Troubled Debt Restructurings and Related Issues

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Agenda
Troubled Debt Restructurings (TDRs)

- Applicable guidance
- TDR vs. Loan Modification
- Identification
- Impairment
- Accrual status
- Documentation
- Call Reporting

TDRs -Applicable Guidance

- Call Report Instructions – Glossary & Schedules RC-C/RC-N
- (NEW) FASB Accounting Standards Update No. 2011-02 – Receivables (ASC 310), A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring
- FAS 15, Accounting by Debtors and Creditors for TDRs (ASC 310)
- FAS 114, Accounting by Creditors for Impairment of a Loan (ASC 310)
- EITF 02-4, Determining Whether a Debtor's Modification or Exchange of Debt Instruments is within the Scope of FAS 15 (ASC 470-60)*
- FAS 118, Accounting by Creditors for Impairment of a Loan (ASC 310)
- FTB 80-2, Classification of Debt Restructurings by Debtors and Creditors (ASC 310/470-60)
- OCC's Bank Accounting Advisory

  http://www.occ.gov/static/publications/BAAS.pdf

TDR vs. Loan Modification

- TDR if:
  - Debtor experiencing financial difficulties; and
  - For economic or legal reasons, a creditor grants a concession to a debtor that it would not otherwise consider.

- A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not a TDR.

TDRs - Identification

- Loan pools (ASC 310-30/SOP 03-3)
  - TDR Status = pool
  - Nonaccrual Status = pool
  - Past Due Status = loan-by-loan

TDRs - Identification

- Troubled borrowers:
  - Currently in default
  - Going concern doubts
  - Securities of debtor delisted
  - CF insufficient to service debt (judgment)
  - Cannot obtain funds from other sources

TDRs - Identification

- Determining “Market Rate”
  - Lack of information – not publicly posted
  - Lack of current trades
  - Challenging in commercial mortgage markets

TDRs – Identification

- **<u>Insignificant</u>** delay in payment (ASU 2011-02): This determination requires judgment and should consider many factors, including, but not limited to:
  - the amount of the delayed payments in relation to the loan's unpaid principal or collateral value,
  - the frequency of payments due on the loan,
  - the original contractual maturity, and
  - the original expected duration of the loan.
- Supplemental Call Report Instructions: FIL-52-2011: http://www.fdic.gov/news/news/financial/2011/fil11052.html

TDRs – ASU Example 1

- 7-year FR loan collateralized by CRE
- Monthly IO payments with balloon @ maturity
- Borrower expected to refinance @ maturity
- Collateral is primary source of repayment
- Before maturity fv of collateral < P
- Borrower is granted 3-mos. extension to liquidate collateral

- **Delay in payment “not insignificant” = TDR**

TDRs – ASU Example 2

- 30-year res mtg w/ P & I
- Year 4:
  - borrower experiences financial difficulty
  - misses 2 payments
- Forbearance & repayment plan:
  - No foreclosure
  - Borrower increases next 4 monthly pmts to include delinquent amount + interest

- **Delay is “insignificant” – No TDR**

TDRs – ASU Example 3

- Commercial revolving line of credit
- 5-year term
- Interest paid every 90 days on avg daily balance
- Near maturity – renegotiate new line of credit
- Temp cf shortage prevents borrower from making final interest payment
- New line @ terms available to other borrowers w/ similar risk
- 3-month deferral granted for missed interest

- **Delay is "insignificant" – No TDR**

TDRs - Impairment

- TDRs involving a modification of terms on a loan held for investment:
  - Consider impaired
  - Apply ASC Topic 310/FAS 114, even if the loan would not otherwise fall within the scope of ASC Topic 310/FAS 114
  - Measure impairment based on PV of expected future cash flows discounted at loan’s effective interest rate (<u>unless loan is determined to be collateral dependent</u>)

TDRs - Impairment

- Collateral dependent “in operation”
  - Collateral is income producing property
  - “Costs to sell” not included in measure of impairment

Example

TDR Example #1:

- Borrower "A" cannot service a $100M loan that is secured. The loan has an effective interest rate of 10%, which is the current market rate.

- FACTS: The loan is restructured, with IO payments of 5% required for 2 years, and a final payment of $105M (principal & interest of 5%) required at the end of the third year. The PV of the expected payments under the restructured terms, discounted at 10% (original effective interest rate) is $87.5M. The loan is not collateral dependent, and does not have an observable market price.

- MEASUREMENT: ASC Subtopic 310-40/FAS 15 and ASC Topic 310/FAS 114 require that impairment be measured based on the PV of expected future cash flows, discounted at the original effective interest rate on the loan. The recorded investment of the loan exceeds the PV of expected future cash flows; therefore, $12.5M is allocated for this loan and is part of the ASC Topic 310/FAS 114 component of the overall allowance. ($100M - $87.5M = **<u>$12.5M</u>**)

Source: OCC Bank Accounting Advisory, 2010

Example

FASB 114 DCF Analysis			
Balance:	$100,000		
Maturity:	3 years		
Period	Principal	Interest	Total
1	$0	$5,000	5,000
2	$0	$5,000	5,000
3	$100,000	$5,000	105,000
Valuation:			
Annual Discount Rate =		10.00%	
Net Present Book Value =		$87,566	
Current Book Value =		$100,000	
Current Impairment =		$12,434	
Discount From Book Value =		12.4%	

TDRs - Accrual Status

- Not specified in GAAP
- Call report glossary – nonaccrual status
  - Is collectability of amounts due in doubt?
  - Period of sustained performance
  - A and B notes

TDRs - Accrual Status

- Nonaccrual Income Recognition:
  - When more likely than not principal is uncollectable = no interest income recognition.
  - Payments applied until reduce principal to amount probable to be collected.
  - Determination (well-documented) that remaining recorded investment is fully collectible, may recognize interest income on cash basis as received.

TDRs - Accrual Status

- Restore Accrual
  - All P & I due has been paid, OR
  - Becomes well-secured and in process of repayment – strict tests.
  - Do not reverse payments applied to reduce recorded investment while on nonaccrual status.

TDRs - Accrual Status

- Restore Accrual
  - Exceptions to general rule:
    - Asset was formally restructured and qualifies for accrual;
    - Asset was an impaired loan or debt security and accounted for under ASDC Topic 310-30 (SOP 03-3);
    - Asset acquired under AICPA PB 6 and meets the criteria therein for amortization; **OR**
    - Borrower resumed payments and the full amount of contractual P & I payments, provided two criteria are met:
      - a) All P & I payments due are reasonably assured of repayment; **AND**
      - b) there is a sustained period of repayment performance (six months) at the contractual terms.

TDRs - Accrual Status

- Restore Accrual
  - **<u>Restructured loan, reasonably assured of repayment and of performance according to prudent modified terms need not be in nonaccrual status</u>**, must be supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms.
  - Must include repayment performance for a reasonable period, six months (payments received prior to the restructure date may be taken into account), prior to the date of return to accrual status.

TDRs - Accrual Status

- Restore Accrual
  - Two notes:
    - First note monthly payments amortize at a market rate of interest that provides for the incremental credit risk.
    - Second note remaining principal balance with below-market interest-only loan that is scheduled to reset in five years to an amortizing payment was charged-off - lack of repayment capacity. Now, reasonable collateral protection for the remaining on-book loan.
  - Since the restructuring, the borrower has made payments on both loans for more than six consecutive months.
  - Accrual for the on-book loan is appropriate. Interest payments for the charge-off note recorded as recoveries - full recovery of principal and interest is not reasonably assured.

TDRs - Accrual Status

- Restore Accrual
  - Institution cannot, when a loan is brought contractually current, reverse the application of interest payments to reduce principal
  - On return to accrual status, GAAP permits an effective interest rate method.
  - From OCC Accounting Advisory Series: an effective interest method would be appropriate for nonaccrual loans that have returned to accruing status.
  - This will result in accreting the amount of interest applied to principal over the remaining term of the loan.

TDRs - Accrual Status

- A and B Note Structure
  - A formal restructuring may involve a multiple note structure in which a troubled loan is restructured into two notes:
  - “A” note represents portion of original loan principal expected to be fully collected
  - “B” note represents portion of original loan that has been charged off

TDRs - Accrual Status

- Can Note A be returned to accrual status?
  - Yes, if <u>all</u> of the following conditions are met:
    - Charge-off of Note “B” is recorded at time of restructuring
    - Ultimate collectability of all amounts contractually due on Note A is not in doubt
    - There is a period of satisfactory payment Performance before Note A is returned to accrual status (generally six months) – According to the Call Report glossary the performance period can begin BEFORE the date of the TDR.

TDRs - Documentation

- Policies and procedures
- Communication b/w loan and accounting departments

TDRs - Call Reporting

- “Once a TDR, always a TDR” – GAAP
- If (1) the TDR is in compliance with its modified terms and (2) the loan yields a market rate, then the TDR need not continue to be reported as a TDR in the Call Report in calendar years after the year in which the restructuring took place.
- TDRs by loan category in Schedule RC-C, Part I, Memo items 1.a. and 1.b.
- TDRs by loan category in Schedule RC-N, Memo item 1

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