

Bank Regulators Provide COVID-19 Relief for TDRs

Over the weekend, bank regulators issued an [interagency statement](#) addressing loan modifications. The agencies, including the Board of Governors of the Federal Reserve System (FRB), the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency (OCC), the Consumer Financial Protection Bureau and the state banking regulators coordinated with FASB, which concurred with the approach.

In these uncertain times, the agencies have called on banks to work with their customers to provide relief that may involve debt modifications or concessions, noting that examiners will not criticize prudent efforts to modify existing loan terms to affected customers. Under current guidance in Accounting Standards Codification (ASC) 310-40, certain modifications may be considered a troubled debt restructuring (TDR). The TDR designation affects measurement and requires additional disclosure. Determining whether a loan renewal, extension, workout or other modification constitutes a TDR can be challenging. The agencies' statement helps alleviate some of these judgment concerns.

See [Appendix A](#) for current TDR guidance. [Appendix B](#) contains accounting guidance for modifications that are not TDRs.

"The agencies will not criticize institutions for working with borrowers and will not direct supervised institutions to automatically categorize all COVID-19 related loan modifications as TDRs."

This is positive news for financial institutions; however, all programs should be carefully reviewed based on their own unique facts and circumstances.

Interagency Relief – March 23

Accounting for Loan Modifications

The agencies have confirmed with FASB that coronavirus disease 2019 (COVID-19)-related short-term modifications made on a good faith basis to borrowers that were current on their loan prior to any relief are not TDRs. This includes short-term, *e.g.*, six months, modifications such as payment deferrals, fee waivers, extensions of repayment terms or other delays in payment that are considered insignificant. Borrowers considered current are those that are fewer than 30 days past due on their contractual payments at the time a modification program is implemented.

For COVID-19-related modification, financial institutions may presume that borrowers that are current on payments are not experiencing financial difficulties at the time of the modification in assessing TDR status, and no further TDR analysis is required for each loan modification in the program.

COVID-19 modification or deferral programs mandated by the federal or a state government would not be in the scope of ASC 310-40, *e.g.*, a state program that requires all institutions within that state to suspend mortgage payments for a specified period.

Efforts to work with borrowers of one-to-four family residential mortgages, where the loans are prudently underwritten and not past due or carried in nonaccrual status, will not result in the loans being considered restructured or modified under FRB, FDIC or OCC risk-based capital rules.

Past Due Reporting

For loans not otherwise reportable as past due, financial institutions are **not** expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferral. A loan's payment date is governed by the due date stipulated in the legal loan documents. If a financial institution agrees to a payment deferral, this may result in no contractual payments being past due, and these loans are not considered past due during the period of the deferral. This also applies for risk-based capital purposes.

Nonaccrual Status & Charge Offs

Each financial institution should refer to the applicable regulatory reporting instructions, as well as its internal accounting policies, to determine if loans to stressed borrowers should be reported as nonaccrual assets in regulatory reports. For COVID-19-related short-term arrangements, these loans generally would not be reported as nonaccrual. As more information becomes available indicating a specific loan will not be repaid, institutions should refer to the charge off guidance in the instructions for the Consolidated Reports of Condition and Income.

Discount Window Eligibility

Loans that have been restructured due to COVID-19 will continue to be eligible as collateral at the FRB's discount window based on the usual criteria.

Other Updates

The FDIC issued a COVID-19 frequently asked questions (FAQ) document. The [FAQ](#) answers 14 questions covering a variety of topics, including payment accommodations, reporting and filing issues and property inspections and appraisals.

Previously, the agencies indicated they would not intervene in the CECL accounting standard-setting process, but this unprecedented crisis prompted the FDIC on March 19 to [write](#) to FASB to delay implementation.

Conclusion

BKD will continue to follow this developing situation. Visit our [website](#) to learn more. If you have questions about these changes, contact your **BKD Trusted Advisor**™.

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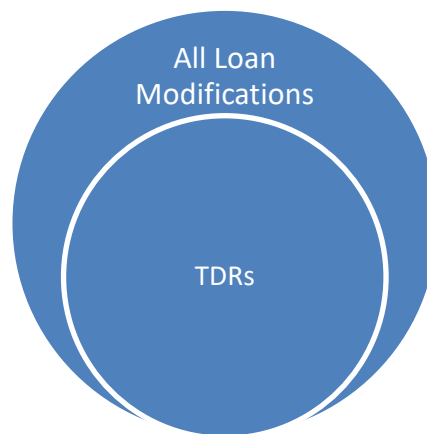
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Appendix A – Current TDR Guidance

Identifying a Loan as a TDR

All TDRs are loan modifications, but not all loan modifications are TDRs. A TDR is defined as a restructuring in which a creditor, for economic or legal reasons related to a debtor’s financial condition, grants a concession to the debtor that it would not otherwise consider. Both criteria must be met for a loan to be considered a TDR. If the modified terms are consistent with market conditions and representative of terms the borrower could obtain in the open market, the restructured loan is not categorized as a TDR. For example, if a bank reduces the effective rate because rates have decreased and the debtor can borrow money elsewhere at a lower rate, the restructured loan is not a TDR, assuming no other changes are made to the loan terms.

Once a loan has been identified as a TDR, it is always considered such until derecognized through repayment, sale or full charge off.



Financial Difficulties

FASB provides several indicators to assess whether a debtor is experiencing financial difficulty. The assessment requires judgment based on the situation’s specific facts and circumstances. Each indicator is a sign that the debtor needs to restructure the debt to avoid default. No indicator is, by itself, determinative of financial difficulty. The following list of indicators should not be considered all-inclusive:

- Debtor currently is in payment default on any debt; a creditor may determine a debtor is experiencing financial difficulties even if the debtor is not currently in payment default, if it is probable the debtor would default without a restructuring
- Bankruptcy
- Ability to continue as a going concern
- Borrower has securities that have been delisting from an exchange or are in the process of delisting
- Cash flow forecasts indicate the debtor’s cash flows will be insufficient to service any of its debt in accordance with the terms of the existing agreement in the near future
- Debtor cannot obtain funds from other sources at current market rates for similar debt for a nontroubled debtor; an increase in the interest on the debt can be considered a concession if the rate is still below the market interest rate that could be obtained from third parties; an interest rate increase is not precluded from being considered a concession for TDR treatment

Insignificant Delay

A restructuring that results only in an insignificant delay in payments is not a concession. The following factors should be considered:

- The amount the restructured payment subject to the delay is insignificant relative to the unpaid principal and will result in an insignificant shortfall in the contractual amount due
- Whether the delay in timing of the restructured payment period is insignificant relative to any of the following:
 - The frequency of payments due under the debtor
 - The debt's original contract maturity
 - The debt's original expected duration

If the debt previously has been restructured, the cumulative effect of the past restructurings should be considered when determining if the delay in payment is insignificant. Management judgment is required—there are no “bright lines” in identifying insignificant delays in U.S. generally accepted accounting principles (GAAP).

Accounting for TDRs

Measurement

TDR measurement is driven by the type of restructuring that has occurred, as noted below:

- Modification of terms of debt, such as one or a combination of any of the following:
 - Absolute or contingent reduction of the stated interest rate for the debt's remaining original life
 - Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risks
 - Absolute or contingent reduction of the face amount or maturity amount of the debt as stated in the instruments
 - Absolute or contingent reductions of accrued interest
- Transfer of assets to the creditor to fully or partially satisfy the borrower's debt—the creditor would measure the transaction with the fair value of the assets transferred
- Combination of modification of terms and receipt of assets—if a portion of a debt is settled and the terms of the remaining amount are altered, a creditor first would reduce the carrying amount of the loan by the fair value of the assets transferred
- Issuing an equity interest in the borrower to the creditor

Impairment (Pre-CECL)

A loan is impaired when it is **probable** that a bank will not be able to collect all amounts due according to the terms of the loan agreement. This includes both principal and interest and encompasses both the timing and amount of payments. “Probable” is defined in ASC 450-20, *Loss Contingencies*, as likely to occur; the level of expectancy is below “virtual certainty” but above “more likely than not.” U.S. GAAP does not specify how a creditor should determine that it is probable it will be unable to collect all amounts due. A creditor should apply its normal loan review procedures in making that judgment.

Individual Versus Pooled Impairment Review

All TDRs are considered impaired loans and should be evaluated for impairment under ASC 310-10. Frequently, a loan restructured through modification of terms is already impaired and would have been assessed for impairment before the restructuring. If a loan has not been assessed for impairment at the time the loan is modified in a TDR, the restructured loan is considered impaired at the time of the restructuring. This means every TDR, regardless of

accounting for the loan prior to restructuring, is required to be assessed for impairment; if impaired, a valuation allowance must be specifically established for that loan.

Most TDRs are **individually** measured for impairment, since the risk characteristics are unique to an individual borrower. However, **U.S. GAAP allows a practical expedient for smaller-balance homogeneous TDRs that could be reviewed on a pooled basis**, since the risk characteristics may be similar to other impaired loans. A financial institution may aggregate such loans and use historical statistics, such as average recovery period and average amount recovered, along with a composite, effective interest rate to measure impairment of those loans. The outcome of a pooled approach must be consistent with and should result in an impairment measurement similar to that for loans that are individually considered impaired.

If the impaired loans have risk characteristics unique to an individual borrower, an entity would apply one of the three measurement methods noted below:

- Observable market price
- Collateral value
- Discounted cash flow method

Impairment is measured by comparing the recorded investment to the present value of cash flows expected to be collected. The recorded investment in the loan includes accrued interest, net deferred loan fees or costs and unamortized premium or discount, but it excludes any valuation allowance associated with the loan. The loan should be moved from the general reserve section of the allowance to the specific reserve section. If the present value of future cash flows is greater than the recorded value of the loan, no impairment charge is recognized. Impairment analysis on TDRs is required every quarter.

How to Calculate Present Value of Expected Future Cash Flows

The purpose of impairment measurement is to identify the deterioration in the loan's credit quality. The amount needs to be isolated from the effect of changes in market interest rates. A TDR is considered a continuation of an existing loan and not a new loan, meaning a creditor would record the restructured receivable at the present value of future expected cash receipts discounted at the original loan's effective interest rate, not the rate specified in the modification agreement.

The calculation should be based on the creditor's judgment and reflect all the available evidence that reflects the creditor's best estimate using reasonable and supportable assumptions and projections. In general, the projected cash flows should be based on current financial information provided by the debtor and reflect the following:

- Estimated costs to sell and expected recoveries
- Industry, geographic, economic and political factors
- Future prepayments, defaults and charge offs

If the contractual rate is a floating rate tied to an index such as the London Interbank Offered Rate, the loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the impairment date. The creditor's choice is to be applied consistently and projections of changes in the index rate **should not** be used to determine the effective interest rate.

Subsequent Measurement

After the initial impairment measurement, if there is a significant change (increase or decrease) in the amount or timing of the loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor would recalculate the impairment and adjust the valuation allowance. The net carrying amount of the loan shall at no time exceed the recorded investment in the loan.

There are several methods available for a creditor to recognize, measure and display interest income on an impaired loan, including the cost-recovery method, a cash-basis method or a combination of those methods. In

addition, U.S. GAAP offers two alternative income-recognition methods to account for changes in the net carrying amount of an impaired loan subsequent to the initial measurement:

- Accrue interest on the net carrying amount of the impaired loan and report other changes in the net carrying amount of the loan as an adjustment to bad-debt expense
- Recognize all changes in the net carrying amount of the loan as an adjustment to bad-debt expense; an entity would need to disclose the amount of interest income that represents the change in present value attributable to the passage of time

Those income recognition methods are not required, and a creditor is not precluded from using either method.

Reporting Requirements (Pre-CECL)

The identification of a restructured receivable as a TDR is significant in determining not only the appropriate measurement model, but also the relevant disclosure. TDRs require more comprehensive information.

Entities are required to disclose the balance in their allowance for credit losses related to TDRs, as well as their recorded investment in TDRs related to the balance in the allowance account. As of each balance sheet date presented, an entity would disclose the amount of commitments to lend additional funds to debtors with TDR loans.

For each period for which a statement of income is presented, the following disclosures are required:

- TDRs that occurred during the period:
 - By class of financing receivable, qualitative and quantitative information, including how the receivables were modified and the financial effects of the modifications
 - By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance for credit losses
- Loans modified as TDRs within the previous 12 months with a payment default during the period:
 - By class of loan, qualitative and quantitative information about defaulted loans, including the types and amounts of receivables that defaulted
 - By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowances for loan and lease losses

Once a loan has been identified as a TDR, it is always considered a TDR for impairment purposes until derecognized through repayment, sale or full charge off. However, for reporting purposes, the impaired loan disclosures need not be repeated in years after the TDR modification if both of the following conditions exist:

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

Appendix B – Accounting for Modifications That Are Not TDRs

If a modification does not meet the TDR definition, the modification is accounted for according to other guidance in U.S. GAAP, depending on the nature of the receivable and modification. Loan modifications that are not TDRs do not require a valuation allowance. If a modification does not meet the TDR definition, the creditor must consider whether to account for the modification as an extinguishment of the original loan and subsequent execution of a new loan or a continuation of the original loan. The creditor accounts for the modification as an extinguishment of the original loan if the following two criteria are met:

- The terms of the modified new loan are at least as favorable to the lender as the terms of the original loan (if the yield of the modified loan is greater than or equal to the effective yield on a comparable loan that is not modified)
- The modification of the original loan is more than minor, *i.e.*, the present value of the cash flows of the modified loan is at least 10 percent different from the present value of the remaining cash flows of the original loan

If the modification meets the two criteria, the new loan is recognized at fair value and the old loan is derecognized, resulting in a gain or loss on extinguishment. The creditor recognizes any unamortized net fees, costs and prepayment penalties associated with the original loan in interest income.

If the modification does not meet the two criteria, the creditor carries forward the net investment in the original loan (including any unamortized fees, cost and prepayment penalties). The recorded investment in the new loan includes the remaining net investment in the original loan, any additional amounts loaned and any fees or costs associated with the refinancing or restructuring.

Examples

The examples below assume a customer's ability and willingness to repay his or her obligation and that the loans are not collateral-dependent and have no observable market price.

Forbearance

Forbearance involves granting the customer a cessation of payments, or temporary acceptance of smaller-than-scheduled payments, for a specified time period. Forbearance **extends** the original term of the loan. It does not grant any reduction in the total repayment obligation (principal or interest). While in forbearance, interest continues to accrue and is capitalized to principal when the loan re-enters repayment status.

Example: Three-Month Forbearance

Borrower A cannot service his \$10,000 student loan because of financial difficulties. The borrower was making interest-only monthly payments of \$100 during four years of school and six months of grace period following graduation. The original interest rate was 12 percent and the original term was 25 years. Under the original terms, the monthly interest and principal payment would have been \$109 for the remaining 246 months, for a total of \$32,329. Under the three-month forbearance agreement, the new monthly interest and principal payments will be \$112 for remaining 249 months, for a total of \$33,397. The present value of the expected payments under the restructured terms, discounted at 12 percent (the original effective interest rate), is approximately \$10,330.

The first condition required for a TDR classification—financial distress—is clearly met. The second TDR requirement is not met—a three-month forbearance on a 25-year loan is an insignificant delay, the delay of \$327 is insignificant relative to the principal amount of \$10,000 and there is no shortfall in the contractual amount due. Therefore, under U.S. GAAP this is not a concession that would result in a TDR classification.

Interest-Only Option

Some banks may modify a loan in a manner that temporarily lowers payment from the required principal and interest payment amount. The borrower pays monthly interest with no amortization of principal balance, and the maturity date of the loan is not extended.

Borrower A cannot service his \$10,000 student loan because of financial difficulties. The borrower was making interest-only monthly payments of \$100 during four years of school and six months of grace period following graduation. The original interest rate was 12 percent and the original term was 25 years. Under the original terms, the monthly interest and principal payment would have been \$109 for the remaining 246 months, for a total of \$32,329. Bank A has approved a payment plan to continue the interest-only payments for an additional 24 months without extending the term of the loan. The new principal and interest payment after the 24-month interest-only period would be \$112 for 222 months, for a total of \$33,738. However, given the high unemployment rate in the area, the student may continue to be unemployed and may not be able to service the debt after the interest-only period. As a result, the present value of the estimated payments given the restructured terms, factoring in continued unemployment, is approximately \$7,500; therefore, an impairment charge of \$2,500 is required.