Federal Deposit Insurance Corporation

MEMO

TO: The Board of Directors

FROM: Patrick Mitchell
Director, Division of Insurance and Research

DATE: July 19, 2022

RE: Assessments, Amendments to Incorporate Troubled Debt Restructuring Accounting Standards Update

RECOMMENDATION

Staff recommend that the FDIC Board of Directors (the Board) adopt and authorize publication of the attached notice of proposed rulemaking (NPR or proposal) with a 30-day comment period. The NPR would conform the risk-based deposit insurance assessment system applicable to all large banks, including highly complex banks, to incorporate a recently updated accounting standard that eliminates the recognition of troubled debt restructurings (TDRs) and enhances financial statement disclosure requirements for loan modifications to borrowers experiencing financial difficulty.

The proposal would amend the assessment regulations to expressly include the new accounting term, "modifications to borrowers experiencing financial difficulty," recently introduced by the Financial Accounting Standards Board (FASB), to replace TDRs in the underperforming assets ratio and higher-risk assets ratio in the scorecards for large and highly complex banks. The proposal would not affect the deposit insurance assessment system for small banks.

BACKGROUND

Deposit Insurance Assessments

The FDIC maintains a risk-based deposit insurance assessment system. A bank's assessment rate is calculated using different methods dependent upon whether the bank is classified as a small, large, or highly complex bank.[1] Large and highly complex banks are assessed using a scorecard approach that combines CAMELS ratings and certain forward-looking financial measures to assess the risk that a large or highly complex bank poses to the Deposit Insurance Fund (DIF).[2] Both scorecards use quantitative financial measures that are useful for predicting a large or highly complex bank's long-term performance.

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[1] For deposit insurance assessment purposes, large banks generally have $10 billion or more in total assets and small banks have less than $10 billion in total assets. A highly complex bank is generally defined as an institution that has $50 billion or more in total assets and is controlled by a parent holding company that has $500 billion or more in total assets, or is a processing bank or trust company. *See* 12 CFR 327.8(e), (f), and (g).
[2] *See* 12 CFR 327.16(b); *see also* 76 FR 10672 (Feb. 25, 2011) and 77 FR 66000 (Oct. 31, 2012).

Concur:

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Harrel M. Pettway
General Counsel

Two of the measures in the large and highly complex bank scorecards, the credit quality measure and the concentration measure, are determined, in part, using restructured loans or TDRs. These measures are described in more detail below.

Credit Quality Measure

The credit quality measure is the greater of (1) the criticized and classified items to the sum of Tier 1 capital and reserves score or (2) the underperforming assets to the sum of Tier 1 capital and reserves score. Each risk measure is converted to a score between 0 and 100 based upon minimum and maximum cutoff values.

The underperforming assets ratio is described identically in the large and highly complex bank scorecards as the:

> "sum of loans that are 30 days or more past due and still accruing interest, nonaccrual loans, restructured loans (including restructured 1–4 family loans), and ORE, excluding the maximum amount recoverable from the U.S. government, its agencies, or government-sponsored agencies, under guarantee or insurance provisions, divided by a sum of Tier 1 capital and reserves."[3]

The specific data used to identify the "restructured loans" referenced in the above description are those items that banks disclose in their Call Report on Schedule RC-C, Part I, Memorandum items 1.a. through 1.g, "Loans restructured in troubled debt restructurings that are in compliance with their modified terms." The portion of restructured loans that is guaranteed or insured by the U.S. government are excluded from underperforming assets. This data is collected in Call Report Schedule RC-O, Memorandum item 16, "Portion of loans restructured in troubled debt restructurings that are in compliance with their modified terms and are guaranteed or insured by the U.S. government."

Concentration Measure

The concentration measure is the greater of (1) the higher-risk assets to the sum of Tier 1 capital and reserves score or (2) the growth-adjusted portfolio concentrations score. Each risk measure is converted to a score between 0 and 100 based upon minimum and maximum cutoff values. The higher-risk assets ratio captures the risk associated with concentrated lending in higher-risk areas. Higher-risk assets include construction and development (C&D) loans, higher-risk commercial and industrial (C&I) loans, higher-risk consumer loans, nontraditional mortgage loans, and higher-risk securitizations.

Higher-risk C&I loans are defined, in part, based on whether the loan is owed to the bank by a higher-risk C&I borrower, which includes, among other things, a borrower that obtains a refinance of an existing C&I loan, subject to certain conditions. Higher-risk consumer loans are defined as all consumer loans where, as of origination, or, if the loan has been refinanced, as of refinance, the probability of default within two years is greater than 20 percent, excluding those consumer loans that meet the definition of a nontraditional mortgage loan. A refinance for purposes of higher-risk C&I loans and higher-risk consumer loans is defined in the assessment regulations and explicitly excludes TDRs.

FASB's Elimination of Troubled Debt Restructurings

On March 31, 2022, FASB issued Accounting Standards Update No. 2022-02 (ASU No. 2022-02), "Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures."[4] This

[3] *See* 12 CFR 327 Appendix A.
[4] FASB Accounting Standards Update No. 2022-02, "Financial Instruments - Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures," March 2022.

update eliminated the recognition and measurement guidance for TDRs for all entities that have adopted ASU 2016-13, "Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" and the Current Expected Credit Losses (CECL) methodology.[5] FASB's rationale was that ASU 2016-13 requires the measurement and recording of lifetime expected credit losses on an asset that is within the scope of ASU 2016-13, and as a result, credit losses from TDRs have been captured in the allowance for credit losses. Therefore, stakeholders observed and asserted that the additional designation of a loan modification as a TDR and the related accounting were unnecessarily complex and provided less meaningful information than under the incurred loss methodology.

The accounting update introduces new financial statement disclosure requirements related to certain modifications of receivables made to borrowers experiencing financial difficulty, or "modifications to borrowers experiencing financial difficulty." Such modifications are limited to those that result in principal forgiveness, interest rate reductions, other-than-insignificant payment delays, or term extensions in the current reporting period. Modifications to borrowers experiencing financial difficulty may be different from those previously captured in TDR disclosures because an entity no longer would have to determine whether the creditor has granted a concession, which is a current requirement to determine whether a modification represents a TDR. The update requires entities to disclose in financial statements information about (a) the types of modifications provided, disaggregated by modification type, (b) the expected financial effect of those modifications, and (c) the performance of the loans after modification.

For entities that have adopted CECL, ASU 2022-02 is effective for fiscal years beginning after December 15, 2022. FASB also permitted the early adoption of ASU 2022-02 by any entity that has adopted CECL. For regulatory reporting purposes, if an institution chooses to early adopt ASU 2022-02 during 2022, Supplemental Instructions to the Call Report specify that the institution should implement ASU 2022-02 for the same quarter-end report date and report "modifications to borrowers experiencing financial difficulty" in the current TDR Call Report line items.[6] These line items include Schedule RC-C, Part I, Memorandum items 1.a. through 1.g., which are used to identify "restructured loans" for the underperforming assets ratio used in the large and highly complex bank scorecards, described above. As a result, a large or highly complex institution that has early adopted ASU 2022-02 and is reporting modifications to borrowers experiencing financial difficulty in the current TDR Call Report line items will be assigned a deposit insurance assessment rate that relies, in part, on this reporting. The FDIC and other members of the Federal Financial Institutions Examination Council (FFIEC) are planning to revise the Call Report forms and instructions to replace the current TDR terminology with updated language from ASU 2022-02 for the first quarter of 2023.

PROPOSED RULE

Summary

Staff propose to incorporate into the large and highly complex bank assessment scorecards the updated accounting standard that eliminates the recognition of TDRs and, instead, requires new financial statement disclosures on "modifications to borrowers experiencing financial difficulty." Staff are proposing to expressly define restructured loans in the underperforming assets ratio to include "modifications to borrowers experiencing financial difficulty." Staff are also proposing to amend the definition of a refinance for purposes of determining whether a loan is a higher-risk C&I loan or a higher-risk consumer loan, both elements of the higher-risk assets ratio. Under the proposal, a refinance would not include modifications to a loan that otherwise would meet the definition of a refinance, but that result in the classification of a loan as a modification to borrowers

[5] FASB Accounting Standards Update No. 2016–13, "Financial Instruments—Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments."
[6] *See* Financial Institution Letter (FIL) 17-2022, Consolidated Reports of Condition and Income for First Quarter 2022. *See also* Supplemental Instructions, March 2022 Call Report Materials, First 2022 Call, Number 299, available at https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_FFIEC051_suppinst_202203.pdf.

experiencing financial difficulty. This proposal would not affect the small bank deposit insurance assessment system.

Underperforming Assets Ratio

Staff propose to amend the underperforming assets ratio used in the large and highly complex bank pricing scorecards to conform to the updated accounting standards in ASU 2022-02. The amended text explicitly defines restructured loans for large and highly complex banks that have adopted CECL and ASU 2022-02 as modifications to borrowers experiencing financial difficulty. For the remaining large and highly complex banks that have not yet adopted CECL and ASU 2022-02, the FDIC would continue to use TDRs for restructured loans and the amended text would explicitly define restructured loans for these banks as TDRs.

The FDIC has included restructured loans in the underperforming assets ratio since the introduction of the large and highly complex bank scorecards in 2011. Restructured loans, in the context of the underperforming assets measure, typically present an elevated level of credit risk because they represent loans to borrowers unable to perform according to the original contractual terms. The FDIC believes it is important to capture such elevated credit risk in its measurement of credit quality. Staff believe the accounting term introduced by FASB in ASU 2022-02, "modifications to borrowers experiencing financial difficulty," will provide a similar and meaningful indicator of credit risk.

Higher-Risk Assets Ratio

Staff propose to amend the definition of a refinance, in determining whether a loan is a higher-risk C&I loan or a higher-risk consumer loan for deposit insurance assessment purposes, to conform to the updated accounting standards in ASU 2022-02. Specifically, a refinance of a C&I loan would not include a modification or series of modifications to a commercial loan that would otherwise meet the definition of a refinance, but that results in the classification of a loan as a modification to borrowers experiencing financial difficulty, for a large or highly complex bank that has adopted CECL and ASU 2022-02, or that results in the classification of a loan as a TDR, for all remaining large and highly complex banks. For purposes of higher-risk consumer loans, a refinance would not include modifications to a loan that would otherwise meet the definition of a refinance, but that result in the classification of a loan as a modification to borrowers experiencing financial difficulty, for a large or highly complex bank that has adopted CECL and ASU 2022-02, or that result in the classification of a loan as a TDR, for all remaining large and highly complex banks.

EXPECTED EFFECTS

As of December 31, 2021, the FDIC insured 148 banks that were classified as large or highly complex for deposit insurance assessment purposes, and that would be affected by this proposed rule. Staff expect most of these institutions will adopt CECL by January 1, 2023, the proposed effective date of the rule.

The primary expected effect of the proposed rule is the change in underperforming assets, and consequent change in assessment rates, that could occur as a result of the difference between the amount of TDRs that most banks are currently reporting and the amount of modifications to borrowers experiencing financial difficulty that banks will report upon adoption of ASU 2022-02. The effect of this proposed rule on assessments paid by large and highly complex banks is difficult to estimate since most banks are not yet reporting modifications to borrowers experiencing financial difficulty, and staff do not know how the amount of reported modifications to borrowers experiencing financial difficulty will compare to the amount of TDRs that affected banks report.

In general, staff expect that the initial amount of modifications made to borrowers experiencing financial difficulty will be lower than previously reported TDRs. This is because under ASU 2022-02, reporting of modifications to borrowers experiencing financial difficulty should be applied prospectively and would therefore apply only to modifications made after a bank adopts the standard. However, in the long term it is possible that the amount of modifications to borrowers experiencing financial difficulty could be higher or lower than the amount of TDRs that banks would have reported prior to adoption of ASU 2022-02. Therefore, under the proposed rule, the underperforming assets ratio could be higher or lower due to the adoption of ASU 2022-02, and the resulting ratio may or may not affect an individual bank's assessment rate, depending on whether it is the binding ratio for the credit quality measure.

Staff do not have the information necessary to estimate the expected effect of the proposal to incorporate the new accounting standard into the large and highly complex bank scorecards. However, the following analysis illustrates a range of potential outcomes based on TDRs reported prior to ASU 2022-02, as the amount of modifications to borrowers experiencing financial difficulty could be higher, lower, or similar to previously reported TDRs. The analysis shows the effect on assessments of higher or lower TDRs in calculating the underperforming assets ratio for deposit insurance assessment purposes.

Staff calculated some illustrative examples of the effect on assessments if modifications made to borrowers experiencing financial difficulty are lower than certain amounts of previously reported TDRs. For example, if all large and highly complex banks had reported zero TDRs as of December 31, 2021, the quarter before FASB issued ASU 2022-02, the impact on the underperforming assets ratio would have reduced total deposit insurance assessment revenue by an annualized amount of approximately $90 million; if modifications were 50 percent lower than TDRs reported as of December 31, 2021, annualized assessments would have decreased by $52 million.

Alternatively, as an extreme and unlikely scenario, if all large and highly complex banks had reported zero TDRs during a period when overall risk in the banking industry was higher, such as December 31, 2011, the impact on the underperforming assets ratio would have reduced total deposit insurance assessment revenue by an annualized amount of approximately $957 million. Between 2015 and 2019, if TDRs were zero, the resulting underperforming assets ratio would have reduced total deposit insurance assessment revenue by about $279 million annually, on average.

Over time, however, under ASU 2022-02 large and highly complex banks will begin to report modifications to borrowers experiencing financial difficulties. As noted above, the effect on assessments will depend on how the newly reported modifications compare to the TDRs that would have been reported under the prior accounting standard. For example, if all large and highly complex banks had reported modifications to borrowers experiencing financial difficulty that were 25 percent greater than the TDRs reported as of December 31, 2021, the impact on the underperforming assets ratio would have increased total deposit insurance assessment revenue by an annualized amount of approximately $30 million; if the modifications exceeded TDRs by 50 percent, annualized assessments would have increased by $65 million; and if the modifications exceeded TDRs by 100 percent, annualized assessments would have increased by $137 million.

The analysis presented above serves as an illustrative example of potential effects of the proposed rule. The analysis does not estimate potential future modifications to borrowers experiencing financial difficulty or how those amounts, once reported, will compare to previously reported TDRs for a few reasons. First, banks were granted temporary relief from reporting TDRs that were modified due to the COVID-19 pandemic, so recent reporting of TDRs is likely lower than it may otherwise have been.[7] Second, the amount of modifications made

[7] On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was signed into law. Section 4013 of the CARES Act, "Temporary Relief From Troubled Debt Restructurings," provided banks the option to temporarily suspend certain requirements under U.S. GAAP related to TDRs to account for the effects of COVID-19. Division N of the Consolidated Appropriations Act, 2021 ((Title V, subtitle C, section 541)) was signed into law on December 27, 2020, extending the provisions in Section 4013 of the CARES Act to January 1, 2022. This relief applied to certain loans modified between March 1, 2020 and January 1, 2022.

by large or highly complex banks vary based on economic conditions and future economic conditions are uncertain. Third, a restructuring of a debt 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, while a modification to borrowers experiencing financial difficulty is not evaluated based on whether or not a concession has been granted. Finally, future Call Report revisions and instructions on how modifications to borrowers experiencing financial difficulties should be reported will affect the future reported amount of modifications to borrowers experiencing financial difficulty.

With regard to the higher-risk assets ratio, the effect on assessments paid by large and highly complex banks is likely to be more muted. The assessment regulations define a higher-risk C&I or consumer loan as a loan or refinance that meets certain risk criteria. The proposed rule would exclude modifications to borrowers experiencing financial difficulty from the definition of a refinance for purposes of the higher-risk assets ratio. As a result, if a modification to a C&I or consumer loan results in the classification of the loan as a TDR under the current regulations, or as a modification to borrowers experiencing financial difficulty under the proposed rule, a large or highly complex bank would not have to re-evaluate whether the modified loan meets the definition of a higher-risk asset. For example, if a higher-risk C&I loan was subsequently modified as a TDR or modification to borrowers experiencing financial difficulty, it would not be considered a refinance and, therefore, would continue to be considered a higher-risk asset. Conversely, if a C&I loan that does not meet the definition of a higher-risk asset was subsequently modified as a TDR or modification to borrowers experiencing financial difficulty, it would not be considered a refinance and, therefore, would not have to be re-evaluated to determine if it meets the definition of a higher-risk asset. Staff assume that these possible outcomes are offsetting and the change to the rule will have minimal to no effect on deposit insurance assessments for large and highly complex banks.

The proposed rule would pose no additional reporting burden for large and highly complex banks.

ALTERNATIVES CONSIDERED

Staff considered two reasonable and possible alternatives. First, the FDIC could require banks to continue to report TDRs specifically for deposit insurance assessment purposes, even after they have adopted CECL and ASU 2022-02. This alternative would maintain consistency of the data used in the underperforming assets ratio and higher-risk assets ratio with prior reporting periods. However, this alternative would impose additional reporting burden on large and highly complex banks. This alternative would also fail to recognize the potential usefulness of the new data on modifications to borrowers experiencing financial difficulty. Ultimately, staff do not believe any benefits from continued reporting of TDRs expressly for assessment purposes would justify the cost to affected banks.

Staff also considered removing restructured loans from the definition of underperforming assets entirely and not incorporating the new data on modifications to borrowers experiencing financial difficulty. However, this alternative fails to recognize that data on modifications to borrowers experiencing financial difficulty provide a meaningful indicator of credit risk throughout economic cycles and should be captured in credit quality measures such as the underperforming assets ratio and the higher-risk assets ratio. Staff believe that the new modifications data required under ASU 2022-02 can provide valuable information and would not impose additional reporting burden. Incorporating this new data in place of TDRs would be the most reasonable option to ensure that large and highly complex banks are assessed fairly and accurately, all else equal.

On balance, staff believe the current proposal would determine deposit insurance assessment rates for large and highly complex banks in the most appropriate, accurate, and straightforward manner.

COMMENT PERIOD, EFFECTIVE DATE, AND APPLICATION DATE

Staff recommend issuing this proposal with a 30-day comment period. Staff expect to issue a final rule with an effective date of January 1, 2023, and applicable to the first quarterly assessment period of 2023 (i.e., January 1-April 1, 2023). Most institutions that have implemented CECL will adopt FASB's ASU 2022-02 in 2023, unless an institution chooses to early adopt in 2022. Institutions implementing CECL on January 1, 2023, also will adopt FASB's ASU 2022-02 at that time. Therefore, by the first quarter of 2023, ASU 2022-02 will be in effect for most, if not all, large and highly complex banks.

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