

## Trouble Debt Restructuring & OREO Accounting

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### Session Objectives

- Identify accounting guidance and principles over trouble debt restructurings (TDR) and accounting for other real estate owned (OREO)
- Determine what events and circumstances result in a TDR and those that result in only a loan modification
- Understand how a TDR impacts allowance for loan losses, accounting practices and regulatory reporting
- Learn accounting for OREO property at each of the three stages its life



### Current Events

- Exotic loan products (non-traditional loans), interest only, negative amortization, liar loans
- Borrowers only able to make payments at current interest rates, not at adjusted rates in the future
- Increase in default and foreclosure contributing to downward pressure on housing prices
- Economic downturn, unemployment



### Current Events

- National unemployment rate 9.6% August 2009
- Expected to peak at 10%
- 1 in 10 US mortgages at least one payment late
- 4.3% of US homes in foreclosure
- Trend see increases in TDRs and foreclosure, OREO
- TDRs in all types of loans, not just RE or business



### Accounting Guidance

- FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"
- FAS 114, "Accounting by Creditors for Impairment of a Loan"
- FAS 118, "Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures"
- EITF 01-7 "Creditor's Accounting for a Modification or Exchange of Debt Instruments"



### Accounting Guidance

- EITF No. 02-4, "Determining Whether a Debtor's Modification or Exchange of Debt Instruments Is within the Scope of FAS 15"
- Center for Audit Quality white paper – "Application of Residential Mortgage Loans that Qualify as TDRs"
- Codified at FASB ASC 310-10 and 310-40



### What is a TDR

A restructuring of a debt constitutes a TDR if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

Concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court.

Need two things:

- > financial difficulties
- > concession



### Financial Difficulties

Indicators of financial difficulties:

- > Currently in default on any debt
- > Has declared bankruptcy
- > Is unable to service the debt; or
- > Has no credit available



### Financial Difficulties

EITF 02-4, if both of the following factors are present, no financial difficulties

- > The debtor is currently servicing old debt and can obtain funds to repay old debt at market rates, and
- > 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.



### Financial Difficulties Yes or No?

- > Member gets into an accident and can't perform their normal job. Due to their injuries, they are reassigned to other work for 3 months. At new position, their salary is reduced. They ask for reduced pmts for the 3 months until they return to prior salary. Financial difficulties?

No, probably not.



### Financial Difficulties Yes or No?

- > Member has lost their job earning \$60,000 a year. However, they found a new job but only earns \$25,000 a year.

Probably, but need to consider if they are able to still meet their financial commitments.



### Concessions

A concession may include, but is not limited to, one or a combination of the following four types:

- > a. Transfer of assets to satisfy debt (including a transfer resulting from foreclosure or repossession).
- > b. Issuance of an equity interest to satisfy debt, unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.



### Concessions

- C. Modification of terms of a debt.
- d. Substitution or addition of debtor(s) when the substitute or additional debtor(s) control, are controlled by, or are under common control with the original debtor.
- Determining if a concession results in a TDR loan is done on a case-to-case basis. Need to document your consideration of each loan.



### Modification of Terms

- Modification of terms of a debt, such as one or a combination of:
  - Reduction of interest rate for the remaining original life of the debt or for a period of time
  - Extension of the maturity date beyond original contractual life
  - Reduction of the amount of the debt and/or accrued interest



### Concession Example

- The Credit Union restructures a loan rolling unsecured debt into a car loan with an interest rate of 5%. This brings the LTV ratio up to 130%. Your Credit Union and others don't offer auto loans with a LTV of 130%.

Concession resulting in a TDR: YES or No

- A loan is extend from 15 yrs to 30 yrs to lower payments. Member is experiencing financial difficulty. Interest rate is left the same, however this rate is not offered on a 30yr loan.

Concession resulting in a TDR: YES or No



### Combination Restructurings

- TDRs involving both a transfer of assets and a modification of terms. Should be accounted for as follows:
  - Asset received recorded at FV (less cost to sell), loan reduced by that amount.
  - The modification on remaining loan balance accounted as an impaired loan.



### Substitute Borrowers

- Should be accounted for according to their substance.
  - Unrelated Borrowers - accounted for as an exchange of debt at FV of new debt.
  - Related Borrowers – accounted for as if the borrowers did not change.



### Auditor Inquires

- Perform procedures to identify TDRs
- Inquire with both collectors and accounting staff
- Determine if credit union has physical assets without formal repossession proceedings
- Consider assets serviced by third parties
- Consider internal control issues once you have a full understanding of their processes.



### You Have a TDR, What Now

- Review for impairment using FAS 114
- Disclose in notes to the financial statements
- Disclose on Call Report



### TDR Impairment

- FAS 114 normally applies to non-homogenous loans, but also applies to TDRs
- Loan impairment exists when it is "probable" that all amounts due will not be collected in accordance with loan agreement
- The term "probable" is consistent FAS 5, likely to occur.
- If loan, when measured for impairment, is less than loan balance, recognize an allowance. If more, no allowance needed



### Insignificant Concessions

- FAS 114 paragraph 8 states:  
An insignificant delay or insignificant shortfall in amount of payments does not require application of this Statement. A loan is not impaired during a period of delay in payment if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate for the period of delay. Thus, a demand loan or other loan with no stated maturity is not impaired if the creditor expects to collect all amounts due including interest accrued at the contractual interest rate during the period the loan is outstanding.



### TDR Impairment

- Non-collateral dependant loans - impairment based on PV of future cash flows
- Collateral dependant loans, impairment based on PV future cash flows or FV of collateral, less costs to sell
- A collateral dependant loan is a loan that will only be repaid solely from the sale of the collateral
- Which method to use can be made on a loan-to-loan basis, but must be consistently applied unless circumstance change, such as imminent foreclosure



### TDR Impairment

- Loan balance = principal, premiums or discounts, deferred fees & costs, accrued interest, less chg-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
- Tvalue5, excellent tool to calculate PV



### Example 1 (Interest Rate Change)

- Two yrs into loan, member not delinquent on CU loan, experiencing financial difficulties with other debt
- Home value at origination of loan \$625,000
- Current value \$350,000
- Current LTV is 131%
- Going interest rate on loan type 5%
- To reduce payments, CU lowers int. rate from 6% to 3%



**Example 1**

	At Origination	At Modification
> Balance	500,000	458,204
> Deferred costs	1,000	800
> Rate *	6%	3%
> Term	180 months	156 months
> Payments	4,219	3,551
> Interest	259,471	95,708

\* - Modification of interest rate



**Example 1**

> Principal balance	458,204
> Deferred costs	<u>800</u>
> Net loan balance	<u>459,004 (B)</u>
> PV of future cash flows	384,007 (A) *
3,551 over 156 months discounted at 6%	
* - No consideration of prepayment.	
> PV – net loan balance (A) – (B)	( 74,997) impaired



**Example 1**

AJE at impairment	Debit	Credit
Provision expense	74,997	
Allowance for loan losses		74,997

  

AJE at payment		
Cash	3,551	
Loans		2,405
Interest income		1,146



Insert Your Logo Here

**Example 1**

Original reserve	74,997
Reduction due to pymnts	<u>( 774)</u>
New reserve in allowance	<u>74,223</u>
Allowance for loan losses	774
Provision for loan losses	774

> Quarterly analysis should suffice



**Example 2 (Combination Restructuring)**

- > CU has a loan at 6% interest rate, principal balance of \$500,000, accrued interest income of \$5,000, deferred income of \$50,000, and an allowance of \$50,000.
- > TDR with the following terms:
  - CU receives RE worth \$150,000
  - Loan reduced to \$180,000
  - Ten annual payments of \$18,000.



**Example 2**

Partial Settlement

> Principal balance	500,000
> Accrued interest	5,000
> Deferred income	<u>( 50,000)</u>
> Net loan balance	455,000
> FV of assets received	(150,000)
> Adjusted loan balance	305,000



**Example 2**

Modification of Terms

- Adjusted loan balance 305,000
- PV of future cash flows (132,000)
- Loss on restructuring 173,000
- Less existing allowance (50,000)
- Additional allowance needed 123,000



**Other Items**

- Legal fees and other direct costs expensed as incurred
- Loans sharing common risk characteristics can be aggregated using historical statistics along with a composite effective interest rate to measure impairment
- For a variable rate loan, 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
- Consider pre-payments, defaults, and recoveries in cash flow projections



**Effect of Prepayment on PV of Cash Flow**

- PV of cash flow no prepayment 384,007 \*
- PV assuming prepayment 397,940 \*\*
- Difference 13,933

\* - example 1 assumed 156 payments to be made, no prepayment consideration

\*\* - prepayment assumed loan will prepay in 7 years, however current prepayments models have slowed significantly in some areas



**Cram Downs**

- A modification of terms due to members financial distress and legal reasons, therefore a TDR
- Reduce loan balance as ordered by the court via charge-off
- Make other modifications as required, int. rate, pymnt
- If payments stop, take action



**In Substance Foreclosure**

- A creditor cannot avoid accounting for an asset at fair value by avoiding a formal foreclosure
- FAS 114 amended FAS 15 to define in-substance foreclosures as transactions where lender takes physical possession of collateral without foreclosure proceedings (ex., deed in lieu of foreclosure)



**Deed in Lieu of Foreclosure & Short Sales**

- Treat as a transfer of assets to satisfy debt
- Record at FV of collateral received
- Remaining debt treatment depends on any agreement with borrower
  - If borrower to repay deficiency balance, TDR loan
  - If borrower not required to pay, charge-off



### Interest Income Recognition

- Cost-recovery method, a cash-basis method or some combination of those methods (FAS 118 restated FAS 114)
- Cost-recovery method - income recognition deferred until all costs have been recovered
- Cash-basis method – income recognition recorded as cash received



### TDR FS Disclosure

- TDR disclosure should include the following, if material:
- The total amount of TRD loans at the end of each period, and
    - the amount of loans for which there is a related allowance for credit losses, and
    - the amount of loans where there is no allowance



### TDR FS Disclosure

- Your interest income recognition policy including the method of recording cash receipts.
- The activity in the allowance for loan losses related to TDRs activity. (Rollforward)
- Disclosure is not required by the creditor if rate is equal to or greater than a loan with comparable risk and loan is not impaired



### TDR FS Disclosure

- For each period results of operations are presented:
- The avg. balance of impaired loans during the period
  - The related amount of interest income recognized on impaired loans
  - And, unless not practical, the amount of interest income using a cash-basis method of accounting while impaired
- Additionally, disclose the amount of commitments, if any, to borrowers in a TDR agreement



### TDRs & the Call Report

- Three areas of disclosure
- 1. Delinquent TDR loans, number and amounts by stage of delinquency
  - include in original delinquent category until six consecutive timely payments received
  - aging during this period is based on old payment
- 2. YTD charge-off and recoveries, TDR loans



### TDRs & the Call Report

- 3. Schedule A "Specialized Lending", reports all RE loans modifications not just those resulting in a TDR
  - number outstanding
  - amount outstanding
  - amount modified YTD



### OREOs & Repossessions

- FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"
- FAS 144 "Accounting for the Impairment or Disposal of Long-Lived Assets"
- FDIC Financial Institutions Letter 62-2008 "Guidance on Other Real Estate"
- Codified at FASB ASC 310-10 and 310-40

### Accounting At Acquisition

- Initially recorded at FV (less costs to sell) at foreclosure/repossession. FV (less cost to sell) becomes "cost" basis
  - New appraisal recommended, certain state laws require
- Loan amount in excess of costs basis, loss to ALLL
- Transfer out of loans to other assets

### Use of Appraisals

Given the significant decline in property values, consider the following when evaluating appraisals:

- Rise/decline in a market area not reflected in appraisal
- Appraisal date, potential changes in market area since
- Est. selling price should reflect price in the near future, not some indefinite future period

### Use of Appraisals

- Source and reliability of evidence supporting assumptions
- Pay special attention to highly sensitive or uncertain assumptions and those susceptible to misapplication or bias
- Consider the sensitivity of the valuation to changes in assumptions and market conditions
- Consider guidance in AU Section 342 "Auditing Accounting Estimates"

### Accounting During Holding Period

- After foreclosure/repossession, re-value periodically, lower of cost or market, charge to disposition on assets
- Call Report instructions state "If sold not shortly after received, declines in value or gain/loss from sale recorded to disposition on assets, not to the ALLL"
- Holding costs expensed as incurred
- Permanent improvements increasing value, capitalize
- If rented, rental income recognized

### Accounting During Disposition Phase

- When sold follow FAS 66 "Accounting for Sales of Real Estate"
- Five methods for profit or loss recognition: full accrual, installment, cost, reduced profit, and deposit
- Profits are recognized based on method used, losses are recognized immediately

**Conclusion**

Questions ??

Thanks for participating

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