TROUBLED DEBT RESTRUCTURING

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Presented by:

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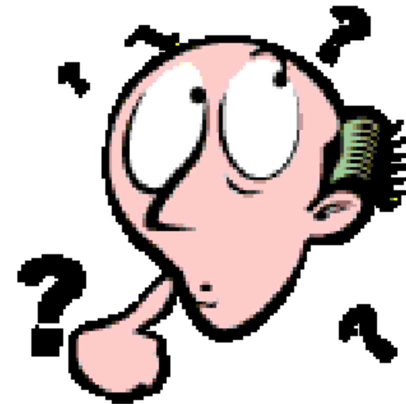
Course Description

Troubled Debt Restructurings (TDRs) have impacted credit unions for several years now. We will discuss what they are, and what makes a loan modification a TDR. Further, we will discuss what a TDR means to the credit union's financial statements. Lastly, we will look at some real-life examples of modifications to gain an understanding of why they are or are not a TDR.

Remember

- All TDRs start as modifications; however
- A loan modification is not always a TDR, but
- All TDRs are loan modifications



Loan Modifications

- Essentially restructuring or modifying terms of an existing loan
- It is not a new loan
- Why is it done?
  - Convert to current terms
  - Assist borrower in difficult times – could be short or long term assistance
  - Add or remove collateral or guarantors

Loan Modifications

"When conducted in a prudent manner, modifications of problem loans are generally in the best interest of both the institution and the borrower and can lead to improved loan performance and reduced credit risk."

Source: Interagency Supervisory guidance Addressing Certain Issues Related to Troubled Debt Restructurings, October 24, 2013

Changes May Include

- Interest rate
  - Reduction in rate
  - Conversion from adjustable to fixed rate
- Final maturity date
- Principal forgiveness
- Interest only payments for a period of time
- Balloon options
- Waiver of late fees
- Reduction or capitalization of past due amounts

Troubled Debt Restructuring

- A loan modification where creditor, for economic or legal reasons, related to the debtor's financial difficulties, grants a concession to the debtor it would not otherwise consider
- The concession is granted by the creditor in an attempt to protect its investment
- Stems from an agreement between creditor and debtor or is imposed by law or a court

Troubled Debt Restructuring

- Creditor’s objective is to make the best of a difficult situation
- Creditor expects to collect more from debtor as a result
- Or increases likelihood of collection

To Evaluate If TDR

- **Both of the following must exist**
- The restructuring or modification constitutes a concession
- The debtor is experiencing financial difficulties

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Concessions

- Creditor does not expect to collect all amounts due, including interest at the original contract rate
- Additional guarantees or collateral received are not adequate for terms of loan
- Debtor does not have access to funds at a market rate for debt with similar risk characteristics, it is below market and therefore may be a concession
- An increase in interest rate could still be a concession if it is below market rates for new debt with similar risk

Not a Concession

- Restructuring that results in insignificant delay in payments
  - Amount of restructured payments subject to delay is insignificant relative to the unpaid principal and will result in insignificant shortfall in contractual amount due
  - Delay in timing is insignificant relative to
    - The frequency of payments due
    - Debt's original contractual maturity
    - Debt's original expected duration

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Cumulative Effect

- If debt has been previously restructured, creditor should consider cumulative effect of past restructurings when determining whether a delay in payment resulting from most recent restructuring is insignificant

Financial Difficulties

- Debtor is in payment default on any of its debt
- Debtor would be in payment default in near future without the modification
- Debtor has declared or is in process of declaring bankruptcy
- Cash flow is not sufficient to service debt
- Debtor cannot obtain funds from other creditors at market rates for non-troubled debtor
- Substantial doubt as to whether debtor will continue to be a going concern

Troubled Debt Restructuring

- May include:
  - Transfer of receivables, or other assets to satisfy fully or partially a debt
  - Issuance of an equity interest in the business
  - Modification of terms of debt, one or a combination of:
    - Reduction in stated interest rate for remaining term of debt
    - Extension of maturity date at rate lower than current market rate for new debt with similar risk
    - Reduction in face amount or maturity amount of debt
    - Reduction in accrued interest

Not All Restructurings are TDRs

- If debtor can obtain funds from other sources at or near market interest rates for non-troubled debt
- Fair value of any cash, assets, or equity interest received at least equals creditors investment in loan
- Reduction in interest rate reflects a decrease in market rates in general or the risk associated with debt
- New debt is being issued at similar market rates

Loan Impairment Issues

- When a loan is modified and/or is a TDR, it must be judged for impairment
- A loan is impaired if it is probable that the creditor will not be able to collect all amounts due according to the original contractual terms of the loan
  - This includes both contractual principal and contractual interest as scheduled in the loan agreement

Measuring Impairment

- Measuring impairment requires judgment and estimates, and the eventual outcome will likely differ from the estimates
- Can be measured loan by loan, or can be aggregated - FASB ASC 310(FAS 114) or FASB ASC 450(FAS 5)
- Impairment should be based on the present value of expected future cash flows discounted at the loan's effective interest rate

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Measuring Impairment

- As a practical expedient, it can be based on observable market price
- **If loan is collateral dependent,** it can be based on fair value of collateral
  - Loan is collateral dependent if repayment is expected to be provided solely by operation or sale of underlying collateral
- If foreclosure is probable, should use fair value of collateral

Measuring Impairment

- Must consider estimated costs to sell
- If present value of expected future cash flows is less than the recorded loan, it is impaired
  - Expected cash flows are not necessarily the new contractual cash flows
- If there is a significant change or if actual cash flows are significantly different than projected, impairment should be recalculated

Subsequent Restructurings

- If a loan is restructured or modified again, consider the following:
  - Is borrower still experiencing financial difficulties?
  - Has a concession been granted this time? Consider cumulative effect of all restructurings.
  - Is interest rate a market rate for debt with similar risk characteristics?
  - Are other terms consistent with market?

Subsequent Restructurings

- If no financial difficulties and/or no concession
- And terms are consistent with debt with similar risk characteristics
- It is no longer a TDR

Day 2 Accounting

- As payments are received on the loan, the amount needed in the Allowance for Loan Losses needs to be reduced.
- Two ways this can be done
  - Reduce future funding needs because it is part of overall funding calculation.
  - Reduce ALL directly through reduction in expense.

Once a TDR

- It is generally always a TDR
  - Loans remain impaired
  - Must be monitored for impairment
- Other than if changes are made that "fix" the problem
  - If subsequent restructuring bears "market" yield and terms

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Important

- Lenders and collectors need to understand TDR rules and implications
- Develop tools to help document evaluation process and conclusions
- If you can determine that a modification is not a TDR, that is critical to this evaluation
- Good policies are critical
  - To address restructuring decisions
  - To deal with borrower difficulties
- Develop controls over decision-making process and documentation

And.....

- Legal fees and other direct costs, including loan origination costs, should be expensed as incurred
- Fees received by lender in connection with restructuring should be applied against recorded investment in loan

An Example

- Member has existing loan balance and is having difficulty paying his debts. Details follow:

Loan balance	$100,000.00
Contractual interest rate	6.00%
Contractual payment	$1,110.21
Modified interest rate	2.00%
Modified payment	$920.13
Length of modification	120 months
Remaining term	120 months

Is It a TDR?

Was borrower experiencing financial difficulty? ......

Was concession granted? ....

Is it a TDR? ....

Excel Formula

=NPV(0.06/12,H5:H$124)

Original rate

Cells representing expected cash flows

TDR1.xlsx

Example #2

- Member calls the CU and asks for a reduction in his interest rate. He would like to reduce his payment. His credit score is good. CU agrees to modify loan.

Loan balance	$100,000.00
Contractual interest rate	6.00%
Contractual payment	$1,110.21
Modified interest rate	4.00%
Modified payment	$1,012.45
Length of modification	120 months
Remaining term	120 months

Is It a TDR?

Was borrower experiencing financial difficulty? ......

Was concession granted? ....

Is it a TDR? ....

Example #3

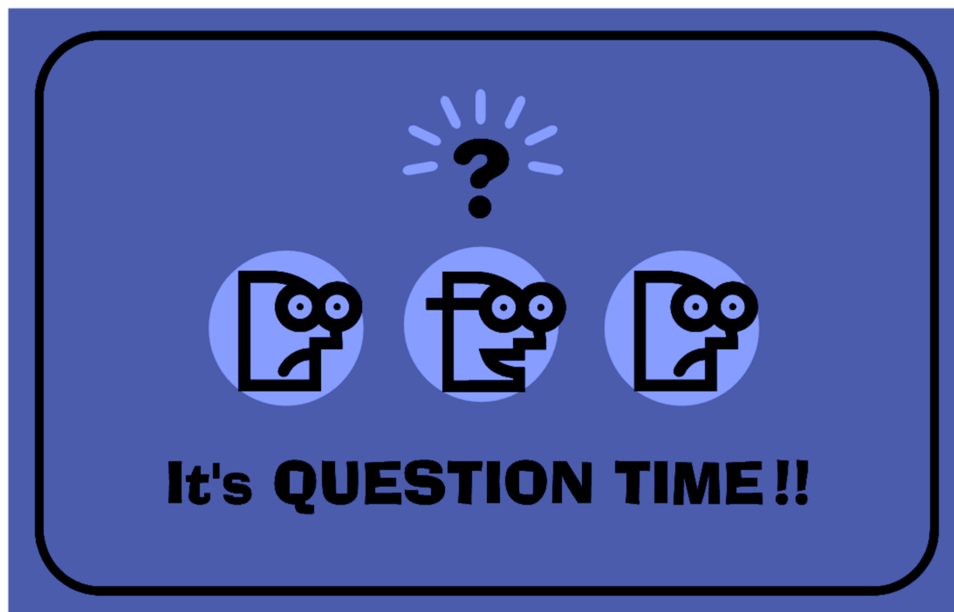
- Member calls the CU and is experiencing some short-term cash flow problems as he required surgery and is unable to work. He expects to be off for about six months and would like to reduce his loan payments temporarily to interest only. His credit score is good and he has always made payments on time. If payments continue to be made on time, CU will likely earn more interest over term of loan. CU agrees to this arrangement.

Is It a TDR?

Was borrower experiencing financial difficulty? ......

Was concession granted? ....

Is it a TDR? ....



Thank You

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Dan Mahalak Bio

Dan is the President & Managing Partner of Cindrich, Mahalak & Co., P.C., a CPA firm specializing in the credit union industry. He joined the firm in 1980 upon graduating from Eastern Michigan University and became a partner in 1988. He is a Certified Public Accountant (CPA) and a Chartered Global Management Accountant (CGMA) and is a member of both the American Institute of Certified Public Accountants (AICPA) and the Michigan Association of Certified Public Accountants (MICPA).

Throughout his career, Dan has worked in all phases of the practice. He is involved in all audit activities and works closely with the staff in training and development. He personally reviews all audit files as part of the firm's quality control standards. His extensive experience allows him to provide clients with unique problem solving insights.

Throughout his tenure, Dan has been responsible for hundreds of credit union audits, and worked in fraud/embezzlement investigations, including filing bond claims, working with authorities, and testifying in criminal proceedings. He also works with credit unions in budgeting and forecasting, asset-liability management consulting, strategic planning, mergers and acquisitions, human resources consulting, regulatory consulting, and a variety of other consulting projects. He is a frequent speaker on topics related to the credit union industry on both a local and national level. He has written articles for several credit union publications.

Cindrich, Mahalak & Co., P.C. is one of the largest credit union auditing firms in the country. They currently audit credit unions ranging from less than $5 million to well over $1 billion in assets. They have concentrated their practice in credit unions and their subsidiaries since their inception in 1971.