Considerations for Troubled Debt Restructuring Identification of Loans
August 2011

Introduction

This document is intended to provide examiners with a general overview of the judgments required by an institution as a creditor to identify and report a troubled debt restructuring (TDR). The charts that follow summarize the TDR designation process for loans and highlight the judgments required. Examiners should refer to applicable generally accepted accounting principles (GAAP) or regulatory reporting instructions (Call Report or FR Y-9C) for more detail. Institutions with significant restructuring activity should have a documented process to identify, account for, and report TDR activity in accordance with applicable guidance.[1]

Consistent with safety and soundness objectives, often an institution will restructure a loan as a risk management strategy to improve prospects for repayment when it views loss of either principal or interest to be likely unless the receivable is restructured. The objective of a loan restructuring is to maximize the collectability or recovery of a loan considering the borrower's willingness and ability to pay. When performed in a safe and sound manner, loan modification and restructuring activity can benefit both the institution and the borrower. The identification of restructurings as TDRs is necessary to fulfill the associated GAAP disclosure and regulatory reporting requirements that are aimed at improving credit quality disclosures. Since the identification of TDRs generally involves significant judgment, it is important to keep in mind that regardless of whether or not a loan modification or restructuring is deemed to be a TDR, an institution's management should ensure that the allowance for loan loss (ALL) and interest income recognition are appropriate given relevant facts and circumstances.

Troubled Debt Restructuring Determination

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," as defined in the Accounting Standards Codification (ASC) glossary. Judgment is required to determine if 1) a borrower is experiencing financial difficulties and 2) if an institution has

[1] Purchased credit impaired loans are excluded from the scope of TDR accounting and are addressed in ASC Subtopic 310-30.

granted a concession that it would not have otherwise considered if not for the borrower's financial difficulties. In considering whether a concession has been granted, the institution's objective is to make the best of a difficult situation. That is, the institution expects to obtain more cash or other value from the borrower, or to increase the probability of receipt, by granting the concession than by not granting it. If a borrower is not experiencing financial difficulty or a concession has not been granted, a restructuring or modification would not be considered a TDR. Clarification is provided under GAAP that an insignificant delay in payment is not a concession and that increasing the interest rate does not preclude a restructuring from being considered a TDR.

Trial modifications are an example of a challenging analysis required in making a TDR determination. Generally, a trial modification is a modification that involves a concession to a borrower in financial difficulty offered for a short period to assess the borrower's ability to perform under the revised terms. There may be diversity in practice with respect to the identification of a trial modification as a restructuring that would be included within the scope of TDR accounting. Some identify such modifications as TDRs only after the borrower successfully completes the trial period and others view such modifications as TDRs at the beginning of the trial period. All relevant facts and circumstances of trial modifications should be considered, including, for example, the volume and type of restructurings, the significance of the delay in payment, the cumulative effect of previous modifications, and materiality of restructurings in total to the financial statements. It is important that an institution has processes to not only identify the borrower's capacity to pay and to recognize appropriate impairment but to also ensure that other related accounting and disclosures are appropriate. An institution's disclosures should adequately describe its significant modification and restructuring practices and provide transparent credit quality disclosures related to these practices. These disclosures could be helpful to examiners by providing a summary of the institution's significant restructuring activities.

Since a TDR involves a concession, it is presumed that a TDR would result in an institution being unable to collect all principal and interest according to the contractual terms, so the loan is considered impaired. Accordingly, a TDR is evaluated for impairment under ASC Topic 310 (formerly FAS 114), the impairment method for individually evaluated loans. Although consumer loans are generally measured for impairment in a pool with other homogeneous loans under ASC Topic 450 (formerly FAS 5), once identified as a TDR, a consumer loan is required to be measured for impairment under ASC Topic 310.[2] However, even if a loan is not deemed to be a TDR but shares similar risk characteristics, an institution should still have a process to ensure that the probable loss measured under ASC Topic 450 is appropriately recorded. This may, for example, require a more granular pool segmentation reflecting larger loss rates or qualitative adjustment to increase the ALLL for that segment of the portfolio. Also, an institution should consider the nature of its restructuring activity and related performance of restructurings (including re-defaults) to ensure that probable loss is appropriately measured.

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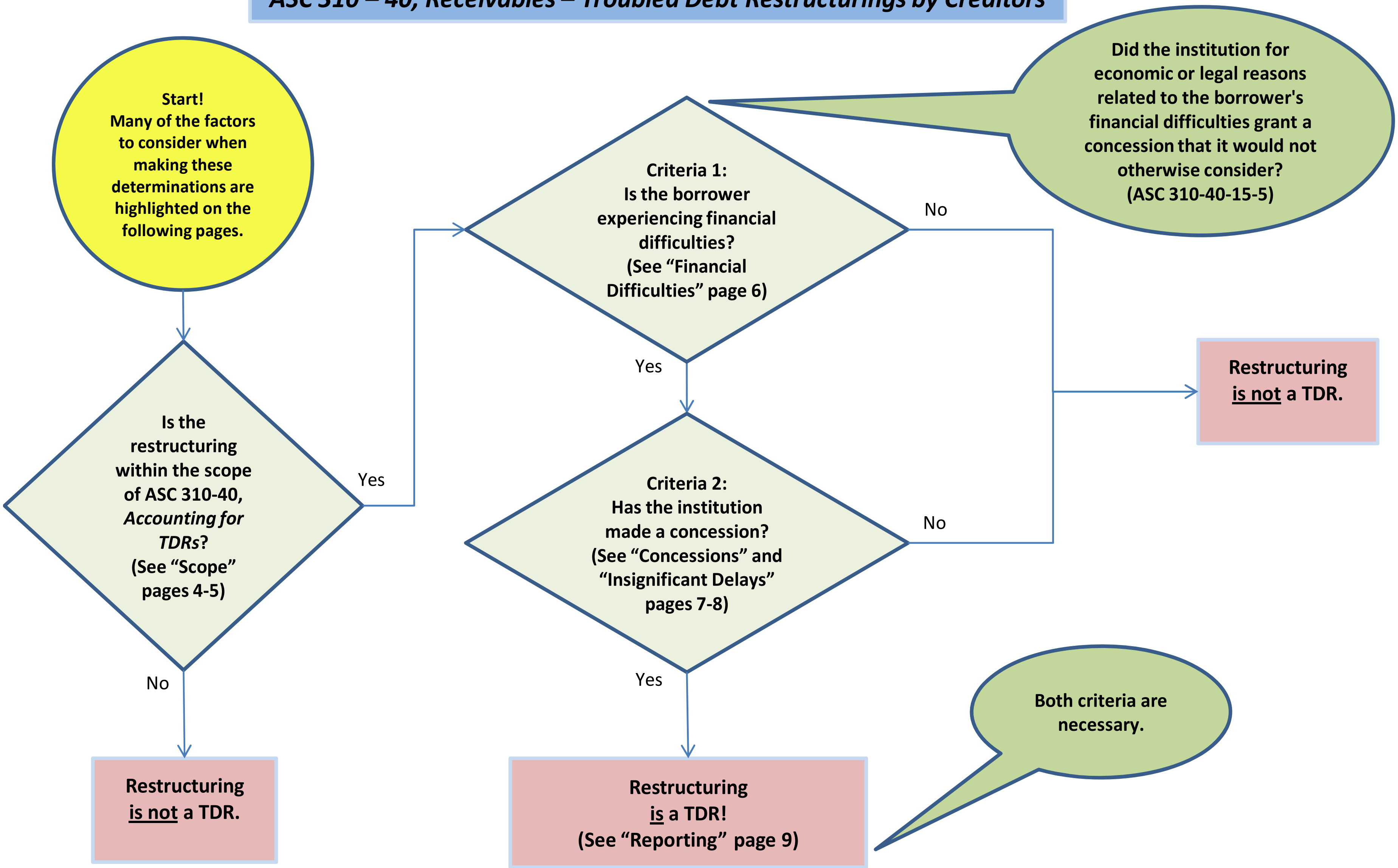
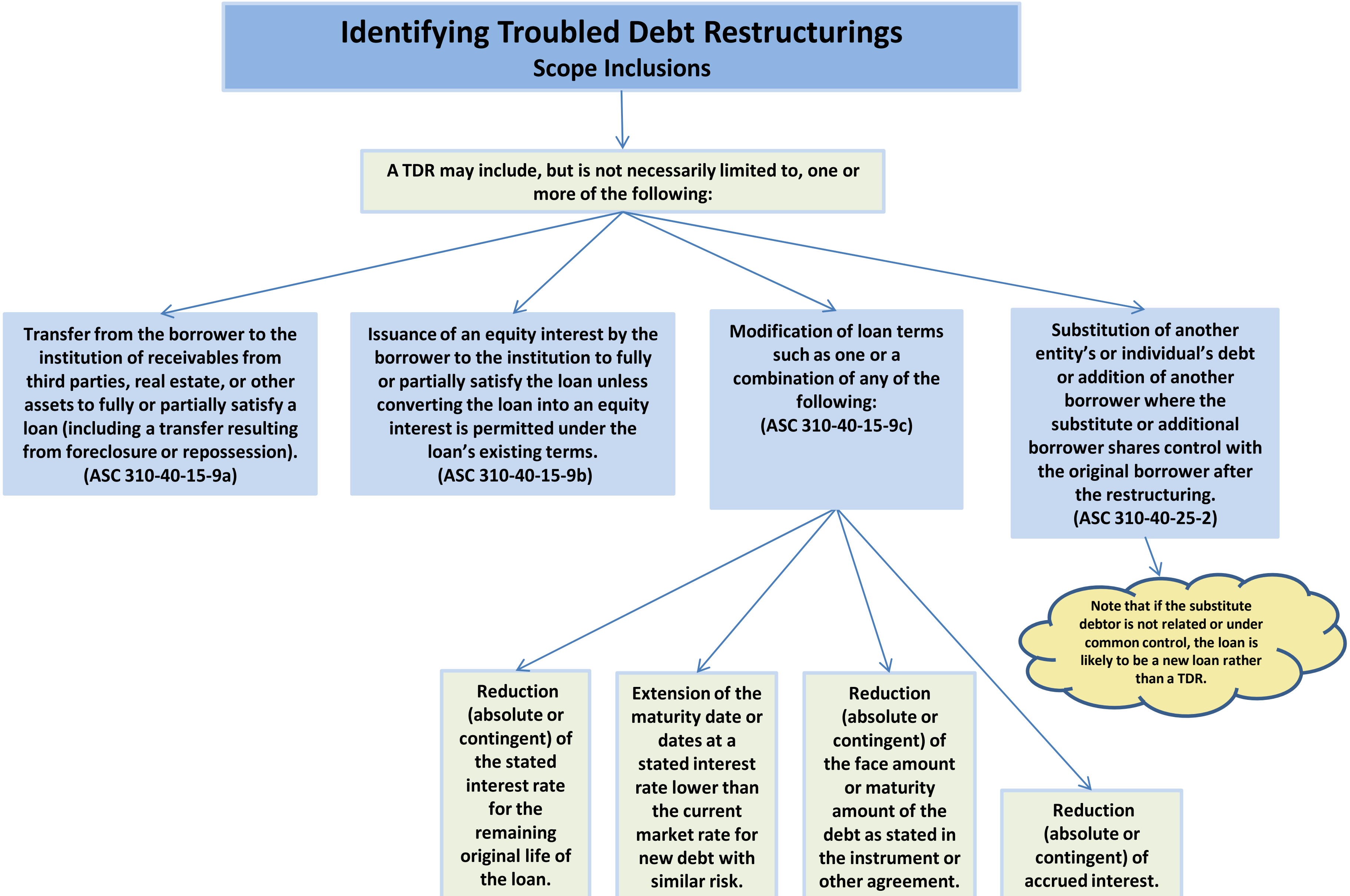
[2] Consistent with ASC paragraph 310-10-35-21, TDRs may be aggregated and measured for impairment with other impaired loans that share common risk characteristics by using historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate. However, such approach must be consistent with the measurement methods under ASC Topic 310 for loans that are individually considered impaired and ***not*** the measurement method under ASC Topic 450 for loans that are collectively evaluated for impairment.

Identifying Troubled Debt Restructurings - Overview

ASC 310 – 40, Receivables – Troubled Debt Restructurings by Creditors




Identifying Troubled Debt Restructurings
Scope Inclusions
A TDR may include, but is not necessarily limited to, one or more of the following:
Transfer from the borrower to the institution of receivables from third parties, real estate, or other assets to fully or partially satisfy a loan (including a transfer resulting from foreclosure or repossession). (ASC 310-40-15-9a)
Issuance of an equity interest by the borrower to the institution to fully or partially satisfy the loan unless converting the loan into an equity interest is permitted under the loan's existing terms. (ASC 310-40-15-9b)
Modification of loan terms such as one or a combination of any of the following: (ASC 310-40-15-9c)
Substitution of another entity's or individual's debt or addition of another borrower where the substitute or additional borrower shares control with the original borrower after the restructuring. (ASC 310-40-25-2)
Note that if the substitute debtor is not related or under common control, the loan is likely to be a new loan rather than a TDR.
Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the loan.
Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
Reduction (absolute or contingent) of accrued interest.

Identifying Troubled Debt Restructurings

Scope Exclusions

The following are not considered TDRs.

- **Modifications of loans within a pool of loans that were purchased in a credit-impaired state. (ASC 310-40-15-11d)**
- **Institution's delay to take legal action to collect overdue amounts, unless they involve an *agreement* between the institution and the borrower. (ASC 310-40-15-11c)**
  - **GAAP does not specify that an agreement must be writing. Therefore, an institution is not precluded from applying TDR guidance on the basis that an agreement hasn't been signed.**
- **The fair value of cash or assets received in satisfaction of the debt equals the institution's recorded investment. (ASC 310-40-15-12a)**
- **Institution's reduction of a loan's interest rate to reflect a decrease in market rates or in risk to retain a borrower *that can readily obtain funds from other sources* at a current market rate of interest. (ASC 310-40-15-12c)**
  - **This scope exclusion would apply even if the borrower is experiencing some financial difficulty, as long as the borrower can "readily obtain funds from other sources at a current market interest rate.*" (ASC 310-40-15-12)**
  - ***To demonstrate that modified terms are at a market rate (and therefore not a concession) an institution needs to perform credit analysis at the time of the restructuring.**
- **Borrower's issuance of new debt with a market rate of interest for similar nontroubled debt in exchange for the borrower's loan. (ASC 310-40-15-12d)**

The following *might* not be considered TDRs.

- **Temporary modifications with short periods that result in insignificant delays in cash flows are not definitively required to be reported as TDRs <u>during the temporary period</u>. (See "Insignificant Delays" page 8)**
  - **However, the longer the temporary period, the more likely the modification would result in a significant delay in cash flows that would result in a TDR.**
  - **Loans in temporary modification periods, even if not considered TDRs, should have an appropriate impairment measurement considering factors that indicate deteriorating credit quality (e.g., not limited to past due status).**

Identifying Troubled Debt Restructurings

Assessing Financial Difficulties

An institution shall carefully consider all relevant facts and circumstances in assessing whether a borrower is in financial difficulty. The following are some examples of indicators of financial difficulties:

If a borrower is not in financial difficulty, there is no TDR.

Borrower does not have to be in default at the time of the modification to be considered to be in financial difficulty. (ASC 310-40-15-20a)

- The borrower is currently in payment default on any of its debt or it is probable the borrower would be in default on any of its debt in the foreseeable future without the modification. *(ASC 310-40-15-20a)*
- The borrower has declared or is in the process of declaring bankruptcy. *(ASC 310-40-15-20b)*
- There is substantial doubt as to whether the borrower will continue to be a going concern. *(ASC 310-40-15-20c)*
- The borrower has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange. *(ASC 310-40-15-20d)*
- On the basis of estimates that encompass only the borrower's current capabilities, the institution forecasts that the borrower's entity-specific cash flows will be insufficient to service any of its debt (both P&I) under the existing agreement's contractual terms for the foreseeable future. *(ASC 310-40-15-20e)*
- Without the current modification, the borrower cannot borrow from sources other than the existing institution at a market rate of interest for similar debt for a nontroubled borrower. *(ASC 310-40-15-20f)*

Identifying Troubled Debt Restructurings

Assessing Concession Granting

If the borrower is experiencing financial difficulty, the next step is to determine whether a concession has been made.

An institution shall carefully consider all relevant facts and circumstances in assessing whether a concession has been granted. The following are some examples of factors to consider:

*To demonstrate that modified terms are at a market rate (and therefore not a concession) an institution needs to perform credit analysis at the time of the restructuring.

An institution *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. (ASC 310-40-15-13)

If a creditor receives additional collateral or guarantees in exchange for a restructuring, the creditor *has granted a concession* if the additional collateral or guarantees are not adequate compensation for other terms of the restructuring. (ASC 310-40-15-14)

A restructuring that results in only a delay in payment that is insignificant *is not a concession*. (ASC 310-40-15-17 through 25) (See Insignificant Delays page 8 for more detail.)

If a borrower does not otherwise have access to funds at a market rate* for loans with similar risk as the restructured loan, it is assumed to be at a below-market rate and *is likely a concession*. However, if a market rate is not available (for example, due to contracted markets), this alone *may not be a concession*. (ASC 310-40-15-15)

A temporary or permanent increase in the interest rate *may be a concession* if the new interest rate on the restructured loan is still below a market rate* for new loans with similar risk characteristics. (ASC 310-40-15-16)

Identifying Troubled Debt Restructurings

Insignificant Delays

The following, when considered together (including the effect of cumulative past restructurings), may reflect an insignificant delay that would not be a concession:

The *amount* of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.

The delay in *timing* of the restructured payment period is insignificant relative to any one of the following:

- ✓ **The frequency of payments due**
- ✓ **The loan's original contractual maturity**
- ✓ **The loan's original expected duration**

Identifying Troubled Debt Restructurings

Regulatory Reporting

Regulatory Reporting Schedules

A TDR is reported in the Call Report (or FR Y-9C) in the appropriate loan category in Schedule RC-C (HC-C) part I, items 1-9, and in the appropriate category in:

- ✓ Schedule RC-C (HC-C), Loans and Leases, memo item 1, if it is in compliance with its modified terms,

  or

- ✓ Schedule RC-N (HC-N), Past Due and Nonaccrual Loans, memo 1, if it is not in compliance with its modified terms.

Changes Effective 1Q11

Regulatory reporting of TDRs was revised effective for the March 31, 2011 report date.

- ✓ Consumer loans must now be reported.
- ✓ The revisions require more granular reporting by loan category.
- ✓ Leases are now excluded from TDR reporting.

Continued Accounting & Reporting as a TDR

- ➢ An identified TDR is *accounted* for as a TDR for the remaining life of the loan.
- ➢ An identified TDR is generally *reported* as a TDR for the remaining life of the loan. However, if a TDR meets the following criteria, it would not be required to be reported in regulatory reports as a TDR in calendar years after the year in which the restructuring took place:
  - ✓ if it was restructured at a market rate for similar debt

    and

  - ✓ if it has demonstrated performance for a period of time under the modified terms.