TDR 101: "ALLL" ABOUT **TROUBLED DEBT RESTRUCTURINGS**

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EXECUTIVE **SUMMARY**

By definition, a loan is considered a TDR when, due to the borrower's financial difficulties, the lender grants a concession that it would not have considered otherwise. This type of concession can take several forms and, in principal, is not necessarily a bad thing. Working closely with borrowers as they experience economic stress is often in the best interest of all parties and is a hallmark of good banking. However, the implications of designating a loan as a TDR can often make bankers question if attempting to work with their borrower was worth all the trouble. In this paper, we will look at the evolution of the regulatory and accounting guidance on TDRs and examine some of the issues regarding TDRs with which institutions often struggle. Specifically, we'll look at issues around identifying loans as TDRs, the impact on the allowance for loan and lease losses (ALLL), risk grading and accrual status as well as some other areas that commonly generate questions.

GUIDANCE **OVERVIEW**

The landscape of the guidance available on TDRs consists of both accounting and regulatory standards. As any in-depth discussion of TDRs must be based on these standards, the following is an overview of the progression of this guidance in recent years and how it has evolved. It is worth noting that much of the more recent guidance issued has served primarily to clarify issues and definitions around TDRs as opposed to fundamentally changing the previous standards.

From an accounting standpoint, the original guidance on the topic dates back to June 1977 with ***FASB 15 – Accounting by Debtors and Creditors for Troubled Debt Restructurings***[1]. This standard established the definition of a troubled debt restructuring and set initial expectations for the accounting for these debts by both the creditor and debtor. This standard also covered what types of modifications could be considered a concession and the disclosures required for both creditors and debtors (all of which would be expanded upon in subsequent guidance).

After FASB 15, the next significant accounting guidance on the topic was ***ASC 310-40: Receivables – Troubled Debt Restructurings by Creditors***[2]. This standard significantly expanded on FASB 15, particularly around the recognition, measurement for impairment and appropriate disclosures, and it still serves as a primary source of guidance on this topic.

Even with the expanded guidance of ASC 310-40, confusion remained among bankers about the handling of TDRs. This confusion became even more pronounced as the "Great Recession" dragged on and lenders found themselves making more and more modifications for their borrowers.

GUIDANCE **OVERVIEW** (CONT.)

FASB responded to the situation and released two ASU updates to help clarify (and amend in some instances) guidance around some of these issues:

> **ASU 2010-20** – *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*[3], significantly expanded disclosure requirements around problem loans, including TDRs.
>
> However it was **ASU 2011-02** – *Determination of Whether a Restructuring is a Troubled Debt Restructuring*[4] that, as the title suggests, finally clarified in more detail when a modification would be considered a TDR and gave expanded definitions around both borrower financial difficulty and concessions. This update expressly prohibited lenders from using the "effective interest rate test" to determine if a restructuring is a TDR as established in ASC 470-60 (which covers TDR accounting issues from the debtor's perspective).

From a regulatory standpoint, the ***Interagency Policy Statement on the Allowance for Loan and Lease Losses***[5] from December 2006 (FIL-105-2005), as well as the ***Call Report Filing Instructions (Reports of Condition and Income Instructions)***[6], set many of the initial standards on the definition of a Troubled Debt Restructure.

GUIDANCE **OVERVIEW** (CONT.)

However, similar to the evolution of the accounting guidance, the regulatory bodies issued subsequent standards to provide more clarity to creditors, specifically the ***Interagency Policy Statement on Prudent Commercial Loan Workouts (FIL-61-2009)***[7] as well as the October 2013 ***Interagency Policy Statement on TDRs (FIL -50-2013)***[8]. The latter, in particular, provided needed definition around risk grading, measuring impairment for TDR loans and expanded definitions related to collateral-dependent loans.

IDENTIFICATION OF **TDRS**

One of the fundamental challenges associated with managing TDR's in the portfolio simply comes down to identifying them. Keeping in mind the relevant guidance just reviewed, it is worth revisiting the regulatory definition of a Troubled Debt Restructuring. As specified repeatedly throughout regulatory guidance, a credit instrument is considered a TDR when:

"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."

The definition makes clear that in order for a loan to be considered a TDR, the borrower must be experiencing financial difficulty AND a concession must made by the lender. As always, the devil lies in the details.

Identifying and documenting evidence of financial difficulty can be challenging, as the responsibility falls on the lender to look beyond just payment performance of the credit in question. Likewise, what constitutes a concession (and what does not) is not as simple as it may seem. Because both of these elements must be true for a loan to be considered a TDR, let's look at each in more detail.

DEBTOR **FINANCIAL DIFFICULTY**

There are, of course, some obvious indicators of financial stress for borrowers. First and foremost, if the borrower is seriously delinquent or in default on any of their debt, this would be a clear indication of difficulty. Additionally, financial difficulty would be evident if the borrower has filed or is in the process of a bankruptcy filing. However, as noted above, FASB's ASU 2011-02 gave additional clarification on this threshold and highlighted some less obvious indicators.

If the lender has "substantial" doubt as to whether the borrower can continue as a going concern, the financial difficulty threshold has been met. This typically would be based on the borrower's payment history as well as a thorough credit analysis. If, based on the most recent information available, the lender's forecast determines the borrower's future cash is insufficient to service any of the borrower's debts without modification, financial difficulty would be established. Additionally, if the borrower is unable to secure debt from other sources besides existing lenders at market terms, this would also be evidence of financial difficulty.

WHAT CONSTITUTES A **CONCESSION?**

Determining whether a modification of a loan should be considered a concession is just as difficult as establishing borrower financial difficulty. Again, there are obvious modifications that, assuming financial stress is evident, would be considered a concession. Examples include lowering the interest rate below market terms to enable the borrower to service the debt, or an outright forgiveness of principal or interest owed on the loan. However, there are less obvious instances, as detailed in ASU 2011-02, that would be considered a concession if the borrower is experiencing financial difficulty. Some examples are:

- Establishing terms for the loan outside of the existing loan policies of the institution and/or existing regulatory guidelines
- Renewing the loan at its existing rate if rate is below market rates for credits with similar terms/risks
- Renewing at a higher rate if that rate is still below prevailing market rates
- Providing an extension of the loan's maturity that the institution would not otherwise consider
- Granting interest-only payments
- Providing collateral or personal guarantee considerations

The last point regarding collateral considerations can be especially challenging. This point was amended by ASU 2011-02 (amending ASC 310-40-15-14) and states that restructuring a credit in exchange for additional collateral or personal guarantees is considered a concession if these do not serve as "adequate compensation" for the terms of the restructure.

WHAT CONSTITUTES A **CONCESSION?** (CONT.)

Determining if the collateral/guarantee is adequate compensation relative to the change of terms can be difficult. The lender must consider market terms for loans of similar type and risk characteristics and is left to its own discretion to decide from there. As always, the lender should be prepared to document assumptions in any determination.

In considering whether a concession has been made to a borrower, the lender must carefully evaluate all information available to them. The line between a modification and a concession can be blurry. For example, payment extensions in many cases could be considered concessions, yet ASU 2011-20 clarified that "insignificant" delays in payment as a result of a restructuring may not be deemed a concession if the amount and timing of the delay is not material relative to the amount and terms of the loan.

ALLOWANCE FOR LOAN AND LEASE LOSSES **IMPLICATIONS**

RESOURCE:

www.ALLL.com

The destination website for the ALLL

One of the key reasons that understanding and managing the TDR process is critical for financial institutions is its impact on the ALLL. By definition, a loan is impaired when it is probable that the lender with not receive all of the principal and interest payments the borrower has contractually agreed to. If a loan is determined to be a TDR, the changes in terms made by the lender ensures that they will not receive all cash flows specified by the original contract. Thus, all loans determined to be TDRs will be considered impaired for allowance purposes.

Once we've established that TDRs are considered impaired loans from an ALLL standpoint, the next issue is their valuation and measurement of required reserves. All relevant guidance on this topic is clear that the appropriate method to value the loan first depends on whether or not the loan is determined to be collateral dependent. This issue was heighted during the Great Recession, as real estate values plunged and problem asset levels exploded at banks around the country. This, in part, prompted FASB to clarify this definition as part of their 2011 standards update (ASU 2011-02).

This updated guidance more narrowly defined collateral dependency, saying that "repayment is expected to be provided solely by the underlying collateral." It further states that this can be from the sale of or the continued operation of the collateral. This standard still requires judgment, however, particularly when considering the continued operation of the collateral as the cash flow for repayment must be provided "solely" by operations in order to be considered dependent. Any potential cash from guarantors or other sources should be carefully considered here.

ALLOWANCE FOR LOAN AND LEASE LOSSES **IMPLICATIONS** (CONT.)

WHITEPAPER:

Collateral Valuation and Documentation

If the loan is determined to be collateral dependent, it should be measured for impairment using the fair market value of collateral methodology as described in the established guidance on the topic (ASC 310-10). If repayment is expected from the sale of the collateral, estimated liquidation costs should be included in the analysis. These costs should be excluded if repayment is based on continued operation.

In the absence of collateral dependency, measurement of TDRs for impairment purposes should be based on the present value of the expected future cash flows. It is important to note that the discount rate used to calculate present values should be the original contractual rate of the loan if it has been modified. Also, the lender should be prepared to justify and document the expected future cash flows and not just rely on the scheduled amortization. An average of recent payment history and/or a credit analysis on the borrower are possible ways to justify these expectations and any expectations of default or prepayments should be considered as well.

RISK GRADING AND **ACCRUAL STATUS**

Additional areas of concern in the treatment of TDRs are those related to risk grading and accrual status. As impaired loans, it is often assumed that a loan classified as a TDR should automatically be put on non-accrual status. Likewise, if a credit is risk graded substandard, it is often assumed that any renewal or extension would cause the loan to be considered a TDR. Though this will often be the case, there are exceptions and the details should be carefully evaluated.

In terms of risk grading, the October 2013 Interagency Guidance on TDRs (FIL-50-2013) states "A TDR designation means the loan is impaired for accounting purposes, but it does not automatically result in an adverse classification or credit risk grade." The guidance goes on to state that an adversely rated TDR loan does not have to remain in TDR status for the remaining life of the loan.

The responsibility is again on the lender to evaluate all available information to make this determination, including a thorough credit analysis of the borrower. If forecasted cash flows from all available sources are sufficient to service the terms of the modified debt, and it is protected by adequate collateral, an adverse grade may not be necessary.

The accrual treatment of TDR loans is similar to risk grading. Using a thorough credit analysis on the borrower and other available information (particularly recent payment history), a TDR loan in many cases may remain on or be returned to accrual status. This analysis would incorporate the revised terms of the restructured loan and the borrower should have made payments under these terms for a "reasonable" amount of time (typically six months). It should be noted, however, that interest-only payments may not meet this threshold as this could bring into question whether repayment in full is assured.

POOLING OF **TDRS**

A common question regarding impairment measurement for TDRs is whether it is appropriate to pool groups of similar loans for analysis, as opposed to individually reviewing each loan. This is especially appealing for institutions when there are large numbers of small balance TDR loans, often residential or consumer credits.

The guidance on this topic is somewhat vague and, anecdotally speaking, appears to often be unevenly applied in the market. In ASC 310-10-35-21, it states that "impaired loans 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."

Both the OCC and FDIC have referenced this accounting guidance and stated that this can also be applied to loans designated as TDRs (OCC Bulletin 2012-10 and FDIC Supervisory Insight – Summer 2012). However, it is also made clear that the methods used to measure impairment must still adhere to ASC 310-10. As such, applying historical loss rates and qualitative adjustments per ASC 450 methodology would not be appropriate.

This leaves bankers in a difficult position, as there is little definition around acceptable pooling practices for TDRs. The accounting guidance references "composite effective interest rate" which suggests a pooled discounted cash flow analysis, however the details on how to accomplish this are lacking. Again speaking anecdotally, we have seen institutions pursue pooling for small balance TDRs and in cases receive push back from regulators to return to individual analysis of these loans.

ONCE A TDR, **ALWAYS A TDR?**

In any in-depth discussion of troubled debt restructuring, you're likely to hear the phrase "once a TDR, always a TDR." This is considered conventional wisdom by many bankers, but as with many of the issues surrounding TDR loans, the truth is not so clear cut.

There is a split here between the allowance view of this questions and the reporting perspective. For reporting purpose, TDRs that are performing under their modified terms and meet certain other conditions (accruing, less than 30 days past due and a market interest rate) do not need to be disclosed as TDRs for call report purposes in following years. However, these loans are still considered impaired for allowance purposes and need to be measured for specific reserves under ASC 310-10-35 (formerly FAS 114).

One exception to this rule was clarified in the September 30, 2014, Supplemental Call Report Instructions. TDR loans that are subsequently restructured again, under certain conditions, can drop their TDR designation altogether. This means they would not need to be disclosed for reporting purposes, nor would they be treated as impaired loans going forward.

Numerous conditions exist that require careful consideration and documentation to remove the TDR designation. Some examples include: no borrower financial difficulty, market rate of interest, no previous charge-offs of principal, etc.

CONCLUSION

In order to understand and deal with troubled debt restructurings, one must navigate numerous sources of both accounting and regulatory standards which can be complex at best, and maddening at worst. Managing the TDRs in your loan portfolio requires both a big-picture view of overall strategy as well as the ability to dig into the weeds around thorny accounting and reporting issues. Ancin Cooley, Principal of Synergy Bank consulting, Inc. describes it this way:

"***Effective TDR management is comprised of three parts: proper risk rating of credits, a consistent framework used to determine whether to retain or exit a particular credit relationship, and the accounting/reporting of that decision. All three of these processes have to work in concert with one another for effective management of TDRs.***"

As with most issues faced by financial institutions, best practices here are based on having established clear policies and procedures that are well-documented. For TDRs, these should focus on methods for identifying and designating loans as TDRs, establishing if any loans are collateral-dependent, applying the appropriate methods for measuring impairment, and ensuring proper reporting.

As market conditions change and evolve, so too will accounting and regulatory standards. By establishing, or even clarifying, your policies and procedures around troubled debt restructurings now, your institution will be in position to adapt to future changes as they come.

ENDNOTES

[1] "Statement of Financial Accounting Standards No. 15" Accounting by Debtors and Creditors for Troubled Debt Restructurings. *Financial Accounting Standards Board*. 1977.

http://www.fasb.org/pdf/aop_FAS15.pdf

[2] "ASC 310-40: Receivables - Troubled Debt Restructurings by Creditors" *Financial Accounting Standards Board*.

http://www.iasplus.com/en-us/standards/fasb/assets/asc310

[3] "ASU 2010-20 - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses" *Financial Accounting Standards Board*. 2010.

http://www.fasb.org/project/loan_disclosures.shtml

[4] "ASU 2011-02 - Determination of Whether a Restructuring is a Troubled Debt Restructuring" *Financial Accounting Standards Board*. 2011

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[5] "Interagency Policy Statement on the Allowance for Loan and Lease Losses" *FDIC, OCC, FED*. 2006

https://www.fdic.gov/news/news/financial/2006/fil06105a.pdf

[6] "Call Report Filing Instructions (Reports of Condition and Income Instructions)" *FDIC*. 2011

https://www.fdic.gov/regulations/resources/call/

[7] "Policy Statement on Prudent Commercial Real Estate Loan Workouts" *FDIC*. 2011

https://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf

[8] "Interagency Policy Statement on TDRs (FIL-50-2013)" *FDIC, OCC, FED*. 2013

https://www.fdic.gov/news/news/financial/2013/fil13050.html

ABOUT **SAGEWORKS & THE AUTHOR**

Sageworks

Sageworks is a financial information company that works with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. Sageworks provides a web-based suite of solutions to streamline credit analysis, risk rating, portfolio stress testing, loan administration and the ALLL calculation.

Sageworks ALLL

Sageworks ALLL is an automated solution for calculating and documenting the allowance calculation. It helps bankers automate their ALLL process and add consistency to their methodology, making it defensible to auditors and examiners. To find out more, visit www.sageworksanalyst.com.

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