Troubled Debt Restructurings (TDRs)

Atlanta Regulatory Conference Call

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Applicable Accounting Standards

- Accounting Standards Codification (ASC) Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors
  - Formerly FAS 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, as amended
- Accounting Standards Update (ASU) No. 2011-02, "A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring"
  - Issued April 2011
  - Amends ASC Subtopic 310-40
  - http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498

Applicable Accounting Standards

- ASU 2011-02
  - Effective date
    - Generally, for public banks, 7/1/11 (with retrospective identification of TDRs back to 1/1/11)
    - Generally, for nonpublic banks, 1/1/12
    - Early adoption permitted (subject to certain conditions for nonpublic banks)
- ASC Section 310-10-35, Receivables – Overall – Subsequent Measurement
  - Formerly FAS 114, *Accounting by Creditors for Impairment of a Loan*, as amended

Other Guidance

- Call Report Instructions
  - Glossary entry for “Troubled Debt Restructurings”
- Call Report Supplemental Instructions
  - Has addressed “Troubled Debt Restructurings and Current Market Interest Rates” since September 2010
    - http://www.fdic.gov/news/news/financial/2011/fil11052a.pdf
- Policy Statement on Prudent Commercial Real Estate Loan Workouts (October 2009)
  - Examples of TDR treatment in Attachment 1
    - http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf

Identifying TDRs

- A restructuring constitutes 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”.
- In a TDR, creditor’s objective is to make the best of a difficult situation
  - Creditor grants concession in an attempt to protect as much of its asset as possible
  - Creditor expects to obtain more cash or other value from the debtor, or increase the probability of receipt, by granting the concession than by not granting it

Identifying TDRs

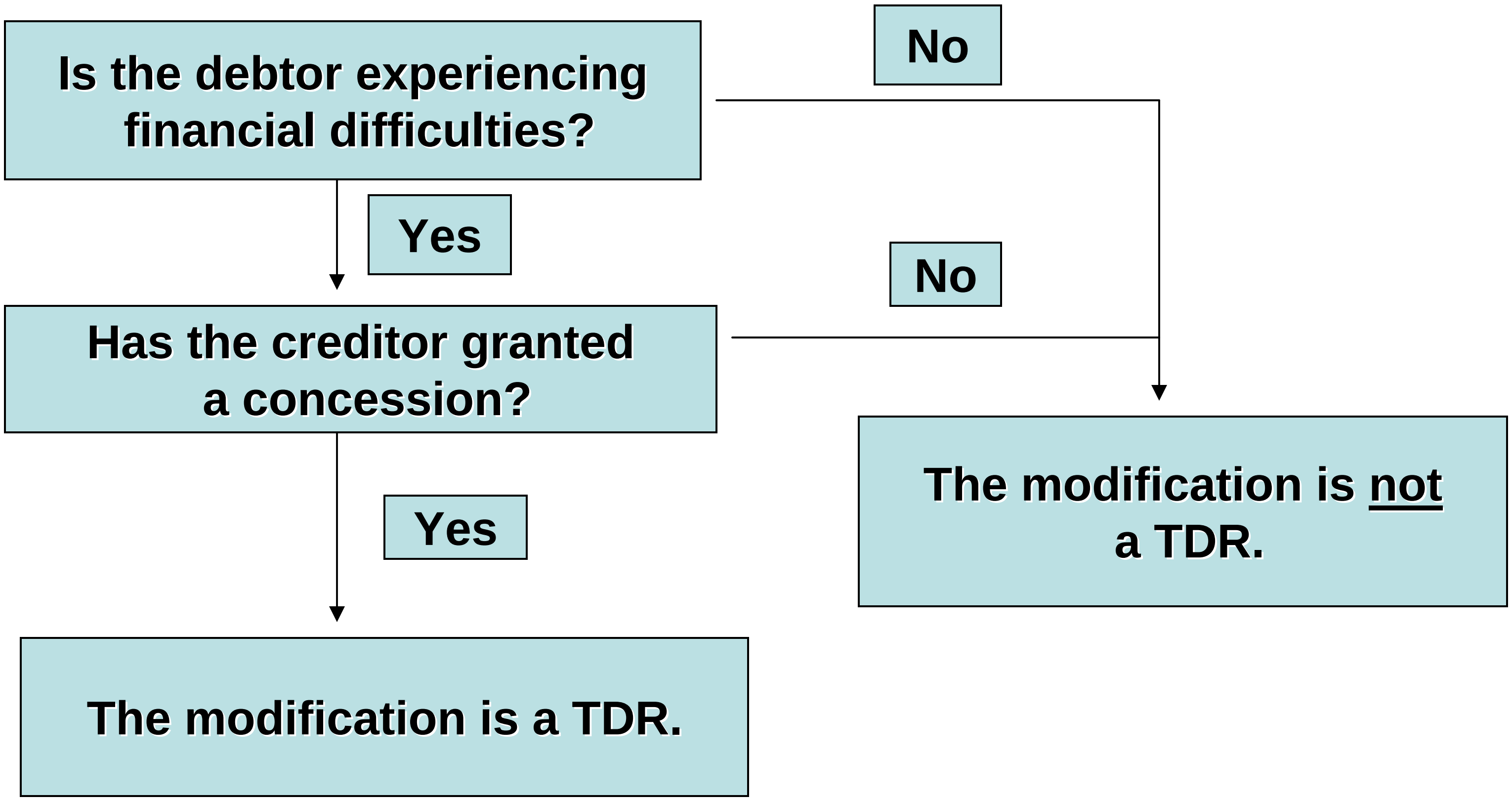
- Concession arises from an agreement between creditor and debtor or is imposed by law or a court, e.g., in bankruptcy
- What types of transactions may be TDRs?
  – A transfer from the debtor to the creditor (including via foreclosure or repossession) of real estate, receivables from third parties, other assets, or an equity interest in the debtor in full or partial satisfaction of the debt,
  – A modification of terms of a debt, or
  – A combination of the above

Identifying TDRs

- What does a modification of terms include?
  – Reduction of stated interest rate for remaining original life of debt
  – Extension of maturity date at a stated interest rate lower than the current market rate for new debt with similar risk
  – Reduction of the face amount of debt
  – Reduction of accrued interest
- Not all loan modifications constitute TDRs
- Identifying whether a loan restructuring is a TDR is based upon individual facts and circumstances and requires the use of judgment

Identifying TDRs

- When is a modification of terms (within the scope of ASC Subtopic 310-40) a TDR?



Identifying TDRs

- Indicators that a debtor is experiencing financial difficulties
  - Debtor is currently in payment default on any of its debt
    - Added by ASU 2011-02: It is probable that debtor would be in payment default on any debt in foreseeable future without the modification, i.e., debtor may be experiencing financial difficulties even if not currently in payment default
  - Debtor has declared or is in process of declaring bankruptcy
  - Significant doubt as to whether debtor will continue to be a going concern

Identifying TDRs

- Indicators that a debtor is experiencing financial difficulties (cont.)
  - Debtor has securities that have been, are in process of being, or are under threat of being delisted from an exchange
  - Based on debtor's current capabilities, debtor's cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity
    - Added by ASU 2011-02: Cash flows will be insufficient to service any debt
  - Without current modification, debtor cannot obtain funds from sources other than existing creditors at an effective interest rate equal to current market interest rate for similar debt for a nontroubled borrower

Identifying TDRs

- Consider all facts and circumstances to determine whether the creditor has granted an interest rate concession or some other type of concession, e.g., terms or conditions outside creditor's policies or common market practices
  - A current market interest rate is an interest rate greater than or equal to the rate the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk
  - A restructured loan does not yield a market interest rate simply because the rate charged under the restructuring agreement has not been reduced

Identifying TDRs

  - An increase, either temporary or permanent, in the contractual interest rate cannot be presumed to be a rate that is at or above the market interest rate
- Evaluate whether the rate on the modified loan is a market interest rate
  - Analyze borrower’s financial condition at the time of the restructuring and compare rate on the modified loan to rates the creditor would charge to borrowers with similar financial characteristics on similar types of loans
  - Include analysis of credit history and scores, loan-to-value ratios or other collateral protection, borrower’s ability to generate cash flow sufficient to meet repayment terms, and other factors normally considered when underwriting and pricing loans

Identifying TDRs

- ASU 2011-02 guidance on concessions
  - 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 original contract rate
    - In this situation, and if payment of principal at original maturity is primarily dependent on value of collateral, creditor shall consider current value of collateral (i.e., at time of restructuring) in determining whether principal will be paid

Identifying TDRs

- ASU 2011-02 guidance on concessions (cont.)
  - If creditor restructures debt in exchange for additional collateral or guarantees
    - Creditor has granted a concession when nature and amount of additional collateral or guarantees received as part of restructuring are not adequate compensation for other terms of restructuring
    - Creditor must evaluate a guarantor’s ability and willingness to pay the balance owed

Identifying TDRs

- ASU 2011-02 guidance on concessions (cont.)
  - If debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, restructuring would be considered to be at a below-market rate, which <u>may</u> indicate that creditor has granted a concession
    - In this situation, creditor must consider all aspects of the restructuring to determine whether it has granted a concession

Identifying TDRs

- ASU 2011-02 guidance on concessions (cont.)
  - A restructuring that results in only a delay in payment that is insignificant is not a concession
  - Following factors, when considered together, may indicate that a restructuring results in insignificant delay in payment
    - Amount of restructured payments subject to the delay is insignificant relative to unpaid principal or collateral value and will result in an insignificant shortfall in contractual amount due
    - Delay in timing of restructured payment period is insignificant relative to frequency of payments due under the debt, debt's original contractual maturity, or debt's original expected duration (i.e., any of these 3)
  - Consider cumulative effect of past restructurings when evaluating delay in payment from current restructuring

Measuring Impairment on TDRs

- When a loan modification constitutes a TDR, the loan is considered impaired
  - If the loan is one that falls within the scope of ASC Section 310-10-35 (former FAS 114), the loan usually would already have been identified as impaired before the restructuring
  - If a loan modified in a TDR was excluded from the scope of ASC Section 310-10-35 before the restructuring because it was part of a “large group of smaller-balance homogeneous loans that are collectively evaluated for impairment,” the creditor must begin to apply this ASC Section to the modified loan
    - Thus, ASC Section 310-10-35 applies to TDRs of 1-4 family residential mortgage loans and consumer loans

Measuring Impairment on TDRs

- Measure impairment on a loan that is a TDR in accordance with ASC Section 310-10-35 (former FAS 114)
  – First, determine whether the restructured loan is collateral dependent or not
  – A loan is collateral dependent if repayment is expected to be provided solely by the sale or operation of the underlying collateral

Measuring Impairment on TDRs

- If loan that is a TDR is not collateral dependent, measure impairment based on present value of expected future cash flows discounted at loan’s effective interest rate
  - Estimates of expected future cash flows should be creditor’s best estimate based on reasonable and supportable assumptions and projections
  - Best estimate is not normally the contractual cash flows under the modified terms
  - When estimating expected future cash flows, consider appropriateness of using default and prepayment assumptions relevant to a pool of loans with similar characteristics, i.e., a pool of similar impaired loans

Measuring Impairment on TDRs

  - Effective interest rate is the original effective interest rate on the loan, <u>not</u> the rate specified in the restructured loan agreement
- If a loan that is a TDR is collateral dependent, measure impairment based on fair value of the collateral
  - If repayment or satisfaction of loan is dependent on sale of collateral, reduce fair value by estimated costs to sell
  - If repayment or satisfaction of loan is dependent on operation of collateral, do not reduce fair value by estimated costs to sell
  - Costs to sell are “incremental direct costs to transact a sale,” including “broker commissions, legal and title transfer fees, and closing costs”

Measuring Impairment on TDRs

- Fair value should be estimated in accordance with ASC Topic 820, Fair Value Measurement (formerly FAS 157, “Fair Value Measurements”)
  - “Fair value” is defined as “the price that would be received to sell an asset . . . in an orderly transaction between market participants at the measurement date,” i.e., not a forced liquidation or distress sale
  - Fair value should reflect the current condition of a property, not the potential value of the property at some future date

Measuring Impairment on TDRs

- As with any impaired loan, the amount of impairment on a loan that is a TDR (i.e., the "FAS 114" allowance) is the amount by which the recorded investment in the loan exceeds
  - The present value of expected future cash flows, if the loan is not collateral dependent
  - The fair value of the collateral (less costs to sell, if appropriate), if the loan is collateral dependent
  - "Recorded investment" is the loan's face amount adjusted for any unamortized loan fees or costs or unamortized premium or discount, less any previous charge-off, plus recorded accrued interest

Measuring Impairment on TDRs

- Aggregation of impaired loans, including loans that are TDRs
  - When impaired loans have risk characteristics in common with other impaired loans, “a creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans”
  - When aggregation is used, it generally is applied to retail loans

Measuring Impairment on TDRs

- Whenever a loan has undergone a TDR, the collectibility of the loan should be reviewed quarterly and any portion of the loan that is deemed uncollectible should be charged off
  - When a modification involves only an interest rate concession on a loan that is not collateral dependent, a bank would not normally be expected to charge the loan down to the calculated present value at the time of restructuring, but would maintain a “FAS 114” allowance
  - If a loan modification includes the forgiveness of principal, a charge-off should be taken (to the extent necessary) at the time of restructuring for the amount forgiven

Reporting and Disclosure of TDRs

- Should loans that are TDRs be placed in nonaccrual status?
  - Most loans (other than retail loans) that undergo a TDR will already have been individually identified as impaired prior to the restructuring and likely would also already be in nonaccrual status at the time of restructuring
    - If loan had been in nonaccrual status prior to the restructuring because payment in full of principal and interest was not expected, reasonable assurance of repayment under modified terms (based on a current credit evaluation) plus demonstrated repayment performance for a minimum of six months is needed to return loan to accrual status

Reporting and Disclosure of TDRs

- Call Report instructions do not require retail loans (1-4 family residential mortgages and consumer loans) to be placed in nonaccrual status when they become 90 days past due
  - Instructions say that “such loans should be subject to other alternative methods of evaluation to assure that the bank’s net income is not materially overstated”
  - If retail loan was current before undergoing a TDR and monthly payments under modified terms are not significantly different than under previous terms, and continued repayment performance is expected, placement in nonaccrual status would not be required

Reporting and Disclosure of TDRs

- In the Call Report, until a loan that is a TDR is paid in full or otherwise settled, sold, or charged off, the loan must be reported as a TDR in:
  - Schedule RC-C, part I, Memo item 1, if it is in compliance with its modified terms, or
  - Schedule RC-N, Memo item 1, if it is not in compliance with its modified terms
  - Sole exception: A TDR that yields a market interest rate (see slide 11) <u>at the time of restructuring</u> and is in compliance with its modified terms need not be reported as a TDR in Schedule RC-C, part I, Memo item 1, in calendar years after the year of the restructuring
    - This may occur if the modification includes a reduction in principal or uses an A/B note structure

Reporting and Disclosure of TDRs

- Call Report TDR revisions effective in March 2011
  - Schedule RC-C, part I, Memo item 1, and Schedule RC-N, Memo item 1, were revised to collect a more detailed breakdown of TDRs by loan category
    - Before 2011, in each Memo item TDRs were reported separately for 1-4 family residential mortgages and all other loans (excluding consumer loans)
    - Beginning in March 2011, separate reporting of TDRs for several real estate loan categories, commercial and industrial loans, and all other loans (including consumer loans), with disclosure of loan categories that are significant components of all other loans

Questions?

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