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# Troubled Debt Restructurings

# Troubled Debt Restructurings

## Presenters

- **David K. Mangian**
  Assistant Regional Director
- **Pamela J. Rich**
  Regional Accountant
- **Examiner Subject Matter Expert Panel**
  Senior Examiner Terrence E. O'Neill
    Chicago, Illinois Field Office
  Supervisory Examiner Eric Walbeck
    Grand Rapids, Michigan Field Office

# Troubled Debt Restructurings

- **Agenda**
  - Troubled Debt Restructuring Overview
  - Examiner Observations
  - Questions and Answers

- **Applicable Accounting Standards**
  - ASC 310-40, *Troubled Debt Restructurings by Creditors* (formerly FAS 15)
  - ASC 310-10-35, *Receivables, Subsequent Measurement* (formerly FAS 114)
  - ASU No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*

# Troubled Debt Restructurings

- **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
  - Policy Statement on Prudent Commercial Real Estate Loan Workouts (October 2009)
    - Examples of TDR treatment in Attachment 1
      - Financial Institution Letter 61-2009

# Troubled Debt Restructurings

- **A restructuring 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 troubled debt restructuring may include**
  - A transfer from the debtor to the creditor (including via foreclosure or repossession) of real estate or other assets,
  - A modification of loan terms, or
  - A combination of the above

# Troubled Debt Restructurings

- **All loans that have undergone a troubled debt restructuring are considered impaired**
- **Impairment is measured under ASC 310-10-35, *Receivables, Subsequent Measurement* (formerly FAS 114)**
  - Impairment is normally measured based on present value of expected future cash flows discounted at loan's original effective interest rate
  - For regulatory reporting purposes, banks and other depository institutions are required to measure impairment based on the fair value of collateral if loan is collateral dependent

# Troubled Debt Restructurings

- **Examiner Observations: Issues most frequently discussed during examinations**
  - TDR Identification
    - Determining whether a modification includes a concession
    - Assessing whether a borrower is experiencing financial difficulty
    - Receipt of assets in full or partial satisfaction of a loan
  - Measurement of Impairment
    - Estimating expected future cash flows
    - Identifying loans that are collateral dependent
  - Reporting and Disclosure of TDR Loans
  - Accrual Treatment

## TDR Identification

- Based upon individual facts and circumstances and requires use of judgment
- Determining whether a modification includes a concession
  - 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

- **TDR Identification**
  - Indicators in assessing whether a borrower is experiencing financial difficulty
    - The debtor is currently in payment default on any of its debt
    - Whether it is probable the debtor would be in payment default on any of its debt in the foreseeable future without the modification
    - The debtor has declared or is in the process of declaring bankruptcy
    - Substantial doubt as to whether the debtor will continue to be a going concern

# Troubled Debt Restructurings

- **TDR Identification**
  - Indicators of financial difficulty (continued)
    - The debtor has securities that have been delisted, are in the process of being delisted, or are under the threat of being delisted from an exchange
    - On the basis of estimates and projections that only encompass the debtor’s current capabilities, the creditor forecasts that the debtor’s entity-specific cash flows will be insufficient to service any of its debt (both interest and principal) in accordance with the contractual terms of the existing agreement for the foreseeable future
    - Without the current modification, the 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 borrower
    - Above list is not all-inclusive

- **TDR Identification**
  - Receipt of assets in full or partial satisfaction of a loan
    - Creditor accepts a third party receivable or other asset of the debtor, in lieu of the receivable (or cash payment) from the debtor
    - Creditor accepts an equity interest in the debtor in lieu of the receivable

- **Measuring Impairment**
  - 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

# Troubled Debt Restructurings

- **Measuring Impairment**
  - If a TDR loan 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
    - 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**
  - If a TDR loan is collateral dependent, measure impairment based on fair value of 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”

# Troubled Debt Restructurings

- **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 at the time of restructuring and is in compliance with its modified terms need not be reported as a TDR in calendar years after the year of restructuring
      - This may occur if the modification includes a reduction in principal or uses an A/B note structure

## Best Practices

- Policies and Procedures
- Identification and Reporting
- Administration and Documentation

# Troubled Debt Restructurings

- **Policy Statement on Prudent Commercial Real Estate Loan Workouts**
  **(Financial Institutions Letter 61-2009)**
  - Effective risk management practices for renewing and restructuring CRE loans should include
    - Management infrastructure to identify, control, and manage the volume and complexity of the workout activity
    - Documentation standards to verify the borrower's financial condition and collateral values
    - Adequacy of management information systems and internal controls to identify and track loan performance and risk, including concentration risk

# Troubled Debt Restructurings

- Effective risk management practices for renewing and restructuring CRE loans (continued)
  - Management's responsibility to ensure regulatory reports of the institution are consistent with regulatory reporting requirements (including GAAP) and supervisory guidance
  - Effectiveness of loan collection procedures
  - Adherence to statutory regulatory and internal lending limits
  - Collateral administration to ensure proper lien perfection of the institution's collateral interests for both real and personal property
  - An ongoing credit review function

- **Policies and Procedures – Best Practices**

**Written Policies**

- Provide Board direction and management intentions regarding restructuring activity
- Establish authority level for restructuring activity
- Provide definitions and examples to aid lending staff in identifying when a borrower is experiencing financial difficulty and when a modification includes a concession
- Address required reporting of restructuring activity for both internal and external purposes

- **Identification and Reporting – Best Practices**
  - Establishment of decision trees
    - For all renewals and modifications
    - Completed and included in the loan file
  - Basic questions specific to borrower and modification
    - Indicators of financial difficulty (see slides 10 and 11)
    - Terms that may represent a concession

- **Identification and Reporting – Best Practices**
  - Questions regarding modified terms - examples
    - Interest only?
    - Market rate of interest?
    - Reduced or delayed payments?
    - Extended amortization?
    - Acceptance of collateral or settlement?
    - Lack of appropriate curtailment?
    - A/B note structure?

- **Administration and Documentation – Best Practices**
  - Identify the resolution strategy to help gauge future performance
    - Document analysis of borrower's repayment capacity, support provided by guarantors, and value of collateral pledged on the debt
    - Require updated financials, pro forma financials and frequent financial reporting
    - Require updated collateral evaluations

- **Administration and Documentation – Best Practices**
  - Restructuring activities that promote the rehabilitation of the borrower
    - Early identification of problems
    - Match restructure to borrower’s financial capacity
    - Consider benefits of an A/B note structure

- **Administration and Documentation – Best Practices**
  - Adopt procedures to ensure critical information is shared between departments
    - To ensure adequate and timely recognition and measurement of TDRs
    - To ensure appropriate allocations to the ALLL
    - To fulfill recordkeeping and reporting requirements

- **Administration and Documentation – Best Practices**
  - Tracking and Reporting
    - Separately track restructured loan performance
      - Monthly summary reports of restructuring activity
      - Quarterly reports of TDR performance, including re-default rates, delinquency, and charge-off rates
    - Document re-default rates and loss rates to support expected cash flow assumptions

# Questions and Answers