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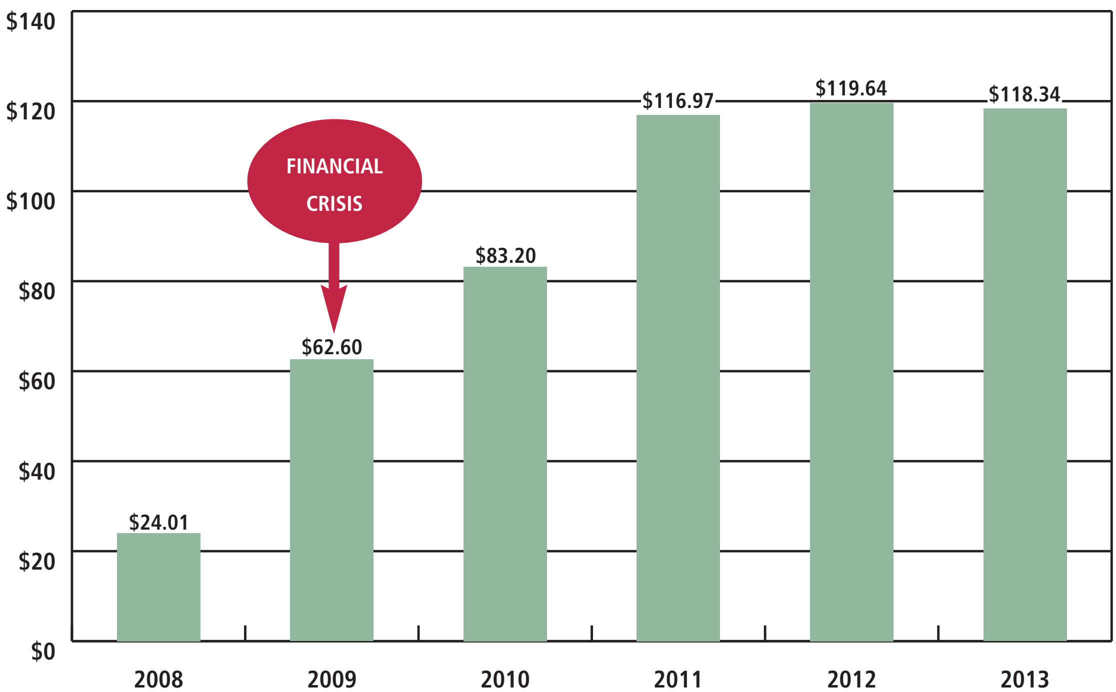
What's Up with Troubled Debt Restructuring?

By John G. Dykeman, CMA, CPA

Troubled debt restructuring (TDR) has been a critical financial reporting concern for the financial services industry the past several years, and the issues stemming from it are expected to continue well into the future. Because TDRs result from concessions made by a creditor to a debtor who is facing financial difficulties, they create concern for bankers and interested stakeholders who monitor the financial condition of banks. To illustrate some of the adverse effects for creditors, a TDR requires public disclosure of the nature and amount of the modified loans, loan impairment measurement, increased loan loss reserves, and, in all likelihood, a more comprehensive loan review by government agencies during regulatory examinations.

Figure 1: Residential Real Estate TDRs
(in billions)



	2008	2009	2010	2011	2012	2013
NUMBER OF INSTITUTIONS	8,305	8,012	7,658	7,357	7,083	6,812
BANK FAILURES	25	140	157	92	51	24

Sources: www2.fdic.gov/sdi/main.asp and www.fdic.gov/bank/individual/failed/banklist.html

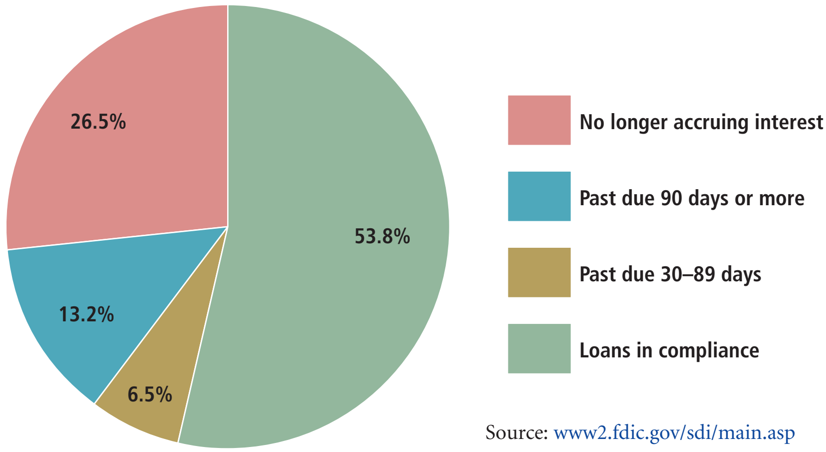
During the recent financial crisis, many borrowers faced economic hardship and needed help to restructure their debts to more favorable terms. Those with mortgages were hit especially hard. Figure 1 illustrates the rising level of residential real estate TDRs outstanding for all U.S. Federal Deposit Insurance Corporation (FDIC)-insured banking institutions since 2008. In addition to the rising volumes of real estate TDRs, the number of institutions has decreased significantly as the financial services industry continues to consolidate. The FDIC reported a large number of bank failures during the *financial crisis* period, and failures continue to be reported. There already have been 14 bank closures in 2014.

Creditors need to carefully monitor the status of the

Table 1: Commercial Real Estate TDRs
(in billions)

	2013	2012	2011
In compliance with new terms	$11.76	$13.47	$13.84
Past due 30–89 days	0.42	0.63	0.59
Past due 90 days or more	0.17	0.24	0.19
No longer accruing Interest	6.27	8.19	9.50
Total Commercial Real Estate TDRs	**$18.62**	**$22.53**	**$24.13**

Figure 2: Residential Real Estate TDR Deliquency Status



Source: www2.fdic.gov/sdi/main.asp

new loan terms and continue to communicate with customers when payment difficulties persist, especially because they want to maximize their investment recovery. Figure 2 shows the delinquency status of the residential real estate TDRs as of December 31, 2013. As you can see, approximately 40% of the restructured loans are either 90 days or more past due or are no longer accruing interest, a leading indicator that borrowers are continuing to struggle to make timely loan payments under the modified loan terms. Banks generally stop accruing interest on loans when they significantly doubt they will collect the full loan investment. Loans no longer accruing interest are the most concerning and may require even higher levels of loan loss reserves going forward, which will result in lower levels of earnings and capital for the banks.

Although most reported TDR loans originate with individuals, the FDIC is also reporting significant troubled debt restructured loans for commercial real estate borrowers (see Table 1).

Financial managers can be encouraged that bank regulators are supporting banks that work with borrowers to restructure their loans. In the Summer 2012 issue of the FDIC's *Supervisory Insights*, the article "Accounting News: Troubled Debt Restructuring" states, "Regulators support institutions proactively working with borrowers…to restructure loans….Financial institutions and borrowers may find it mutually beneficial to work together to improve the borrower's repayment prospects." The key factor here could be in timely communication with their bankers regarding any difficulties in meeting current loan obligations. Bank loan officers are more likely to work with borrowers if these issues are discussed promptly and candidly because it can build mutual trust and strengthen banking relationships.

The FASB Steps In

Because of the increased volume of delinquencies and the concern regarding TDR reporting requirements, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, to help clarify what factors trigger TDR classification. The appropriate FASB Codification Subtopic 310-40, *Troubled Debt Restructurings by Creditors*, has been updated to reflect the ASU 2011-02 changes. Although the effective date of the ASU was for annual periods after June 15, 2011, for public entities and after December 15, 2012, for nonpublic entities, creditors are expected to experience these issues well into the future as the economy recovers. Government agencies such as the FDIC, the Federal Financial Institutions Examination Council (FFIEC), the Federal Reserve, and the Office of the Comptroller of the Currency (OCC), which governs bank financial reporting, are continuing to provide financial reporting guidance regarding TDRs that incorporates the FASB clarifications.

What Triggered ASU 2011-02?

More clarity was needed to define what specific factors triggered a troubled debt restructuring classification because of the conflicting views on how creditors defined a TDR. During deliberations with the FASB and as outlined in ASU 2011-02, several stakeholders raised concerns about whether additional guidance or clarification was needed to help determine whether a creditor has granted a concession for purposes of classifying a restructuring as a TDR. Several respondents stated that there is diversity in practice and inconsistency in applying the existing guidance. These clarifications are designed to improve consistency and comparability among financial institutions. The primary outcomes of these deliberations were that the following sections were added to the FASB codification relating to troubled debt restructuring:

- Creditors aren't allowed to use interest rate changes alone to determine TDR status.
- A creditor must determine whether it has granted a concession.
- A creditor must determine whether a debtor is experiencing financial difficulties.

ASU 2014-04

The FASB also issued ASU 2014-04—*Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, which provides clarity on how to determine when a creditor is considered to have received physical possession of residential real estate property as collateral in a consumer mortgage loan. These conditions are satisfied when either (1) the creditor obtains legal title to the property upon completion of foreclosure or (2) the borrower conveys all interest in the real estate property to the creditor to satisfy that loan (through a deed in lieu of foreclosure or a similar legal agreement). This update establishes when assets have been received through physical possession to satisfy a loan obligation. Once this happens, creditors must follow the guidance in FASB Codification Subtopic 310-40-40, paragraphs 2 through 5, *Receivables—Troubled Debt Restructuring by Creditors—Derecognition*, which requires recording the new assets at fair value, removing the loan, and recognizing any loss in net income during the period.

Summary of Changes to the FASB Accounting Standards Codification

Subtopic 310-40-15, *Troubled Debt Restructurings by Creditors—Scope and Scope Exceptions*, is updated as follows:

A new paragraph was added as Subtopic 310-40-15-8A, which states that a creditor shall not apply the guidance that debtors use to evaluate a TDR per Subtopic 470-60-55-10. When debtors evaluate whether a restructuring is a TDR, they are permitted to compare the effective interest rate before and after the restructuring to determine if a concession was made. **This practice is prohibited for creditors**, primarily because creditors must consider all terms of the restructuring, not solely the effective interest rate change.

Determining whether a creditor has granted a concession was added and provides guidance to determine if a concession was made per Subtopic 310-40-15, paragraphs 13-16. A creditor should consider the following, in whole or in part, when evaluating whether it gave the debtor a concession.

1. Does the creditor expect to collect *all* amounts due per the original agreement? Any collateral value also must be considered if collection is dependent on collateral.

2. Did the creditor restructure debt in exchange for additional collateral or guarantees? Do the new collateral or guarantees serve as adequate compensation?

3. Does the debtor have access to funds at a market rate for debt with similar risk? If not, the restructuring is considered below market rate.

4. Was a temporary or permanent increase in the contractual interest rate made during restructuring? This doesn't by itself exclude the restructuring from being considered a concession because the interest rate could still be below market interest rates for debt with similar risk.

One of the primary clarifications of the new guidance is that no single factor will automatically classify TDR status. Thus it's critical for creditors to review all relevant facts and circumstances regarding the restructuring to determine if a concession has been made to the borrower. There are several different forms of concessions that can be negotiated between the parties as creditors attempt to find optimal modified loan terms for their debtors while simultaneously protecting as much of their investment as possible. Some of the more common forms are transfer of receivables or other assets, reduction of the stated interest rate, extension of maturity date at a lower interest rate, reduction of the face amount or maturity amount, and reduction of accrued interest.

Determining whether a debtor is experiencing financial difficulties was added as an additional paragraph in Subtopic 310-40-15-20. The creditor shall consider the following six criteria to determine whether the debtor is experiencing financial difficulties. Other factors also may be considered based on creditor judgment.

1. The debtor is currently in default on any of its debt *or* is anticipated to be so in the foreseeable future. The debtor doesn't have to be in default at present to meet the standard.

2. The debtor has declared or is in the process of declaring bankruptcy.

3. There is substantial doubt the debtor will continue as a going concern.

4. The debtor has publicly issued securities that actually are delisted, are in the process of being delisted, or are under threat to be delisted from an exchange.

5. Based on creditor projections, cash flows will be insufficient to service *any* of the debtor's debt.

6. Without modifying the debt, the debtor can't access funds from sources other than the creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

Determining a TDR Classification

A TDR classification ultimately comes down to answering the following questions that are outlined in the FASB Codification discussed previously:

1. Did the creditor grant the debtor a concession it otherwise wouldn't consider?

2. Is the debtor facing financial difficulty?

If both 1 and 2 are yes, a TDR is reported. If either is no, then the restructured debt isn't a TDR.

What Isn't a TDR

The FASB guidance isn't applicable to all borrowing arrangements. Per Subtopic 310-40-15, paragraphs 11-12, the following items aren't included in the scope of the TDR guidance: lease agreements, employment-related agreements, trade credit, loan pool cash flow changes, and when creditors refinance interest rates when borrowers want a lower market rate of interest during a declining interest rate economic cycle.

Loan Impairment

After a creditor has determined it is carrying a TDR on its books, loan impairment must be measured by applying the FASB guidance, which requires banks to record the impairment amount as a charge to earnings through the loan loss provision with an offsetting credit to the allowance for loan loss, lowering net loans, earnings, and capital levels.

Regardless of the measurement method used, any loan impairment must be reflected in earnings as of the restructuring date. This creates concern for stakeholders who have a vested interest in bank earnings and capitalization levels—including investors, customers, and third parties who rely on a strong banking system to supply credit, provide economic stability, and perform other ancillary services.

Although ASU 2011-02 didn't modify the loan impairment subtopic, here are some examples of different acceptable methods of measuring loan impairment that illustrate the potential impact to bank financial statements.

There are three basic acceptable methods to measure loan impairment:

1. The fair value of assets received in satisfaction of a loan.

This method is to be used exclusively when creditors accept assets (or collateral) to satisfy a borrower's loan obligation. These assets can take several forms (third-party receivables, real estate assets, or equity instruments). Any difference between the fair value (less costs to sell) of assets received and the loan carrying balance (net of any loan allowances) equals a loss that must be recognized in net income during the period per FASB Codification Subtopic 310-40-40, paragraphs 2 through 5, *Receivables—Troubled Debt Restructuring by Creditors—Derecognition*. The assets received will be initially recorded at their fair value (less costs to sell).

2. A loan observable market price, if available.

This method is also acceptable to use to measure loan impairment if a fair market price of the loan can be determined. It's important to refrain from using distressed sale prices because they would violate the *fair value* principle within the FASB Codification.

3. The present value of future cash flows.

This method requires discounting all future cash flows at the loan's *original effective interest rate* and generally is used when no assets or collateral were exchanged or when a market price isn't available.

Table 2: Loan Amortization and Payment Summary

ORIGINAL LOAN
Annual Payments: $745,147
Interest Rate: 8%

TDR LOAN
Annual Payments: $622,687
Interest Rate: 3%

	ORIGINAL LOAN			TDR LOAN		
DATE	PRINCIPAL	INTEREST 8%	LOAN BALANCE	PRINCIPAL	INTEREST 8%	LOAN BALANCE
Beg of Yr 1	—	—	$5,000,000			
End of Yr 1	$345,147	$400,000	4,654,853			
End of Yr 2	372,759	372,388	4,282,093			
End of Yr 3	402,580	342,567	3,879,513	—	—	$3,879,513
End of Yr 4	434,786	310,361	3,444,727	$506,301	$116,385	3,373,212
End of Yr 5	469,569	275,578	2,975,158	521,490	101,196	2,851,722
End of Yr 6	507,135	238,013	2,468,023	537,135	85,552	2,314,587
End of Yr 7	547,706	197,442	1,920,317	553,249	69,438	1,761,338
End of Yr 8	591,522	153,625	1,328,795	569,846	52,840	1,191,492
End of Yr 9	638,844	106,304	689,951	586,942	35,745	604,550
End of Yr 10	689,951	55,196	—	604,550	18,137	0

LOAN PAYMENT SUMMARY

	PRINCIPAL	INTEREST	TOTAL
Original Payments (first three years)	$1,120,487	$1,114,956	$2,235,442
Remaining Payments (last seven years)	3,879,513	479,292	4,358,806
Total Payments Full Term	5,000,000	1,594,248	6,594,248
Original Loan Agreement	5,000,000	2,451,474	7,451,474
Concession Given to Debtor	—	$857,226	$857,226

Methods 2 and 3 apply *only* when assets aren't received during loan restructuring negotiations and are appropriate when new loan terms are changed (change in principal, interest due, or maturity date, and the like). The general guidance is found in FASB Codification Subtopic 310-10-35, *Receivables—Subsequent Measurement*. Specific guidance is provided in paragraphs 20 through 30 (*Measurement of Impairment*).

Application of the Present Value Method

The present value method is more complex than the other methods discussed, so let's take a look at an example that illustrates the application of this method where **only the interest rate was changed. Loan impairment can be recognized if the only modification is a lower interest rate if the creditor has determined that the debtor is facing financial difficulties and the creditor wouldn't otherwise consider lowering the interest rate—i.e., granting a concession.**

Table 2 contains the amortization table of both the original loan and the TDR loan after the modification, in addition to a loan payment summary. The original terms were $5 million at 8% for 10 years. After three years, however, the interest rate was lowered to 3% to help the borrower improve its cash flow to service its debt obligations. The assumption here is that this loan meets the requirements for TDR classification.

Although the full $5 million in principal has been returned, a concession was given to the debtor in the form of interest. Therefore, impairment must be recog-

Table 3: Loan Impairment

Annual Loan Payments Over Remaining Seven Years	$622,687
Present Value of Annuity Factor for Seven Years at 8%	5.206
Present Value of Future Loan Payments	3,241,706
Net Loan Balance at Restructuring Date (after any allowances)	3,879,513
Loan Impairment	$(637,807)

nized against earnings after discounting the future cash flow payments using a discount factor of 8%—**the original interest rate of the loan**. The loan impairment is calculated in Table 3.

Arguably, the current loan impairment measurement provision is the most worrisome component of TDR accounting principles. I would recommend that stakeholders continually monitor the financial strength of their individual financial institutions **as part of their service provider risk management policy**. I would also suggest establishing relationships with a few different banks to diversify risks and perform an analysis of pricing, services, and financial statement review. Businesses can be affected if banks have highly concentrated TDR levels. Because banks must maintain minimum regulatory capital-to-asset ratios, lower levels of earnings and capital could tighten available credit. A bank's liquidity position can also be impaired if the bank is experiencing significantly high loan delinquency ratios, which could raise the concerns of depositors (both individuals and businesses) who rely on a strong banking system to provide liquidity to their deposited funds. The FDIC currently insures up to $250,000 in deposit insurance coverage, so businesses with large deposits should be aware of the financial strength of their banking relationships. Regular monitoring, and diversifying balances with different banks, can help mitigate these risks. Finally, financial managers should keep their bankers informed if they are facing financial difficulties in meeting their debt obligations. Prompt communication may help businesses realize more favorable loan terms as the banks continue to work with borrowers during economic recovery.

Where to Find Bank Financial Statements

All bank financial statements (call reports) are publicly available on the FFIEC website for anyone who wants to monitor the level of TDRs or general bank performance. Please visit www.ffiec.gov, follow the link on the right under CDR Information Site: Public Information, and then type in the institution name. TDRs are reported in the RC-C (Loans) schedule in the memorandum section. There is also a great report query tool available at www2.fdic.gov/sdi/main.asp where you can select individual institutions, create peer groups (or industry consolidated data), select only the data you need, and compare to prior periods.

Future Developments

We management accountants and financial managers will need to stay tuned to see what the government and the FASB do next to address the financial market concerns in this ever-changing industry! There are significant regulatory and accounting changes in process to address the recent financial collapse and strengthen the banking system. One of the major changes is an FASB-proposed Accounting Standards Update, *Financial Instruments—Credit Losses* (Subtopic 825-15) dated December 2012, which could significantly affect how banks measure their credit loss allowance. To date, no final standards have been issued, and it's unclear what dates any standards will be effective. Basel III is a second major banking-related legislation that was issued jointly by the OCC, FDIC, and the Federal Reserve that will require higher capital standards for all banks. This legislation also includes limitations on capital distributions and discretionary payments to executive officers if minimum capital levels are below defined thresholds. These new capital standards will be phased in over a period of years beginning in 2014 for larger institutions and 2015 for smaller banks. The rules are expected to be completely phased in by 2019. **SF**

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