NCUA Webinar

Troubled Debt Restructurings: What Are They & How Does the Accounting Work?

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Introduction

- Current Landscape
  - Loan modifications
- Identification
  - Why does it matter?
  - Accounting objective
- Challenges
- Recent Developments from FASB

Agenda

I. **TDR overview**
II. Loan modifications
III. Single loan example
IV. Variable rate loans
V. Prudent CRE Workouts
VI. Beyond the accounting
VII. Other accounting & reporting matters

Key TDR Accounting Guidance

- Codification Topic 310-40 (Receivables/Troubled Debt Restructurings by Creditors)
- Formerly:
  - FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings
  - FAS 114, Accounting by Creditors for Impairment of a Loan
  - FAS 118, Accounting by Creditors for Impairment of a Loan, Income Recognition and Disclosures

Other Sources

- Accounting Profession
  - CAQ Whitepaper, Application of SFAS 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructurings, issued Dec. 23, 2008
    - http://thecaq.org/newsroom/pdfs/FAS114_LoanModifications.pdf
- Regulatory
  - FFIEC Policy Statement on Prudent Commercial Real Estate Loan Workouts, issued Oct. 30, 2009
    - http://www.ncua.gov/news/press_releases/2009/FFIEC_PR_CRE_Workouts_10-30am.pdf
  - OCC Bank Accounting Advisory Series (BAAS), Topic 2A, updated Oct. 2010
    - http://www.occ.gov/static/publications/BAAS.pdf
  - OTS Thrift Bulletin 85, Regulatory and Accounting Issues Related to 1-4 Family Residential Mortgage Loans, issued Aug. 28, 2009
    - http://www.ots.treas.gov/_files/84303.pdf

Loan Modification: Defined

- A change in an existing loan contract which has been agreed to by the borrower and lender
  - Not all loan modifications constitute a TDR
  - Not all TDRs involve a modification of terms
- For modifications which are not TDRs:
  - Refinancing/major modification
    - Market terms
    - Accounted for as a new loan
  - Minor modifications
    - Accounted for as the continuation of the existing loan

TDR Types

- A troubled debt restructuring may include, but is not limited to:
  - Modification of debt terms, for example:
    - Reduction in the contractual interest rate
    - Forgiveness of accrued interest
    - Forgiveness of a portion of the principal
    - Extended repayment period
  - Assets received in satisfaction of some or all of the debt
    - Includes foreclosure or deed in lieu of foreclosure

Our focus today

- On Oct. 12, 2010, the FASB issued Proposed Accounting Standards Update—Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors
    - Proposal provides "clarifications" about several specific key definitional matters

Agenda

I. TDR overview
II. Loan modifications
  a. Guidance
  b. Measurement
III. Single loan example
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TDR Prerequisites

- A loan modification is a TDR when two conditions are present:
  - Borrower is experiencing <u>financial difficulty</u>
  - Creditor grants a <u>concession</u> it would not otherwise consider but for the borrower's financial difficulties

"A restructuring of a debt constitutes a troubled debt restructuring for purposes of this Subtopic 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."
ASC 310-40-15-5

The Criteria (Topic 470-60-55)

Determining Whether the Borrower is Experiencing Financial Difficulty	Determining Whether Concession has been Granted

- Default on any debt
- Bankruptcy
- Going concern
- Unable to service debt (current/future)
- Credit availability

From FASB's Proposal:
A borrower that is not currently in default may still be considered to be experiencing financial difficulty when payment default is considered "probable in the foreseeable future."

- Compared to prior debt
  - Forgiveness of principal or interest would be included)
- Effective borrowing rate of restructure

From FASB's Proposal:
A creditor would be precluded from using the borrower's effective rate test in paragraph 470-60-55-10 (formerly EITF 02-4) in its evaluation of whether a restructuring constitutes a TDR.

Non-TDR Loan Modifications

- Customer retention programs historically have not been judged to be TDRs
- 310-40-15-8: "In general, a debtor that can obtain funds from sources other than the existing creditor at market rates at or near those for non-troubled debt is not involved in a TDR."
  - Example: Lender reduces the interest rate on a loan primarily to reflect a decrease in market interest rates in order to maintain a relationship with a borrower that can readily obtain a loan from other sources at the current market interest rate

Refinancing or TDR?

- Particularly in the current market (declining collateral values, tighter credit standards, challenging economic conditions) there is a <u>rebuttable presumption</u> that loan modifications are TDRs
- Updated underwriting documentation should be gathered to support conclusion the modified loan terms are "at market" and other borrowers (with comparable credit risk) would have qualified for these terms
- Contemporaneous updating of underwriting at the time of modification

From FASB's Proposal:
A restructuring that results in a temporary or permanent <u>increase</u> in the contractual interest rate cannot be presumed to be at a rate that is at or above market.

From FASB's Proposal:
If a borrower does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at below a market rate and therefore should be considered a TDR.

FAQs

- Can a modification of a loan that is current still be a TDR?
- Are all loan modifications TDRs?
- Are TDRs considered to be impaired?
- What about insignificant delays? Is there a rule of thumb for insignificant delays?
- Are "skip a payment" program's considered TDRs?

From FASB's Proposal:
A restructuring that results in an insignificant delay in contractual cash flows may still be considered a troubled debt restructuring. That is, that factor should be considered along with other terms of a restructuring to determine whether a troubled debt restructuring exists.

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Measurement of Impairment

- All loans whose terms are modified in a TDR are subject to 310-40 which states that a creditor shall apply the provisions of 310-40 to all restructured loans, including those exempt under 310-10-35-13a (FAS 114) prior to restructuring
  - FASB declined a request for relief from applying 310-40 to residential mortgage TDRs and to be able to continue to apply ASC Topic 450 (FAS 5) for measuring impairment

> "Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Those loans may include but are not limited to credit card, residential mortgage, and consumer installment loans.
> ASC 310-10-35-13a (FAS 114, par. 6a)

Measurement of Impairment

- A creditor shall measure impairment:
  - Based on the present value of expected future cash flows * discounted at the original loan's effective interest rate
  - Except that as a practical expedient, a creditor may measure impairment based on
    - The observable market price of the loan, or
    - The fair value of the collateral if the loan is collateral dependent

* Expected future cash flows are not necessarily the contractual cash flows under the modified terms.

Recorded Investment in the Loan

- Loan balance (principal + capitalized amounts)
- \+ Unamortized net deferred loan costs
- \- Unamortized net deferred loan fees
- \+ Unamortized premium
- \- Unamortized discount
- \- Previous charge-offs
- \+ Recorded accrued interest

Could be less than contractual interest due

- = Recorded investment in the loan

Measurement of Impairment

- Recognize impairment when the present value (or alternative measurement) of loan is less than the recorded investment by either:
  - Creating a valuation allowance with a corresponding charge to bad-debt expense
  - Adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense
  - Recording a direct charge-off

Measurement of Impairment: Which Method?

- Present value of expected future cash flows discounted at the loan's effective interest rate

- Loan's observable market price
  - Likely not applicable to either residential nor CRE mortgage loans as obtaining an observable market price for an impaired loan may be very difficult, especially in the current market

Often used in practice

- Fair value of the collateral
  - Practice Note: When a loan is modified, often the lender has concluded and can demonstrate that there is an additional source of repayment other than the underlying collateral and this method would not be used to measure impairment.

Present Value of Cash Flows

- Measure impairment based on the present value of **expected future cash flows** discounted at the loan's **effective interest rate**
- The <u>effective interest rate</u> is the rate of return implicit in the original loan
  - <u>Original</u> contractual interest rate adjusted for any deferred loan fees or costs, premium or discount existing at the origination or acquisition of the loan
  - It is NOT
    - The rate specified in the restructuring agreement
    - The teaser / introductory rate on the original loan

Collateral Dependent

- Collateral dependent loans
  - A loan is considered collateral dependent if repayment of the loan is expected to be provided <u>solely</u> by the underlying collateral
    - If a loan is impaired and considered collateral dependent, fair value of the collateral is required for measuring impairment.
    - Many loans are considered collateral dependent, despite a modification of terms.
  - Measure of impairment is <u>fair value of the collateral</u>
  - <u>Deduct costs to sell</u> if expected to reduce cash flows available

CAUTION

- A TDR does not make a collateral dependent loan "good" again
- Cannot "Extend and Pretend"
- Document
  - Current financial information
  - Current collateral valuation
  - Current business conditions
  - Outlook for the future
  - Why & when will this loan get better again?

FAQs

- How is the allowance established for a TDR?
- How are prepayments considered?
- What about if we have an abundance of collateral, but the borrower is just cash strapped, so no principal loss is expected? Do we still do a cash flow analysis or a fair value of collateral analysis to determine the specific reserve?
- Can similar TDRs be tracked in pool(s) for impairment analysis and allowance for loan losses impact?

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A Single Loan Example

- Original Terms
- Rate = 8%
- Term = 120 months
- Payment = $1,213
- Principal = $100,000
- Interest = $45,593
- Total = $145,593

- Revised Terms
- Rate = 5%
- Term = 120 months
- Payment = $1,061
- Principal = $100,000
- Interest = $27,279
- Total = $127,279

Present value computation

AT MODIFICATION

8.00%	Original rate
5.00%	Modified rate
100,000.00	principal
120.00	months
1,061.00	new monthly
(87,449.64)	PV at 8% discount (modified rate)

PV(A3/12,A6,A7,1)	PV Formula

A Single Loan Example

PV of total revised cash flows @ 8% =	$87,421
Recorded investment in loan =	$100,000)
Valuation allowance =	($12,579)

Journal Entry:

Bad Debt Expense	$12,579	
ALLL		$12,579

To record valuation allowance for TDR

A Single Loan Example

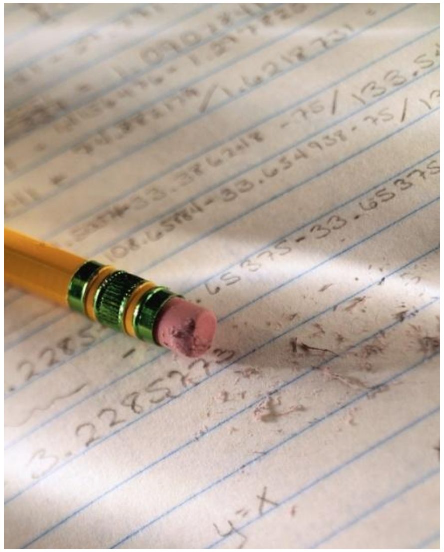
<u>Journal Entries for Month 1:</u>

Cash	$1,061	
Loan Principal		$644
Interest Income (5%)		$417

To record receipt of monthly payment

ALLL	$166	
Bad Debt Expense		$166

To record monthly reversal of TDR valuation allowance



Computation

AFTER FIRST PAYMENT

8.00%	Original rate
5.00%	Modified rate
100,000.00	principal
119.00	Remaining months
1,061.00	new monthly

Original loan balance	100,000.00
Less principal paydown	(644.00)
New loan balance	99,356.00
PV at old rate	($86,971.19)
Reserve	12,384.81
Beginning reserve	12,551.00
ALLL Adjustment	166.19

Expected Future Cash Flows

- Include all P&I payments that are expected to occur subsequent to the loan being modified. That is, future cash flows begin on the date of the loan modification.
  - Do not include cash flows that have already occurred and have been accounted for in past periods
  - Do not use only cash flows expected to be received after the predicted default date
- Prepayment assumptions included? Yes
- Default and recovery assumptions included? Yes
  - NOTE: Given the nature of the restructured loans it may NOT be appropriate to use prepayment, default and loss severity assumptions that are generally derived from the broad population. Assumptions must be those expected of the TDR population.

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Effective Interest Rate?

- For ARMs, rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date of restructure
- For ARMs with initial fixed interest rates, calculate the rate using a blend of the initial fixed interest rate over the fixed period and the variable rate on the date of loan modification over the variable period
- Inappropriate to use the single teaser rate as the effective interest rate for calculating the present value of the expected future cash flows of the modified loan at the impairment date
- Should prepayment or default assumptions be included when determining the period over which to calculate the effective interest rate? NO.

Adjustable Rate Example

- Assume the following facts:
- $100,000 3/27 variable rate loan
- Interest rate:
  - 6% for 3 years
  - LIBOR + 6% for 27 years (years 4-30)
- LIBOR:
  - At origination = 4%
  - At date of impairment / modification = 6%
- Loan underwent TDR at end of month 36

Modification – Short & Long Term

	At Origination	At Time of Modification	
Loan balance	$100,000	$96,084	
FV of collateral	$125,000	$100,000	
LTV	80%	96%	
Term remaining	30 years	27 years	
		Short Term Mod	Long Term Mod
Interest rate	*Years 1-3* 6%	*Mod Years 1-5* 6%	*Mod Years 1-27:* 6%
	Years 4-30: LIBOR + 6%	*Mod Years 6-27:* LIBOR + 6%	
LIBOR	4%	6%	6%
Fully indexed rate	10%	12%	N/A
Estimated yield (IRR)	8.85%	9.23%	6.00%
Yield if prepays 8 years after modification		7.75%	6.00%

Adjustable Rate Example

- What is the appropriate effective interest rate used to measure impairment for this ARM?

  a) 6% (rate in effect before modification)

  b) 10% (fully indexed rate at origination)

  c) 12% (fully indexed rate at modification)

  d) 8.85% (blend of 6% for 3 years & 10% for 27 years)

  e) 10.17% (blend of 6% for 3 years & 12% for 27 years)

  f) None of the above

May be okay as a practical expedient

Effective Interest Rate

- Effective interest rate on the original loan is used to discount expected cash flows when measuring impairment at time of TDR modification

Years 1-3	Years 4-30
Introductory Rate	Fully Indexed Rate (LIBOR of 6% + Margin of 6%)
6%	12%

Blended Rate

10.17%

Computation

- Prepare schedule of cash flows yielded by the terms being analyzed
  - 3 years at 6% on 30 yr amortization
  - 27 yrs at 12% on 30 yr amortization
- Solve for IRR that sets cash flows equal to principal balance at day one
- COMPLEX COMPUTATION, but resulting discount rate likely more favorable than the “practical expedient”

Impact of Prepayments:Short vs. Long-term

	Short Term (5 yr) Modification		Long Term (27 yr) Modification	
Scenario	**No Prepayment**	**Prepayment**	**No Prepayment**	**Prepayment**
Modified Terms	**6% for 5 years, then LIBOR+6%**	**6% for 5 years, then LIBOR+6%**	**6% for remain. 27 years**	**6% for remain. 27 years**
Assumed prepayment	**None**	**8 years after Modification**	**None**	**8 years after Modification**
Discount rate	**10.17%**	**10.17%**	**10.17%**	**10.17%**
O/S loan balance*	**$96,084**	**$96,084**	**$96,084**	**$96,084**
PV of expected CF	**$88,129**	**$83,457**	**$66,142**	**$75,500**
Measure of impairment	**$7,956**	**$12,627**	**$29,943**	**$20,584**
% impairment	**8.28%**	**13.14%**	**31.16%**	**21.42%**

Prepayments ***NO prepayments***

Larger Loss

* Assumes principal balance equals recorded investment in the loan (i.e., no deferred net loan fees/cost, premiums/discount, accrued interest, or charge-offs)

Non-Accrual or Accrual?

- GAAP does not provide specific guidance but in general, should not recognize income unless it is realizable and earned
- Regulators have provided guidance related to whether impaired loans (which includes modified loans that are troubled debt restructurings) should be considered accrual or non-accrual loans:
  - Generally requires that interest should only be recorded on a restructured loan when there has been a sustained period of repayment performance and collection under the revised terms is assessed as probable.

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Prudent CRE Workouts: Overview

- Interagency Policy Statement on Prudent Commercial Real Estate (CRE) Loan Workouts
  - Issued jointly by the federal financial institution regulators, including the NCUA, on Oct. 30, 2009
  - Addresses risk management elements for loan workout programs, loan classification, and accounting/regulatory reporting considerations
  - Responds to concerns that supervisory policies and actions have curtailed availability of credit to sound borrowers
  - Promotes supervisory consistency
- For credit unions, may apply to Member Business Loans

http://www.ncua.gov/news/press_releases/2009/FFIEC_PR_CRE_Workouts_10-30am.pdf
http://www.ffiec.gov/guidance/cre103009.pdf

Credit Union’s Responsibilities

- Establish sound policies and practices for renewals and restructurings that address
  - Management infrastructure to identify, control, and manage volume and complexity of workouts
  - Documentation standards
  - Adequacy of information systems and internal controls
  - Accuracy of accounting and regulatory reporting
- Renewals and restructurings should improve prospects for repayment and maximize recovery potential
  - Management responsible for making business decisions on workouts

Credit Union's Responsibilities

- When undertaking a workout, management should
  - Develop a well-conceived and prudent workout plan for an individual credit after
    - Analyzing updated and comprehensive financial data on borrower, RE project, and any guarantor
    - Considering borrower's global debt service capacity
    - Assessing current value of pledged collateral
    - Determining appropriate loan structure and terms
  - Document the workout plan appropriately
  - Implement performance monitoring procedures
  - Grade the workout to accurately reflect the risk
  - Properly account for and report workout, including timely recognition of credit losses

Credit Union’s Responsibilities

- Focus on repayment, not collateral
  - Analyze borrower’s overall financial condition, resources, and payment record
  - Assess nature and degree of protection of cash flow from business operations or collateral on a global basis, considering borrower’s total debt obligations
  - Evaluate market conditions that may affect repayment prospects or cash flow from business operations or collateral
  - Watch for liberal use of extensions, renewals, or interest reserves or loan underwriting structures that mask loan weaknesses and obscure borrower’s repayment capacity or ability to meet reasonable repayment terms

Credit Union's Responsibilities

- Consider guarantor strength and support
  - Does guarantor have both financial capacity and willingness to provide support?
- Assess reasonableness of collateral values
  - Review the institution's collateral assessment and consider reasonableness of major facts and assumptions
  - Bring weaknesses to management's attention
  - Assess collateral protection when analyzing or classifying a loan if management is unable or unwilling to address weaknesses in a timely manner, which may include making adjustments to collateral value
- Determine which value to use when classifying a loan: "as is" versus "as complete" versus "as stabilized"

Examiner Considerations

- Should not adversely classify restructured or renewed loans solely because collateral value has declined below loan amount
- Adverse classification of a restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms
- Do not criticize institutions for workouts, even if loans are adversely classified, if management engaged in the workouts in a prudent manner

Examiner Considerations

- Evaluating loan workouts and Programs
  - Consider all facts and circumstances and exercise judgment when evaluating whether a restructuring is a TDR
  - No single factor by itself is determinative of whether a modification is a TDR
  - Overall general decline in the economy or some deterioration in a borrower's financial condition does not automatically mean the borrower is experiencing financial difficulties

CRE Workout Example: Office Building

- At origination
  - $15 million loan at market interest rate to purchase building
  - Monthly P&I payments based on 20-year amortization, 3-year term, $13.6 million balloon payment at maturity
  - $20 million "as stabilized" market value
  - 75 percent LTV ratio
  - Debt service coverage ratio of 1.35x
  - Loan expected to be renewed at maturity
- Since origination
  - Decline in cash flow due to rental concessions to retain existing tenants
- At maturity
  - No delinquencies on monthly payments
  - Current RE valuation not ordered but lender estimates current market value is $14.5 million and 94 percent LTV ratio
  - Current borrower financial information not requested

CRE Workout Example: Office Building

- Action
  - Loan renewed at market interest rate with monthly P&I payments based on 17-year amortization
  - Debt service coverage ratio declined to 1.12x, but not expected to fall below 1.05x from additional rental concessions
- TDR evaluation
  - No history of default
  - Borrower experiencing some financial deterioration, but has sufficient cash flow to service debt
  - Borrower not experiencing financial difficulties
  - No need to consider whether concession granted
- Risk management issues - Administrative deficiencies
  - Failure to request current financial information and updated collateral valuation
  - Credit graded as special mention

CRE Workout Example: Version 2

- At maturity
  - Sporadic delinquencies on monthly payments
  - Majority of tenants have short-term leases and some tenants are delinquent on rental payments
- Action
  - Loan renewed on interest-only basis for 12 months at below market interest rate
  - Debt service coverage of 1.12x based on interest-only terms
  - Recent appraisal shows $14.5 million "as stabilized" market value and 94 percent LTV ratio

CRE Workout Example: Version 2

- TDR evaluation
  - Sporadic payments with some delinquencies
  - Declining collateral value
  - Rental income and cash flow declining
  - Property’s ability to generate sufficient cash flow to service debt with reasonable repayment terms is questionable
  - Borrower is experiencing financial difficulties
  - Interest rate reduced to below market rate
  - Principal payments deferred for 12 months
  - Lender granted concession
  - Report as a TDR

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Beyond the Accounting

- Given the environment, the expectation is that TDRs will increase
- Credit union controls and procedures need to be reviewed and updated:
  - Education
  - Policy development and update
  - Support systems
  - Reporting

Beyond the Accounting

- Education
  - Lenders and workout teams need to understand TDR rules and implications
  - Tools need to be developed to document evaluation process and conclusions
  - Determination that a modification is NOT a TDR is as critical a conclusion as otherwise

- Policy Development and Update
  - Policies need to be established to address restructure decisions and development of programs targeted towards dealing with borrower difficulties

Beyond the Accounting

- Systems
  - Develop controls over decisions to restructure and documentation of decisions
  - Determine accounting systems needs related to tracking, income recognition, allowance computation, etc.

- Reporting
  - Board/Senior level review of volume and terms of restructuring decisions and programs
  - Ongoing review of “success” of such decisions including impact on realized loan losses and portfolio yield

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Disclosures: GAAP

- Disclosures:
  - Add accounting policy disclosures to loan and allowance sections of accounting policy footnote
  - TDRs are included in impaired loan totals (year end and average balances) and in the disclosures of income recognized during the year
  - Disclose amount of allowance for loan losses allocated to TDRs
  - Disclose commitments to lend additional amounts to borrowers under loans classified as TDRs (e.g., lines of credit)
- Not uncommon to disclose information about TDRs separately from disclosures about other impaired loans
- Consider disclosure of systemic modification programs
- ALLL disclosures greatly expanded for 12-31-11 year ends, including TDR details (see ASU 2010-20)

Disclosures: Call Reporting

- For credit unions, the Form 5300 Call Report includes disclosure as follows:
  - Page 8, lines 16b – 20b, includes delinquency information for modified loans.
  - Page 9, line 21, includes amount outstanding and modified to date for consumer loans not secured by real estate.
  - Page 13, line 12, includes amount outstanding and modified to date for loans secured by real estate.
  - Page 14, line 28, includes amount outstanding and modified to date for member business loans not secured by real estate.
  - For the lines above, for all troubled debt restructured loans for which the member has not made six consecutive payments in compliance with the modified terms, the loans should still be considered delinquent and reported as such.

FAQ

- Once a loan modification is deemed to be a TDR, is it always a TDR?
- Is it appropriate to establish a materiality threshold when evaluating and accounting for TDRs?

FASB's Exposure Draft

- On Oct. 12, 2010, the FASB issued Proposed Accounting Standards Update—Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors

Key items:

- A creditor would be precluded from using the borrower's effective rate test in paragraph 470-60-55-10 (formerly EITF 02-4) in its evaluation of whether a restructuring constitutes a TDR.
- If a borrower does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at below a market rate and therefore should be considered a troubled debt restructuring.

FASB’s Exposure Draft

Key items

- A restructuring that results in a temporary or permanent increase in the contractual interest rate cannot be presumed to be at a rate that is at or above market.
- A borrower that is not currently in default may still be considered to be experiencing financial difficulty when payment default is considered “probable in the foreseeable future.”
- A restructuring that results in an insignificant delay in contractual cash flows may still be considered a troubled debt restructuring. That is, that factor should be considered along with other terms of a restructuring to determine whether a troubled debt restructuring exists.

FASB's Exposure Draft

Proposed effective date and transition

- Disclosures are effective for interim and annual reporting periods ending after June 15, 2011. Retrospective application is required for receivables restructured on or after the beginning of the earliest period presented.
- Identification of additional TDRs may result in an entity changing the method of calculating impairment from the guidance in Subtopic 450-20 (formerly FAS 5) to the guidance in Section 310-10-35 (formerly FAS 114).
  - The effect of the change in the method of calculating impairment shall be effective for interim and annual reporting periods ending after June 15, 2011, applied prospectively.

Thank You!

Questions?

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