
    - The amount needs to be isolated from the impact of changes in market rates of interest.
  - Therefore, the discount rate to be used in the DCF calculation is the original contractual rate.
    - Not the rate specified in the modification agreement.
  - If the contractual rate is a variable rate based on a factor, the discount rate may be calculated:
    - Based on the factor as it changes over the loan life;
    - Fixed at the rate in effect at the date of modification.
      - Projection of changes in the factor should not be made.

# What is NOT considered a TDR?

- When the debtor can obtain funds from sources other than the existing creditor at market interest rates *at or near* those for non-troubled debt.
- Changes in lease agreements
- Modifications of loans within a pool
  - Pooled loans are accounted for in accordance with ASC 310-30

# What is NOT considered a TDR?

- If the fair value of the assets accepted by the creditor for full satisfaction of its receivable at least equals the creditor's *recorded investment in the receivable*
- Creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk
  - To prevent debtor from moving business elsewhere

# What IS considered a TDR?

- Partial or full satisfaction of a debt by a debtor by transfer of receivables from third parties, real estate, or other assets.
- Includes:
  - Foreclosure and repossession
  - Issuance or granting of an equity interest to the creditor by the debtor unless that interest is granted pursuant to existing debt conversion terms
  - Restructurings under the Federal Bankruptcy Act

# What IS considered a TDR?

- Modification of terms, including:
  - Reduction of the stated interest rate for the remaining original life of the debt
  - Extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk
  - Reduction of the face or maturity amount
  - Reduction of accrued interest

# How Should Impairment be Measured?

- Based on the present value of expected future cash flows, discounted at the loan's effective interest rate.
  - Effective interest rate = loan's contractual interest rate, adjusted for any premiums, discounts deferred fees and costs.
- Two practical expedients are also offered:
  - Based on a loan's observable market price.
  - Based on the fair value of the collateral if the loan is collateral dependent.

# How Should Impairment be Measured?

- The method used can be elected on a loan-by loan basis with one exception:
  - When foreclosure of a loan is considered probable.
    - In this situation, impairment must be measured based upon the fair value of the underlying collateral.
    - To do otherwise would result in the deferral of a loss until the foreclosure process was consummated.

# How to Calculate the Present Value of Expected Future CF?

- Based on all the available evidence that reflects the creditor's best estimate using reasonable and supportable assumptions and projections.
  - Estimated costs to sell and expected recoveries
  - Industry geographic, economic and political factors
  - Future prepayments, defaults and charge-offs
- Based on a creditor's judgment.
- May differ from actual cash flows received.
- Future cash flows begin on the date of modification.

# What if the Loan's Contractual Interest Rate is Variable?

- Creditor may determine the effective interest rate one of two ways, but must be consistent:
  - Variable method: based on the independent factor (e.g. LIBOR, Prime) as it changes over the life of the loan.
  - Fixed method: fix the rate based on the independent factor when the loan is determined to be impaired.
- At the initial date of impairment, the impairment amount would be the same under both methods.
- Creditor's choice of which method to use. But must be consistent for all variable rate loans.

# What if the Loan's Contractual Interest Rate is Variable?

- In subsequent periods, the impairment would be calculated as show below, assuming:
  - Rate in effect at the date of impairment = 6%.
  - Rate in effect at subsequent measurement date = 8%.

	Variable Method	Fixed Method
Project* future cash flows on the impaired loan as of measurement date	8%	8%
Discount the projected future cash flows on the impaired loan	8%	6%

\* The creditor *should not* project future movement in the interest factor after the measurement date.

# TDRs - Accrual or Nonaccrual?

- U.S. GAAP does not provide specific guidance on whether a loan modified in a TDR should be classified as accrual or nonaccrual status.
- Creditors should follow their established nonaccrual policy.
- General revenue recognition guidance states that income should not be recognized unless it is both earned and realizable.

# TDRs - Accrual or Nonaccrual?

- A loan is placed on nonaccrual status once the loan's principal and interest is no longer reasonably assured of collection.
  - Therefore, it is likely that a loan modified in a TDR was already placed on nonaccrual.
- A loan should remain on nonaccrual until the debtor has demonstrated a willingness and ability to make the restructured loan payments.
  - Sustained period of repayment performance (at least 6 months).
  - Loan should be well secured.

# TDRs - Accrual or Nonaccrual?

- If the loan was current (on accrual) prior to the TDR, the new payment amount is not significantly more than the prior payment amount, and the debtor is expected to continue to repay the loan according to the modified terms:
  - Nonaccrual would not be required.



# *Disclosures*

# Required Disclosures

- As of each balance sheet date presented, the amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in a TDR – ASC 310-40-50-1.
- Modifications of financing receivables – ASC 310-10-50-31 through 50-34.
- Impaired loans – ASC 310-10-50-15 through 50-20
- Impact of ASU 2010-20, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*

# Subsequent Disclosures

- Impaired loan disclosures need not be repeated in years after the TDR if both of the following conditions exist:
  - TDR agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of restructuring for a new loan with comparable risk.
  - The loan is not impaired based on the terms specified by the TDR agreement.

# Subsequent Disclosures - Example

- Facts and Circumstances:
  - \$10,000, 12% interest only balloon loan, due in 5 yrs
  - Recorded investment of \$10,000
  - Market interest rates for a similar loan are 10%
  - Debtor is experiencing financial difficulties
  - Creditor modifies the loan by forgiving \$1,000 of principal and reducing the interest rate to 10%
- Creditor is able to exclude the loan from impaired loan disclosure in the periods following the TDR as long as the loan is not impaired using the restructured terms.

# *Examples*



# *Flowcharts*



# *Questions?*