



Troubled Debt Restructurings, FASB Rules and Related Guidance

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Why the New Guidance?

- Limited and dated GAAP guidance (mostly FASB 15)
- Regulatory guidance more robust than GAAP
- Credit crisis — higher volume of loan modifications and workouts
- Perceived diversity in practice and potential for “underreporting” of TDRs
- TDRs are impaired loans (so a different impairment model applies to the allowance for loan losses)
- Guidance requested by various constituents, including the bank regulators and SEC

FASB began a limited-scope project in July 2010 and issued final guidance in April 2011.

New FASB Guidance on TDRs

- ASU 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*
- New guidance addresses the two conditions for a TDR (when both are present, the modification is a TDR):
 - Borrower experiencing financial difficulty, and
 - Concession granted by lender
- Guidance did not change:
 - Basic accounting concepts for an identified TDR
 - Disclosures — including some new requirements

When is the New Guidance Effective?

Public Companies

- Interim and annual periods ending on or after June 15, 2011
 - Form 10-Q for the quarter ending September 30, 2011
- Apply guidance (TDR identification) to transactions on or after the beginning of the fiscal year of adoption
 - “Look-back” process to potentially identify additional TDRs
 - January 1, 2011 for a calendar year company

Non-Public Companies

- Annual periods ending on or after December 31, 2012, including interim periods within those annual periods
 - Same look-back process (January 1, 2012 for a calendar year company)

Lender Concessions

- Lender action “that it would not otherwise consider”
- Lender’s objective “is to make the best of a difficult situation”
- Examples of concessions:
 - Reduce the interest rate for the remaining term
 - Extend maturity at interest rate lower than the current market rate for similar debt
 - Reduce (forgive) unpaid principal balance or accrued interest
 - Areas addressed in the new FASB guidance — interest rates and payment delays

Has the Lender Granted a Concession?

Effective Rate Test

- Test included in GAAP for borrowers, not lenders
 - For borrowers — If the effective interest rate immediately after the restructuring is equal to or greater than the rate immediately before, then no rate concession
- New guidance — Lenders prohibited from applying the borrower's effective rate test by analogy

Interest Rate Increases

- Permanent or temporary increase in the interest rate ***does not*** mean there was no concession

Access to Funds at a Market Rate

- If the borrower cannot access funds at a market rate for debt with risk characteristics similar to the restructured debt, the restructuring would be considered a below-market-rate transaction
- That ***may*** indicate a concession was granted

Has the Lender Granted a Concession?

Delay in Payments

- An “insignificant “ delay in payments is **not** a concession
- Evaluate significance based on:
 - Dollar amount involved in the payment delay, and
 - Length of time covered by the delayed payments
- **Amount** of the restructured payments subject to the delay is:
 - Insignificant relative to the unpaid principal or collateral value, and
 - Will result in an insignificant shortfall in the contractual amount due.
- **Length** of the restructured payment period is insignificant relative to **any one** of the following:
 - Frequency of payments due
 - Original contractual maturity
 - Original expected duration

Financial Difficulties

Existing Guidance:

Indicators of financial difficulties:

- currently in default on any debt

- has declared (or is in process of declaring) bankruptcy

- significant doubt about debtor's ability to continue

- the debtor cannot obtain funds from sources other than the existing creditors at an effective rate equal to the current market interest rate for similar debt for a non-troubled debtor

- the debtor's cash flows will be insufficient to service current debt (both P&I)

Financial Difficulties

New Guidance:

Additional Indicators of financial difficulties:

- A creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default. A creditor should evaluate whether it is probable that the debtor would be in payment default on any of debt in the foreseeable future without the modification.
- The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange

Financial Difficulties

If both of the following factors are present, no financial difficulties:

- Debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a non-troubled debtor.
- The creditors agree to restructure old debt solely to reflect a decrease in current market rates or positive changes in the creditworthiness of debtor since origination.

You Have a TDR, What Now?

- Review for impairment using ASC 310-10-35
- Disclose in notes to the financial statements:
 - Add to current impaired loan disclosures
 - New disclosures required under ASU 2010-20 “Receivables”:
 - TDR’s that occurred during the period
 - TDR’s within the previous 12 months that defaulted during the period
- Additional Call Report disclosures

TDR = Impaired Loan

“A loan restructured in a troubled debt restructuring is an impaired loan.” (ASC 310-40-35-10)

Practically – probably already s/h/b impaired, unless it is homogeneous (i.e. residential real estate, consumer)

TDR Impairment

- **Non-collateral dependent loans** - impairment based on PV of future cash flows
- **Collateral dependent loans** - impairment based on PV future cash flows or FV of collateral, less costs to sell

Note: A collateral dependent loan is a loan that will only be repaid solely from the sale of the collateral (i.e. foreclosure situation)

Generally, TDR's s/b valued based on the pv of cash flows.

TDR Impairment

- Loan balance = principal, unamortized premiums or discounts, deferred fees & costs, accrued interest, less previous charge-offs
- PV measured using the effective interest rate (contractual interest rate adjusted for net deferred items and premiums or discounts)
- When facts and circumstances change either in collateral value or estimated cash flows, recalculate impairment up or down

TDR Impairment (concluded)

- Legal fees and other direct costs expensed as incurred
- For a variable rate loans, the effective interest rate may be the rate at time of modification or a rate based on a factor as it changes over the life of the loan (must apply consistently to all variable rate loans)
- May consider pre-payments, defaults, and recoveries in cash flow projections

Once a TDR, Always a TDR?

ASC 310-40-50-2 (TDR's by Creditors)

TDR's involving a modification of terms need not be included in the disclosures in years after the restructuring if both of the following conditions are met:

- The restructuring agreement specifies the interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk
- The loan is not impaired based on the terms specified by the restructuring agreement

Beyond the Accounting

Education

- Understanding the TDRs requirements at the right level of the organization
 - ✓ Loan Officers
 - ✓ Loan Committee
 - ✓ Credit administration
 - ✓ Accounting/finance
 - ✓ Executive management
 - ✓ Directors

Beyond the Accounting

Policy Development and Update

- Credit Policies should be reflective of the guidance and establish appropriate lines of authority
 - ✓ Individual restructure decisions
 - ✓ Programs targeted toward dealing with borrower financial difficulties
- Internal audit policies and scope should include evaluation of compliance with bank policies on modifications

Beyond the Accounting

Support Systems

- Controls over decisions to restructure and documentation of decisions
 - ✓ Current financial information
 - ✓ Current business conditions
 - ✓ Outlook for future
 - ✓ Why and when will this loan get better again?
- Accounting systems
 - ✓ Most core loan applications not equipped
 - ✓ Cannot modify and forget

Beyond the Accounting

Reporting

- Board/Senior-level review of volume and terms of restructuring decisions and programs
- Ongoing review of “success” of such decisions
- Audit / risk management reporting

FASB Project on Accounting for Financial Instruments

Project Background

- **Goal – increase convergence with IFRS and develop a comprehensive accounting model**
- **Joint project of the FASB and IASB – but different approach and timing**
- **Classification and measurement**
 - Fair value or amortized cost?
 - Based on characteristics of the instrument and business strategy
 - Changes in fair value – report in net income or in “other comprehensive income”?
- **Impairment**
 - Address the concern about “too little, too late” and develop a single impairment model
 - Timing of loss recognition – Day 1 or over time?
 - Amount of loss – cover the full life of the asset or some shorter period?
- **Hedge accounting (derivatives)**
- **Project status and timing**

Classification and Measurement – Business Strategy

Amortized Cost

- **Business strategy:** Manage through customer financing or lending activities, with primary focus on collection of substantially all contractual cash flows
- Holder has ability to manage credit risk
- Not held for sale

Fair Value with Changes Reported in Other Comprehensive Income

- **Business strategy:** Invest to either (1) maximize total return by collecting or selling, or (2) manage interest rate or liquidity risk by holding or selling
- Not held for sale

Fair Value with Changes Reported in Net Income

- **Business strategy:** Held for sale at acquisition *-or-*
- Actively managed and monitored internally on a fair value basis

Financial Assets – Classification Examples

Amortized Cost

- Loans held for investment
- Private placement debt securities - ?
- Trade receivables

Fair Value with Changes Reported in Other Comprehensive Income

- Debt securities now classified as held-to-maturity
- Most debt securities now classified as available-for-sale

Fair Value with Changes Reported in Net Income

- Trading portfolio
- Loans held for sale
- Equity securities (other than equity method investments)

Impairment Model Currently Under Development

The Boards are currently developing a “three-bucket approach” to impairment that would reflect the general pattern of deterioration in the credit quality of financial assets.

Bucket 1

- Assets not affected by observable events that provide direct evidence of a probable future default
- Includes loans with changes in credit loss expectations due to macroeconomic events not specific to a group of loans or a specific loan
- Allowance for credit losses: Losses expected to occur in the next 12 (or 24?) months based on an annual loss rate

Bucket 2

- Assets affected by the occurrence of events that indicate a direct relationship to possible future defaults
- However, the specific assets in danger of default have not yet been identified
- Allowance for credit losses: All remaining lifetime credit losses (portfolio level)

Bucket 3

- Assets for which information is available that specifically identifies that credit losses are expected to occur (or have occurred) on individual assets
- Allowance for credit losses: All remaining lifetime expected losses (individual assets)

Questions??

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