NEW RULES FOR DETERMINING WHETHER A LOAN RESTRUCTURING IS A TROUBLED DEBT RESTRUCTURING

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In April 2011 the Financial Accounting Standards Board issued new rules for determining whether a loan restructuring is a troubled debt restructuring (Accounting Standards Update No. 2011-02). The new rules, which go into effect on July 1, 2011 for public entities[1] (January 1, 2012 for nonpublic entities), are far more expansive than the old rules, and are likely to result in more loans being accounted for (and reported) as troubled debt restructurings.

A restructuring constitutes a troubled debt restructuring (TDR) only if 1) the restructuring constitutes a concession, ***and*** 2) the debtor is experiencing financial difficulties. These two basic criteria have not changed under the new rules. What has changed, however, is the expansion of the concept "concession".

We should note up front that a loan has to be restructured (or in some cases renewed) in order to be a possible TDR. Many problem loans with troubled debtors never get restructured or renewed, and although they may be deemed impaired, they would not be considered TDRs.

What constitutes a concession?

As already stated, in order for a restructuring to be a TDR, the restructuring must constitute a concession. Concessions can take many forms – reduced interest rate, extension of the maturity date, forgiveness of interest or principal, among other things. Essentially any change in the loan contract can potentially be a concession if it is a change the creditor makes because of the debtor's distressed financial situation. To determine whether such a change is a concession, ASU 2011-02 provides the following guidance:

> If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession.

As this quote indicates, ASU 2011-02 is concerned primarily with the question of whether the debtor could obtain a loan from another creditor at a market rate. Under most circumstances, and especially in today's lending environment, it would be very difficult for a debtor who is experiencing financial

[1] Banks are "public entities" if, among other things, their debt or equity securities trade in a public market either on a stock exchange (domestic or Foreign) or in an over-the-counter market, including securities quoted only locally or regionally. A bank does not have to be an SEC registrant to be a public entity under generally accepted accounting principles.

difficulties to qualify for a loan from another creditor at an interest rate the debtor could afford. Given this condition, it is easy to see how a loan modification could constitute a concession.

In some cases a creditor may restructure debt in exchange for an increased interest rate. The increased rate does not eliminate the possibility that a concession has been granted, because the increased rate may still be below the market rate for new debt with similar risk characteristics.

In other cases, a creditor may restructure debt in exchange for additional collateral or guarantees from the debtor. If the additional collateral or guarantees represent adequate compensation for the favorable modifications granted to the debtor, then the restructuring does not constitute a concession.

Restructurings in the form of payment delays are not considered concessions if the delay is insignificant. A creditor can determine whether a payment delay is insignificant by comparing the dollar amount of payments subject to delay to the unpaid loan balance or collateral value, or by comparing the delay period to the original contractual period. If the debt has been previously restructured, the cumulative effect of past restructurings must be considered when determining whether the payment delay is insignificant.

Determining whether a debtor is experiencing financial difficulty

The second criteria for determining whether a restructuring is a TDR is whether the debtor is experiencing financial difficulty. Some years ago FASB established criteria for determining what constitutes evidence of a debtor experiencing financial difficulty. This guidance was originally presented from the standpoint of the debtor. These same criteria have now been duplicated in the new guidance for creditors in ASU 2011-02. When determining whether a debtor is experiencing financial difficulty, a creditor shall consider the following indicators:

1) The debtor is currently in default on ***any*** of its debt, not just the debt in question (emphasis added).

2) Although the loan in question is not currently in default, it is probable that the debtor will be in payment default in the foreseeable future without the modification.

3) The debtor has declared or is in the process of declaring bankruptcy.

4) There is substantial doubt as to whether the debtor will continue as a going concern.

5) The debtor has securities that are delisted, are in the process of being delisted, or are under threat of being delisted from an exchange.

6) It is probable that the debtor's entity-specific cash flows will be insufficient to service the debt in accordance with the existing loan agreement for the foreseeable future. The probability of insufficient cash flows must be determined on the basis of estimates and projections that only encompass the debtor's current capabilities.

7) The debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.

The above list is not all-inclusive, and other indicators may need to be considered.

Regarding item 7), it stands to reason that if a debtor is not experiencing financial difficulty, it would be able to obtain a loan from another creditor, at a rate that would be available to a healthy debtor. The very fact that the debtor cannot obtain a loan from another creditor at a "nontroubled" rate indicates that it is having financial difficulty.

Effective interest rate test is not allowed for creditors

In practice, creditors often used the effective interest rate test to determine whether a restructuring constituted a concession. Under the effective interest rate test, if the effective borrowing rate immediate after a restructuring was at least equal to the effective borrowing rate immediately before the restructuring, then the restructuring did not constitute a concession and the restructuring would not be considered a TDR. However, this test was meant to be used only by debtors and not creditors. Also, the FASB determined that the test failed to consider all terms of a restructuring. Therefore, creditors are now precluded from using the effective interest rate test (debtors can still use this test).

What about loan renewals?

ASU 2011-02 does not specifically address loan renewals, but in our view there may be instances where the new TDR rules may apply. Upon considering whether to renew a loan that has come due, a creditor may have obtained financial information that indicates the debtor is having financial difficulty. The creditor may decide to renew the loan because the debtor is unable to pay off the loan as required by the loan terms (through a refinancing with another creditor or otherwise). If a creditor does not obtain adequate compensation for the additional risk inherent in the debtor's deteriorated financial condition (for instance, by obtaining additional collateral, guarantees, or a rate increase), the renewed loan may be deemed a TDR. This is a highly judgmental area, and specific facts and circumstances must be carefully considered.

Accounting for TDRs

If a loan is determined to be a TDR, it is by definition an impaired loan and therefore must be measured for impairment. Impairment is measured based on the fair value of the collateral if the loan is collateral-dependent[2]. Otherwise, impairment should be based on the present value of future cash flows discounted at the loan's effective interest rate prior to the restructuring. Furthermore, under current regulatory guidance, the loan most likely will have to be placed on nonaccrual status.

Once a loan has been determined to be a TDR, it will always be considered a TDR unless all of the following criteria are met:

1) The loan is no longer on nonaccrual status
2) The loan has been performing flawlessly under the modified terms, and payment has been in cash or equivalent
3) The creditor is reasonably sure that flawless performance will continue

[2] If repayment of the loan is dependent on the sale of the collateral, fair value should be reduced by estimated selling costs. However, if repayment is dependent only on the operation, rather than the sale, of the collateral, fair value should not be reduced by estimated selling costs.

4) The restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of restructuring for a new loan with comparable risk
5) The restructured loan term has entered a new calendar year.

The accounting for TDRs has not been affected by ASU 2011-02.

Disclosure of TDRs

Certain financial statement disclosures are now required for TDRs as follows:

1) For TDRs that occurred during the interim or annual reporting period:

    a. By loan class, qualitative and quantitative information about how the loans were modified and the financial effects of the modification

    b. By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance for loan losses

2) For TDRs that occurred during the previous 12 months and for which there was a payment default during the interim or annual reporting period:

    a. By loan class, qualitative and quantitative information about those defaulted TDRs, including the types and amounts of TDRs that defaulted

    b. By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance for loan losses.

These disclosures are effective for public entities for interim and annual periods beginning after June 15, 2011. For nonpublic entities, the disclosures are effective for annual periods ending after December 15, 2012, including interim periods within those annual periods.

Contact Information

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