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Accounting News: Troubled Debt Restructurings

Shannon M. Beattie

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This regular feature focuses on topics of critical importance to bank accounting. Comments on this column and suggestions for future columns can be e-mailed to SupervisoryJournal@fdic.gov.

Over the last several years, many parts of the United States experienced declining real estate values and high rates of unemployment. This economic environment has rendered some borrowers unable to repay their debt according to the original terms of their loans. Interagency guidance encourages bankers to work with borrowers who may be facing financial difficulties.[1] Prudent loan modifications are often in the best interest of financial institutions and borrowers, and in fact many financial institutions are restructuring or modifying loan terms to provide payment relief for borrowers whose financial condition has deteriorated. These loan modifications may meet the definition of a troubled debt restructuring (TDR) found in the accounting standards.

FDIC examiners and supervisors frequently receive questions from bankers about TDRs. Often the answers to these questions can be found in the framework for TDRs established by the accounting standards, a framework which governs the identification of TDRs, the impairment analysis that banks must perform, and the required disclosures. Other important guidance is found in the banking agencies' published instructions for the Consolidated Reports of Condition and Income (Call Report) and selected policy statements of the federal banking agencies. This article summarizes and distills the aspects of these standards and guidance that are most relevant to identifying and accounting for TDRs and complying with the associated regulatory reporting requirements.[2]

Accounting Guidance

A modification of the terms of a loan is a TDR when a borrower is troubled (i.e., experiencing financial difficulties) and a financial institution grants a concession to the borrower that it would not otherwise consider. The following discussion will focus on the generally accepted accounting principles (GAAP) that provide relevant guidance for the financial reporting of TDRs. The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 310 provides the basis for identifying TDRs and treating TDRs as impaired loans when estimating allocations to the allowance for loan and lease losses (ALLL).[3] In this regard, ASC

[1] FIL-35-2007, *Statement on Working with Mortgage Borrowers*, April 17, 2007, www.fdic.gov/news/news/financial/2007/fil07035.html; FIL-128-2008, *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, November 12, 2008, www.fdic.gov/news/news/financial/2008/fil08128.html; FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, www.fdic.gov/news/news/financial/2009/fil09061.html; and FIL-5-2010, *Interagency Statement on Meeting the Credit Needs of Creditworthy Small Business Borrowers*, February 12, 2010, www.fdic.gov/news/news/financial/2010/fil10005.html.

[2] Additional guidance on accounting for TDRs is included in the transcript from the FDIC's Seminar on Commercial Real Estate Loan Workouts and Related Accounting Issues, December 15, 2011, www.fdic.gov/news/conferences/2011-12-15-transcript.html.

[3] ASC Subtopic 310-40, Receivables – Troubled Debt Restructurings by Creditors (formerly Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*), and ASC Subtopic 310-10, Receivables – Overall (formerly Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*), respectively.

Subtopic 310-40 addresses receivables that are TDRs from the lending institution's standpoint. Other GAAP guidance addresses the accounting for TDRs from the borrower's standpoint, a discussion of which is beyond the scope of this article.[4] Finally, this article incorporates the new guidance in the FASB's Accounting Standards Update No. 2011-02 (ASU 2011-02) that, among other clarifications of TDR issues, discusses whether a delay in payment as part of a loan modification is insignificant.[5] These resources along with complementary regulatory guidance provide the foundation for discussing TDRs.

Identification of a TDR

A TDR involves a troubled borrower and a concession by the creditor. ASU 2011-02 identifies several indicators a creditor must consider in determining whether a borrower is experiencing financial difficulties. These indicators include, for example, whether the borrower is currently in payment default on any of its debt and whether it is probable the borrower would be in payment default on any debts in the foreseeable future without the modification. Thus, a borrower does not have to be in payment default at the time of the modification to be experiencing financial difficulties. Types of loan modifications that may be concessions that result in a TDR include, but are not limited to:

- A reduction of the stated interest rate for the remaining original life of the debt,
- An extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk,
- A reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement, or
- A reduction of accrued interest.

The lending institution's concession to a troubled borrower may include a restructuring of the loan terms to alleviate the burden of the borrower's near-term cash requirements, such as a modification of terms to reduce or defer cash payments to help the borrower attempt to improve its financial condition. An institution may restructure a loan to a borrower experiencing financial difficulties at a contractual interest rate below a current market interest rate, which normally is considered to be a concession resulting in a TDR. However, a change in the interest rate on a loan does not necessarily mean that the modification is a TDR. For example, an institution may lower the interest rate to maintain a relationship with a borrower that can readily obtain funds from other sources. In this scenario, extending or renewing the borrower's loan at the current market interest rate for new debt with similar risk is not a TDR. To be designated a TDR, both borrower financial difficulties and a lender concession must be present at the time of restructuring.

Determining whether a modification is at a current market rate of interest at the time of the restructuring can be challenging. The following scenarios

[4] ASC Subtopic 470-60, Debt – Troubled Debt Restructurings by Debtors (formerly Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*).

[5] Accounting Standards Update No. 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring.*

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regarding interest rates on modified loans are often encountered:

- *Rate for a troubled versus nontroubled borrower* – The stated interest rate charged to a troubled borrower in a loan restructuring may be greater than or equal to interest rates available in the marketplace for similar types of new loans to nontroubled borrowers at the time of the restructuring. Some institutions have concluded these restructurings are not TDRs, which may not be the case. These institutions may not have considered all the facts and circumstances – other than the interest rate – associated with the loan modification. An interest rate on a modified loan greater than or equal to those available in the marketplace for similar new loans to nontroubled borrowers does not preclude a modification from being designated as a TDR when the borrower is troubled.
- *Market rate for a troubled borrower* – Generally, the contractual interest rate on a modified loan is a current market interest rate if the restructuring agreement specifies an interest rate greater than or equal to the rate the institution was willing to accept at the time of the restructuring for a new loan with comparable risk, i.e., comparable to the risk on the modified loan. The contractual interest rate on a modified loan is not a market interest rate simply because the interest rate charged under the restructuring agreement has not been reduced.
- *Below-market rate* – According to ASU 2011-02, if a borrower does not have access to funds at a market interest rate for debt with similar risk characteristics as the restructured debt, the rate on the modified loan is considered a below-market rate and may indicate the institution has granted a concession to the borrower.
- *Increased rate* – When a modification results in either a temporary or permanent increase in the contractual interest rate, the increased interest rate does not preclude the modification from being considered a concession. As noted in ASU 2011-02, the new contractual rate on the modified loan could still be a below market interest rate for new debt with similar risk characteristics.

When evaluating a loan modification to a borrower experiencing financial difficulties, all relevant facts and circumstances must be considered in determining whether the institution has made a concession to the troubled borrower with respect to the market interest rate or has made some other type of concession that could trigger TDR accounting and disclosure. This determination requires the use of judgment and should include an analysis of credit history and scores, loan-to-value ratios or other collateral protection, the borrower's ability to generate cash flow sufficient to meet the repayment terms, and other factors normally considered when underwriting and pricing loans. If the terms or conditions related to a restructured loan to a borrower experiencing financial difficulties are outside the institution's policies or common market practices, then the restructuring may be a TDR. Financial institutions must exercise judgment and carefully document their conclusions about market interest rates and other terms and conditions under restructuring agreements and whether the restructurings are TDRs.

A modification of a loan to a borrower experiencing financial difficulties involving only a delay in payment also needs to be evaluated for TDR status. According to ASU 2011-02, lenders must consider many factors, including, but not limited to the following:

- the amount of the delayed payments in relation to the loan's unpaid principal or collateral value,
- the frequency of payments due on the loan,
- the original contractual maturity of the loan, and
- the original expected duration of the loan.

If an institution determines that a restructuring results in only a delay in payment that is insignificant, then the institution has not granted a concession to the borrower. This determination may lead to the conclusion that a particular modification to a troubled borrower is not a TDR.

Impairment

All held-for-investment loans whose terms have been modified in a TDR are impaired loans that must be measured for impairment under ASC Subtopic 310-10. This guidance applies even if the loan that has undergone a TDR is not otherwise individually evaluated for impairment under ASC Subtopic 310-10, as in the case of residential mortgages and other smaller-balance homogeneous loans that are collectively evaluated for impairment. ASC Subtopic 310-10 specifies that an institution should measure impairment (and, hence, the amount of any allocation to the ALLL for an impaired loan) based on:

- the present value of expected future cash flows discounted at the loan's effective interest rate,
- the loan's observable market price, or
- the fair value of the collateral if the loan is collateral dependent.

The fair value of collateral and present value of expected future cash flows methods warrant further discussion. When an impaired loan is collateral dependent, the banking agencies' regulatory reporting guidance requires that the fair value of collateral method be used to measure impairment.[6] In contrast, the fair value of collateral method may not be used when an impaired loan is not collateral dependent, even if the loan is collateralized. An impaired loan, including a TDR, is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. According to ASC Subtopic 310-10, if an institution uses the fair value of the collateral to measure impairment of an impaired collateral dependent loan, and repayment or satisfaction of the loan is dependent only on the operation, rather than the sale, of the collateral, estimated costs to sell should not be incorporated into the impairment measurement. In contrast, an institution should adjust the fair value of the collateral to consider estimated costs to sell when measuring the impairment of an impaired collateral dependent loan if repayment or satisfaction of the loan is dependent on the sale of the collateral. According to the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses*, any portion of the recorded investment in an impaired collateral dependent loan in excess of the fair value of the collateral (less estimated costs to sell, if appropriate) that can be identified as uncollectible (i.e., a confirmed loss) should be promptly charged off against

[6] GAAP permits impairment on an impaired collateral dependent loan to be measured based on the fair value of the collateral, but requires the use of this impairment measurement method only when foreclosure is probable.

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Fair Value of Collateral Method
Questions and Answers

Q) Is the definition of collateral dependent for regulatory reporting purposes the same as under GAAP, which includes loans for which the cash flow from the operation of the collateral is the only source of repayment? Or is a loan collateral dependent only when repayment is dependent on the sale of the collateral?

A) Collateral dependent is defined in ASC Subtopic 310-10, which is the same definition used in the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses:* A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral.[7] The instructions for the Call Report elaborate on this definition, noting that it applies to situations where there are no other available and reliable sources of repayment other than the underlying collateral. Thus, the definition of collateral dependent includes cases where repayment of the loan is dependent on the sale of the collateral as well as cases where repayment is dependent only on the operation of the collateral.

Q) Impairment measurement on an impaired collateral dependent loan for which repayment is dependent only on the operation of the collateral should not reflect costs to sell. What is the reference for this guidance?

A) FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*, was the original source. This guidance is now in ASC paragraph 310-10-35-23, which states "if repayment or satisfaction of the loan is dependent only on the operation, rather than the sale, of the collateral, the measure of impairment shall not incorporate estimated costs to sell the collateral."

Q) When is an allocation to the ALLL appropriate for a collateral dependent TDR and when is a charge-off needed?

A) The December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* and the Glossary section of the Call Report instructions provide guidance on measuring impairment relevant to TDRs. Each institution must maintain an ALLL at a level appropriate to cover estimated credit losses associated with the loan and lease portfolio in accordance with GAAP.[8] Additions to, or reductions of, the ALLL are to be made through charges or credits to the "provision for loan and lease losses" in the Call Report income statement.[9] When available information confirms that specific loans or portions thereof are uncollectible, including loans that are TDRs, these amounts should be promptly charged off against the ALLL.[10]

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[7] FIL-105-2006, *Allowance for Loan and Lease Losses Revised Policy Statement and Frequently Asked Questions*, December 13, 2006, www.fdic.gov/news/news/financial/2006/fil06105.html.

[8] Ibid.

[9] *Instructions for the Preparation of Consolidated Reports of Condition and Income*, Glossary, "Allowance for Loan and Lease Losses," page A-3 (9-10), http://www.fdic.gov/regulations/resources/call/crinst/2012-03/312Gloss_033112.pdf.

[10] Furthermore, the *Uniform Retail Credit Classification and Account Management Policy* calls for charge-offs of retail loans, including TDRs, in certain circumstances. See FIL-40-2000, June 29, 2000, www.fdic.gov/news/news/financial/2000/fil0040.html.

For an individually evaluated impaired collateral dependent loan, including a TDR, the banking agencies require that impairment be measured using the fair value of collateral method in ASC Subtopic 310-10. In this situation, as discussed in the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, if the recorded amount of the loan exceeds the fair value of the collateral (less costs to sell if repayment of the loan is dependent on the sale of the collateral), this excess represents the measurement of impairment on the loan and is the amount to be included for this loan in the overall ALLL. However, determining the portion of this difference that represents a confirmed loss, if any, which should be charged against the ALLL in a timely manner, is based on whether repayment is dependent on the sale or only on the operation of the collateral.[11]

Q) Are institutions required to evaluate impairment using the present value of expected future cash flows method when an impaired loan, including a TDR, is not collateral dependent? Can an institution use the fair value of collateral method to measure impairment on an impaired non-collateral dependent loan?

A) A TDR is not collateral dependent when there are available and reliable sources of repayment other than the sale or operation of the collateral. ASC Subtopic 310-10 acknowledges that a loan's observable market price may be used as a practical expedient to measure impairment. However, such a price is not usually available for individual impaired loans, including TDRs. Therefore, the present value of expected future cash flows method normally would be used when a TDR is not collateral dependent.

The fair value of collateral method may only be used when an impaired loan, including a TDR, is collateral dependent. It would be inappropriate under GAAP to measure impairment using the fair value of collateral method when an impaired loan or TDR is not collateral dependent.

the ALLL.[12] Institutions must apply the fair value of collateral method appropriately to TDRs.

With regard to the present value of cash flows method, an institution's estimate of the expected future cash flows on a TDR should be its best estimate based on reasonable and supportable assumptions (including default and prepayment assumptions) and projections. GAAP also specifies the effective interest rate to be used for discounting. Under ASC Subtopic 310-10, when measuring impairment on a TDR using the present value of expected future cash flows method, the cash flows should be discounted at the effective interest rate of the original loan, not the rate after the restructuring. For a restructured residential mortgage loan that originally had a "teaser" or starter rate less than the loan's fully indexed rate, the starter rate is not the original effective interest rate. In this case, the effective interest rate should be a blend of the "teaser" rate and the fully indexed rate. If the results are not materially different from using the blended rate, the fully indexed rate may be used as the effective interest rate. Using the proper effective interest rate is critical to allocating the appropriate amount to the ALLL when measuring impairment on a TDR under the present value method.

[11] FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, www.fdic.gov/news/news/financial/2009/fil09061.html.

[12] FIL-105-2006, *Allowance for Loan and Lease Losses Revised Policy Statement and Frequently Asked Questions*, December 13, 2006, www.fdic.gov/news/news/financial/2006/fil06105.html.

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Applying the Appropriate Impairment Measurement Method

Example 1: Discounted Cash Flow Method

FACTS: A banker makes a commercial loan to a small wholesale business, which has a market interest rate at origination. The loan matures in five years and is secured by a first lien on the business's warehouse.

- After 24 months, the local economy has weakened, adversely affecting the borrower's wholesale business. The borrower has fallen delinquent on several loans including this commercial loan, which is 90 days past due. After carefully analyzing the borrower's personal and business financial statements and credit reports, the banker determines that it is likely the borrower's business will be able to generate only enough cash flow to partially service this commercial loan. The borrower plans to operate the business for five more years and expects economic conditions to improve by the end of this period, enabling the borrower to sell the business at that time, including remaining inventory and the warehouse.
- The banker decides to restructure the remaining principal balance of this commercial loan to mature in five years. Based on the borrower's expected cash flows from the business, the banker lowers the contractual interest rate to a below market rate (i.e., to an interest rate that is less than the rate the banker would charge at the time of the restructuring for a new loan with comparable risk). The required monthly payments are reduced, with these payments expected to come from business operations. A balloon payment is scheduled at the end of five years.
- Based on reasonable and supportable assumptions and projections, which take default probability into account, the banker develops an estimate of the expected monthly cash flows over the five year loan term. The banker also concludes that the current "as is" appraised value of the warehouse is not likely to increase over this period. Considering the borrower's current inventory levels and other information, the banker estimates that the sale of the borrower's warehouse and other available business assets at the end of five years would generate additional funds to satisfy the debt.
- Considering all available evidence, including the borrower's current financial difficulties, the banker's best estimate is that 90 percent of the contractual loan payments under the modified terms will be collected.

IMPAIRMENT MEASUREMENT METHOD: This restructured commercial loan is a TDR subject to impairment measurement in accordance with ASC Subtopic 310-10. Because the available and reliable sources of repayment include cash flow from the borrower's business operations, this commercial loan is not collateral dependent. The banker will use the discounted cash flow method to determine the impairment amount.[13]

[13] The commercial loan does not have an observable market price.

Example 2: Fair Value of Collateral Method

FACTS: A banker makes a commercial real estate loan, the collateral for which is an apartment building. The collateral at origination has normal occupancy and rental rates and its value provides sufficient collateral coverage.

- The borrower subsequently experiences financial difficulties. The banker obtains a current appraisal, which shows that the prospective "as stabilized" and the "as is" market values have declined in comparison to market values in the original appraisal as a result of a significantly increased vacancy rate and a decline in rental rates. The banker has reviewed the current appraisal and found the assumptions and conclusions to be reasonable.
- The banker also concludes that the current "as is" market value conclusion is an appropriate estimate of the fair value of the collateral for financial reporting purposes.
- Available evidence indicates that the local economy is beginning to improve. Thus, the banker reasonably expects that the property will reach the current appraisal's prospective "as stabilized" value within two years.
- The borrower has no other assets and his ability to service the debt from other sources is nonexistent.
- After a thorough analysis of the borrower's financial condition and the operating statements for the apartment building, the banker concludes that the loan can be repaid only through the operation of the collateral. Liquidation of the collateral is not anticipated.
- The banker determines that a prudent loan workout would be in the best interest of the bank and the borrower. In order to recover as much of the loan as reasonably possible, the banker negotiates reduced monthly payments that the cash flow from the apartment building is expected to be sufficient to service at an interest rate below a current market interest rate for a new loan with comparable risk.

IMPAIRMENT MEASUREMENT METHOD: This restructured commercial real estate loan is a TDR subject to impairment measurement in accordance with ASC Subtopic 310-10. This commercial real estate loan is collateral dependent. The banker must use the fair value of collateral method to determine the impairment amount. Only the operation of the collateral is expected to repay this loan; therefore, the measurement of impairment shall not incorporate estimated costs to sell the collateral.

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Example 3: Fair Value of Collateral Method

FACTS: Same as Example 2 except that a thorough analysis of the borrower's financial condition, the operating statements for the apartment building, and the borrower's inability to increase rental rates, leads the banker to conclude that the apartment building provides insufficient collateral coverage. Local economic conditions are not expected to improve in the near term and the banker is not confident that the current appraisal's "as stabilized" market value can be achieved within a reasonable time period.

- As a consequence, the banker determines that repayment of the loan is dependent on the liquidation of the collateral by the borrower or by the bank through foreclosure. As an interim measure to recognize the apartment building's reduced cash flow until collateral liquidation, the banker modifies the loan terms to lower the monthly payments at an interest rate below a current market interest rate for a new loan with comparable risk.
- Under either scenario, the banker has determined that the well supported current appraisal's "as is" market value conclusion is an appropriate estimate of the fair value of the collateral.
- Costs to sell the property are estimated.

IMPAIRMENT MEASUREMENT METHOD: This restructured commercial real estate loan is a TDR subject to impairment measurement in accordance with ASC Subtopic 310-10. This commercial real estate loan is collateral dependent. The banker must use the fair value of collateral method to determine the impairment amount. Liquidation of the collateral is expected to repay this loan; therefore, the measurement of impairment must incorporate estimated costs to sell the collateral.

The appropriate impairment measurement method, determined as discussed above, is applied to TDRs and other impaired loans on a loan-by-loan basis. However, ASC Subtopic 310-10 permits an institution to aggregate impaired loans that share risk characteristics in common with other impaired loans. For example, modified residential mortgage loans that represent TDRs and have common risk characteristics may be aggregated for impairment measurement purposes. In this scenario, an institution uses historical statistics along with a composite effective interest rate to measure impairment of this pool of impaired loans. Institutions may aggregate TDRs to measure impairment in accordance with GAAP and regulatory guidance.

Accrual Status

The Glossary section of the Call Report instructions provides guidance for nonaccrual status, which is consistent with GAAP and applies to loans that have undergone TDRs. The general rule is that institutions shall not accrue interest on any loan:

- which is maintained on a cash basis because of deterioration in the financial condition of the borrower,
- for which payment in full of principal or interest is not expected, or
- upon which principal or interest has been in default for a period of 90 days or more unless the loan is both "well secured" and "in the process of collection."[14]

Assuming the accrual of interest has not already been discontinued on a loan undergoing a TDR, this Call Report general rule should be considered when evaluating whether the loan should be placed in nonaccrual status.

However, the general rule need not be applied to consumer loans and loans secured by one-to-four family residential properties on which principal or interest is due and unpaid for at least 90 days. If not placed in nonaccrual status, these loans should be subject to alternative methods of evaluation to assure the institution's net income is not materially overstated. When such consumer and residential loans are treated as nonaccrual by the institution, these loans must be reported as nonaccrual in the Call Report. The exception from the general rule for nonaccrual status and related guidance also apply to consumer and residential loans that are TDRs.

- A loan is "well secured" if it is secured by collateral in the form of liens on or pledges of real or personal property, including securities, with a realizable value sufficient to discharge the debt (including accrued interest) in full, or by the guarantee of a financially responsible party.
- A loan is "in the process of collection" if collection of the loan is proceeding in due course through either legal action or other collection efforts which are reasonably expected to result in repayment of the loan or in its restoration to a current status in the near future.[15]

[14] *Instructions for the Preparation of Consolidated Reports of Condition and Income*, Glossary, "Nonaccrual Status," page A-59 (9-10), http://www.fdic.gov/regulations/resources/call/crinst/2012-03/312Gloss_033112.pdf.

[15] Ibid.

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A nonaccrual loan may be restored to accrual status:

- when none of its principal and interest is due and unpaid, and the institution expects repayment of the remaining contractual principal and interest, or
- when it becomes "well secured" and "in the process of collection" as previously defined.

With regard to satisfying the first parameter, the institution must have received repayment of the past-due principal and interest unless the loan has been formally restructured in a TDR and qualifies for accrual status. Thus, a nonaccrual loan that has been formally restructured and is reasonably assured of repayment (of principal and interest) and performance according to the modified terms may be returned to accrual status even though amounts past due under the original contractual terms have not been repaid. In this scenario, the restructuring and any charge-off taken on the loan must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. Otherwise, the restructured loan must remain in nonaccrual status. The credit evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period before the date the loan is returned to accrual status. A sustained period of repayment performance is generally a minimum of six months and involves payments of cash or cash equivalents. In returning a nonaccrual TDR to accrual status, sustained historical repayment performance for a reasonable time before the restructuring may be considered. Such a restructuring must improve the collectability of the loan in accordance with a reasonable repayment schedule and does not relieve the institution from the responsibility to promptly charge off identified losses. Returning a nonaccrual TDR to accrual status must be carefully documented and supported.

The structure of a modified loan that is a TDR may influence whether the loan is reported in nonaccrual or accrual status. A formal restructuring may involve a multiple note structure in which a troubled loan is divided into two notes. In accordance with the October 2009 *Policy Statement on Prudent Commercial Real Estate Loan Workouts*[16] and the Call Report instructions, institutions may separate the portion of an outstanding troubled loan into a new legally enforceable note (i.e., the first note) that is reasonably assured of repayment (of principal and interest) and performance according to prudently modified terms. The second note represents the portion of the original loan that is unlikely to be collected and has been charged off at or before the restructuring. The first note may be placed in accrual status provided the conditions in the preceding paragraph are met and the restructuring has economic substance and qualifies as a TDR under GAAP.

In contrast, a loan that undergoes a TDR should remain or be placed in nonaccrual status if the modification does not include the splitting of the troubled loan into multiple notes, but the institution instead internally

[16] FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, October 30, 2009, www.fdic.gov/news/news/financial/2009/fil09061.html.

recognizes a partial charge-off for the identified loss on the loan before or at the time of its restructuring as a single note. A partial charge-off would indicate the institution does not expect full repayment of the amounts contractually due under the loan's original terms. After the restructuring, the remaining balance of the TDR may be returned to accrual status without having to first recover the charged-off amount if the conditions for returning a nonaccrual TDR to accrual status discussed above are met. The charged-off amount may not be reversed or re-booked when the loan is returned to accrual status.

If a loan appropriately in accrual status has its terms modified in a TDR, the loan may not meet the criteria for placement in nonaccrual status at the time of the restructuring. The TDR can remain in accrual status provided the borrower's sustained historical repayment performance for a reasonable time prior to the TDR (generally a minimum of six months) is consistent with the loan's modified terms and the loan is reasonably assured of repayment (of principal and interest) and of performance in accordance with its modified terms. This determination must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms.

Income on nonaccrual TDRs should be reported in accordance with the Call Report instructions and GAAP. For a nonaccrual TDR, some or all of the cash interest payments received may be recognized as interest income on a cash basis provided the remaining recorded investment in the loan (i.e., after charge-off of identified losses, if any) is deemed fully collectible. If a nonaccrual TDR that has been returned to accrual status subsequently meets the criteria for placement in nonaccrual status as a result of past-due payments based on its modified terms or for any other reason, the TDR must again be placed in nonaccrual status.

Regulatory Reporting

Properly applying the accounting and Call Report requirements for TDRs provides useful financial information about the quality of the loan portfolio and an institution's efforts to work with troubled borrowers. Two Call Report schedules specifically disclose information on TDRs by loan category:

- Schedule RC-C, Part I, "Loans and Leases," Memorandum item 1, if the TDR is in compliance with its modified terms, and
- Schedule RC-N, "Past Due and Nonaccrual Loans, Leases, and Other Assets," Memorandum item 1, if the TDR is not in compliance with its modified terms.

To be considered in compliance with its modified terms, a loan that is a TDR must be in accrual status and must be current or less than 30 days past due on its contractual principal and interest payments under the modified terms. A TDR that meets these conditions must be reported as a restructured loan in Schedule RC-C, Part I, Memorandum item 1. In the calendar year after the year in which

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the restructuring took place a TDR may be removed from being reported in this memorandum item if:

- the TDR is in compliance with its modified terms, and
- the restructuring agreement specifies an interest rate that at the time of the restructuring is greater than or equal to the rate that the bank was willing to accept for a new loan with comparable risk, i.e., a market interest rate.[17]

When a loan has been restructured in a TDR, it continues to be considered a TDR for purposes of measuring impairment until paid in full or otherwise settled, sold, or charged off, even if disclosure of the loan as a TDR is no longer required. The loan remains an impaired loan for accounting purposes because impairment is evaluated in relation to the contractual terms specified by the original loan agreement, not the restructured terms. Thus, the impairment measurement requirements for impaired loans in ASC Subtopic 310-10, discussed above, continue to be applicable for all TDRs, even if they are no longer subject to disclosure as TDRs.

Conclusion

Regulators support institutions proactively working with borrowers in the current economic environment to restructure loans with reasonable modified terms and expect these modifications to be properly reflected in Call Reports. Although borrowers may experience deterioration in their financial condition and other challenges, many continue to be creditworthy customers with the willingness and capacity to repay their debts. In such cases, financial institutions and borrowers may find it mutually beneficial to work together to improve the borrower's repayment prospects. Accurate Call Reports allow regulators and the public to monitor the extent and status of modifications that represent TDRs.

Shannon M. Beattie, CPA
Regional Accountant, New York Region
sbeattie@fdic.gov

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[17] *Instructions for the Preparation of Consolidated Reports of Condition and Income*, Schedule RC-C, Part I, "Loans and Leases," page RC-C-21 (3-11), www.fdic.gov/regulations/resources/call/crinst/2011-09/911RC-C1_093011.pdf.