

# Troubled Debt Restructurings Job Aid: Workflow, Case Studies, and Q&As



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<sup>1</sup> Policy Statement on Prudent Commercial Real Estate Loan Workouts, October 2009

<sup>2</sup> Comptroller of the Currency, Bank Accounting Advisory Series, October 2010

## Troubled Debt Restructurings Job Aid: Workflow, Case Studies, and Q&As

### Introduction:

Troubled Debt Restructurings (TDR) is an accounting mechanism under which a lender modifies an existing debt agreement with a borrower. More specifically, a TDR occurs when a bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that the bank would not otherwise consider. The process of determining whether or not a loan modification qualifies as a TDR can be complex. This document offers examiners a workflow diagram to aid in the proper identification of TDRs, examples of situations and the resulting TDR determination, and common questions and answers. While mentioned, this document is not intended to offer guidance on some aspects of TDR accounting. Accounting guidance published by the federal agencies, as well as the FASB, can be found in the references section. This document references those publications, as well materials provided by the state banking departments.

### The basics:

Determining whether a loan modification is a TDR is a two-step process. Step one is to determine whether the borrower is experiencing financial difficulty. The key to that delineation is that a restructuring is deemed troubled because of a borrower's financial difficulty. Step two is to determine whether the bank has granted a concession. It is important to highlight that not all loan modifications constitute a TDR, and not all TDRs involve a modification of terms.

### Accounting:

The accounting standards for TDRs are set forth in FASB Accounting Standards Codification™ Subtopic 310-40, Troubled Debt Restructurings by Creditors. In April 2011, the FASB issued Accounting Standards Update 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*, which provided greater clarity when determining whether a modification is a TDR. Some of the provisions in this update become effective for nonpublic entities beginning with periods after December 15, 2012. Entities are permitted to adopt these provisions early. Prior to the codification standards, TDRs were addressed by Statement of Financial Accounting No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, and by Statement of Financial Accounting Standards No. 114, Accounting by Creditors for Impairment of a Loan. The Call Report Glossary has an entry for TDR accounting and reporting.

### Responsibilities of the institution:

Institutions are expected to have adequate procedures and policies in place that facilitate the identification and reporting of Troubled Debt Restructurings. During an examination, examiners are encouraged to determine whether the institution has established policies and procedures for assessing the accounting consequences of loan modifications that include determining whether the loan modification meets the definition of a TDR. This procedure is outlined in Examination Documentation Module: *TDR Core Analysis* linked below.

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## References:

- [Examination Documentation Module: TDR Core Analysis](#) (Links to CSBS website)
- [Policy Statement on Prudent Commercial Real Estate Loan Workouts](#) (October 30, 2009)
- [FDIC Risk Management Manual of Examination Policies – Loan Problems](#)
- [FRB Commercial Bank Examination Manual – Section 2040 \(Loan Portfolio Management\) – Page 15](#)
- [OCC Banking Circular 255: Troubled Loan Workouts & Loans to Borrowers in Troubled Industries](#)
- [Comptroller of the Currency Bank Accounting Advisory Series: Troubled Debt Restructurings, October 2010 \(Pages 28-51\)](#)
- [FASB Accounting Standards Update No. 2011-02, Receivables \(Topic 310\) \(April 2011\)](#)

## Definitions<sup>3</sup>:

### *Financial difficulties:*

In making a determination whether a borrower is experiencing financial difficulties, a creditor shall consider the following indicators of financial difficulty: (1) the borrower is currently in payment default on any of its debt, or that payment default is probable in the foreseeable future on any of its debt, (2) the borrower has declared, or is in the process of declaring, bankruptcy, (3) there is substantial doubt as to whether the debtor will continue to be a going concern, (4) the debtor has securities that have been , or are in the process of being, delisted, (5) the creditor's forecasts of the debtor's entity-specific cash flows will be insufficient to service any of its debt in accordance with the contractual terms of the existing agreement and for the foreseeable future, (6) the borrower 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 non-troubled borrower. There may be other indicators of a borrower's financial difficulty not listed here.

### *Concession:*

A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest accrued at the original contract rate. A concession has not been granted when a delay in payments is considered insignificant.

### *Insignificant delay in payment:*

A restructuring that results in only an insignificant delay in payment is not a concession. Certain factors, when considered together, may indicate that a restructuring results in an insignificant delay in payment. Examples of these factors include, but are not limited to (1) the amount of the restructured payments subject to a delay is insignificant relative to the unpaid principal or collateral value of the debt, (2) the delay in timing of the restructured payment period is insignificant relative to the frequency of payments due, the debt's original contractual maturity, or the debt's original expected duration, (3) the cumulative effect of past restructurings, if any.

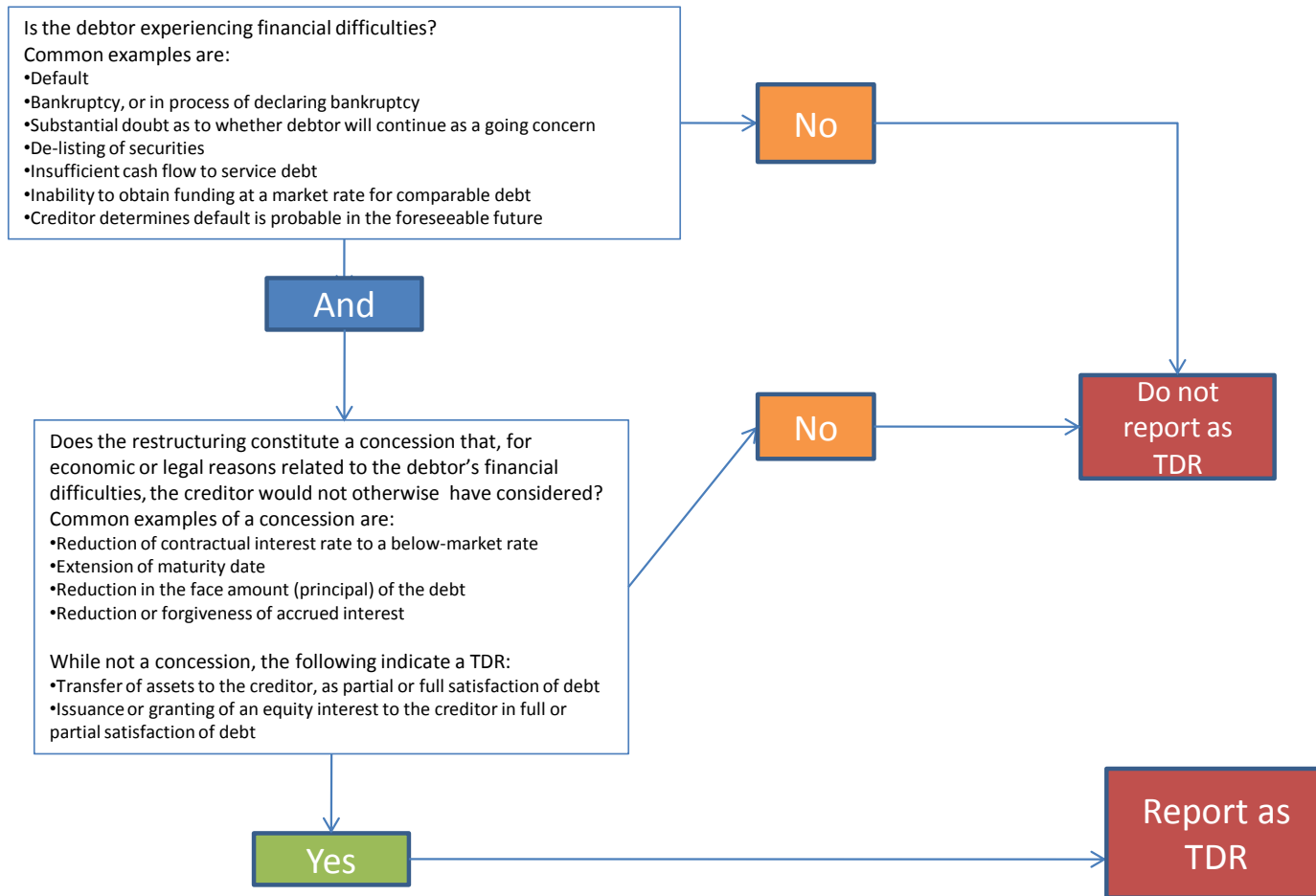
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<sup>3</sup> Financial Accounting Standards Board Accounting Standards Update No. 2011-02, Receivables (Topic 310) *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring* [April 2011]

# Troubled Debt Restructurings Job Aid: Workflow, Case Studies, and Q&As

## Workflow Diagram

### Identifying a Troubled Debt Restructuring (TDR)



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## Case Studies

### A. Income Producing Property – Office Building

**BASE CASE:** A lender originated a \$15 million loan for the purchase of an office building with monthly payments based on an amortization of 20 years and a balloon payment of \$13.6 million at the end of year three. At origination, the loan had a 75 percent loan-to-value (LTV) based on an appraisal reflecting a \$20 million market value on an “as stabilized” basis, a debt service coverage ratio of 1.35x, and a market interest rate. The lender expected to renew the loan when the balloon payment became due at the end of year three. The project’s cash flow has declined, as the borrower granted rental concessions to existing tenants in order to retain the tenants and compete with other landlords in a weak economy.

**SCENARIO 1:** At maturity, the lender renewed the \$13.6 million loan at a market rate of interest that provides for the incremental credit risk and amortized the principal over the remaining 17 years. The borrower had not been delinquent on prior payments and has sufficient cash flow to service the market rate terms at a debt service coverage ratio of 1.12x. A review of the leases reflects the majority of tenants are now stable occupants with long-term leases and sufficient cash flow to pay their rent. A recent appraisal reported an “as stabilized” market value of \$13.1 million for the property, reflecting an increase in market capitalization rates, which results in a 104 percent LTV.

Classification	Nonaccrual Treatment	TDR Treatment
Pass	Accrual	Not TDR
The borrower has the ability to continue making payments on reasonable terms despite a decline in cash flow and in the market value of the collateral.	The borrower has demonstrated the ability to make the regularly scheduled payments and, even with the decline in the borrower’s creditworthiness, cash flow appears sufficient to make these payments and full repayment of principal and interest is expected.	While the borrower is experiencing some financial deterioration, the borrower has sufficient cash flow to service the debt and has no record of payment default; therefore, the borrower is not <i>experiencing financial difficulties</i> .

**SCENARIO 2:** At maturity, the lender renewed the \$13.6 million loan at a market rate of interest that provides for the incremental risk and amortized the principal over the remaining 17 years. The borrower had not been delinquent on prior payments. The building’s net operating income has decreased and current cash flow to service the new loan has declined, resulting in a debt service coverage ratio of 1.12x. Some of the leases are coming up for renewal and additional rental concessions may be necessary to keep the existing tenants in a weak economy. However, the project’s debt service coverage is not expected to drop below 1.05x. A current valuation has not been ordered. The lender estimates the property’s current “as stabilized” market value is \$14.5 million, which results in a 94 percent LTV. In addition, the lender has not asked the borrower to provide current financial statements to assess the borrower’s ability to service the debt with cash from other sources.

Classification	Nonaccrual Treatment	TDR Treatment
Special Mention	Accrual	Not TDR
While the borrower has the ability to continue to make payments, there has been a declining trend in the property’s income stream, continued potential rental concessions, and a reduced collateral margin. In addition, the lender’s failure to request current financial information and to obtain an updated collateral valuation represents administrative deficiencies.	The borrower has demonstrated the ability to make regularly scheduled payments and, even with the decline in the borrower’s creditworthiness, cash flow is sufficient at this time to make payments and full repayment of principal and interest are expected.	While the borrower is experiencing some financial deterioration, the borrower is not <i>experiencing financial difficulties</i> as the borrower has sufficient cash flow to service the debt, and there was no history of default.

**SCENARIO 3:** At maturity, the lender restructured the \$13.6 million loan on a 12-month interest-only basis at a below market rate of interest. The borrower has been sporadically delinquent on prior payments and projects a debt service coverage ratio of 1.12x based on the preferential terms. A review of the leases, which were available to the lender at the time of the restructuring, reflects the majority of tenants have short-term leases and that some were behind on their rental payments to the borrower. According to the lender, this situation has not improved since the restructuring. A recent appraisal reported a \$14.5 million “as stabilized” market value for the property, which results in a 94 percent LTV.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard	Nonaccrual	TDR
The borrower has limited ability to service a below market rate loan on an interest-only basis, sporadic delinquencies, and the reduced collateral position.	Because the loan was not restructured with reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced estimate of cash flow from the property indicates that full repayment of principal and interest is not reasonably assured.	The borrower is <i>experiencing financial difficulties</i> : the project’s ability to generate sufficient cash flows to service the debt is questionable, the lease income from the tenants is declining, loan payments have been sporadic, and collateral values have declined. In addition, the lender granted a <i>concession</i> (i.e., reduced the interest rate to a below market level and deferred principal payments).

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## B. Income Producing Property – Shopping Mall

**BASE CASE:** A lender originated a 36-month \$10 million loan for the construction of a shopping mall to occur over 24 months with a 12-month lease-up period to allow the borrower time to achieve stabilized occupancy before obtaining permanent financing. The loan had an interest reserve to cover interest payments over the three-year term of the credit. At the end of the third year, there is \$10 million outstanding on the loan, as the shopping mall has been built and the interest reserve, which has been covering interest payments, has been fully drawn. At the time of origination, the appraisal reported an “as stabilized” market value of \$13.5 million for the property. In addition, the borrower had a take-out commitment that would provide permanent financing at maturity. A condition of the take-out lender was that the shopping mall had to achieve a 75 percent occupancy level.

Due to weak economic conditions, the property only reached a 55 percent occupancy level at the end of the 12-month lease up period and the original takeout commitment became void. Mainly due to a tightening of credit for these types of loans, the borrower is unable to obtain permanent financing elsewhere when the loan matured in February (i.e., due to market factors and not due to the borrower’s financial condition).

**SCENARIO 1:** The lender renewed the loan for an additional year to allow for a higher lease-up rate and for the borrower to seek permanent financing. The extension is at a market rate that provides for the incremental credit risk and on an interest-only basis. While the property’s historical cash flow was insufficient at 0.92x debt service ratio, recent improvements in the occupancy level now provides adequate coverage. Recent improvements include the signing of several new leases with other leases currently being negotiated.

In addition, current financial statements reflect that the builder, who personally guarantees the debt, has sufficient cash on deposit at the lender plus other liquid assets. These assets provide sufficient cash flow to service the borrower’s global debt service requirements on a principal and interest basis, if necessary. The guarantor covered the initial cash flow shortfalls from the project and provided a good faith principal curtailment of \$200,000 at renewal. A recent appraisal on the shopping mall reports an “as is” market value of \$10 million and an “as stabilized” market value \$11 million.

Classification	Nonaccrual Treatment	TDR Treatment
Pass	Accrual	Not TDR
The project continues to progress and now cash flows the interest payments. The guarantor currently has the ability and demonstrated willingness to supplement the project’s cash flow and service the borrower’s global debt service requirements. The interest-only terms were reasonable because the renewal was short-term and the project and the guarantor have demonstrated repayment capacity. In addition, this type of loan structure is commonly used	The guarantor has sufficient funds to cover the borrower’s global debt service requirements over the one-year period of the renewed loan. Full repayment of principal and interest is reasonably assured from the project’s and guarantor’s cash flow despite a decline in the collateral margin.	While the borrower has been affected by declining economic conditions, the level of deterioration does not warrant TDR treatment. The borrower was not <i>experiencing financial difficulties</i> because the borrower and guarantor have the ability to service the renewed loan, which was prudently underwritten at a market rate of interest, plus the borrower’s other obligations on a timely basis, and the lender’s expectation to collect the full amount of principal and interest from the borrower’s or guarantor’s sources (i.e., not from

to allow a project to achieve stabilized occupancy, but any subsequent loan terms should likely have a principal amortization component. The LTV should be based on the “as stabilized” market value as the lender is financing the project through the leaseup period.		interest reserves).
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**SCENARIO 2:** The lender restructured the loan on an interest-only basis at a below market rate for one year to provide additional time to increase the occupancy level and thereby enable the borrower to arrange permanent financing. The level of lease-up remains relatively unchanged at 55 percent and the shopping mall projects a debt service coverage ratio of 1.02x based on the preferential loan terms. At the time of the restructuring, the lender inappropriately based the selection of the below market interest rate on outdated financial information, which resulted in a positive cash flow projection even though file documentation available at the time of the restructuring reflected that the borrower anticipates the shopping mall’s income stream will decline due to rent concessions, the loss of a tenant, and limited prospects for finding new tenants.

Current financial statements indicate the builder, who personally guarantees the debt, is highly leveraged, has limited cash or liquid assets, and has other projects with delinquent payments. A recent appraisal on the shopping mall reports an “as is” market value of \$9 million, which results in a LTV ratio of 111 percent.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard/Loss	Nonaccrual	TDR
The amount not protected by the collateral value, \$1 million, is Loss and should be charged off. The examiner did not factor costs to sell into the loss classification analysis, as the source of repayment is not reliant on the sale of the collateral at this time. The remaining loan balance, based on the property’s “as is” market value of \$9 million, as Substandard given the borrower’s uncertain repayment capacity and weak financial support.	The partial charge-off is indicative that full collection of principal is not anticipated and the lender has continued exposure to additional loss due to the project’s insufficient cash flow and reduced collateral margin, and the guarantor’s limited ability to provide further support.	This is TDR because (a) the borrower is <i>experiencing financial difficulties</i> as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe; and (b) the lender granted a <i>concession</i> as evidenced by the reduction in the interest rate to a below market rate.

**SCENARIO 3:** Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this credit. The lender chose not to restructure the \$10 million loan into a new single amortizing note of \$10 million at a market rate of interest because the project’s projected cash flow would only provide a 0.88x debt service coverage ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reported an “as is” market value of \$9 million, which results in a LTV of 111 percent.

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Therefore, at the original loan's maturity in February, the lender restructured the \$10 million debt into two notes. The lender placed the first note of \$7.2 million (i.e., the A note) on monthly payments that amortize the debt over 20 years at a market rate of interest that provides for the incremental credit risk. The project's debt service coverage ratio equals 1.20x for the \$7.2 million loan based on the shopping mall's projected net operating income. The lender placed the second note of the remaining principal balance of \$2.8 million (i.e., the B note) into a 2 percent interest-only loan that is scheduled to reset in five years to an amortizing payment. The lender then charged-off the \$2.8 million note due to the project's lack of repayment capacity and to provide reasonable collateral protection for the remaining on-book loan of \$7.2 million. Since the restructuring, the borrower has made payments on both loans for more than six consecutive months.

Classification	Nonaccrual Treatment	TDR Treatment
Pass	Accrual	TDR
The lender restructured the original obligation into A and B notes. The lender charged off the B note, and the borrower has demonstrated the ability to repay the A note. Using this multiple note structure with the charge-off of the B note enables the lender to recognize interest income and limit the amount reported as a TDR in future periods. If the lender had restructured the loan into a single note, the credit classification and the nonaccrual and TDR treatments would have been different.	<p>The loan of \$7.2 million is returned to accrual status as the borrower has the ability to repay the loan, has a record of performing at the revised terms for more than six months, and full repayment of principal and interest is expected.</p> <p>Interest payments received on the off-book loan have been recorded as recoveries because, in this case, full recovery of principal and interest on this loan was not reasonably assured.</p>	<p>The loan should be reported as a TDR because (a) the borrower is <i>experiencing financial difficulties</i> as evidenced by the borrower's high leverage, delinquent payments on other projects, and failure to meet the proposed exit strategy because of the inability to lease the property in a reasonable timeframe and the unlikely collectability of the charged-off loan; and (b) the lender granted a <i>concession</i>. The concessions included a below market interest rate and protracted payment requirements on the charged-off portion of the debt and extending the on-book loan beyond expected timeframes.</p> <p>If the borrower continues to perform according to the modified terms of the restructured loan, the lender plans to stop reporting the on-book loan as a TDR after the regulatory reporting defined time period expires because it was restructured with a market rate of interest. For example, since the restructuring occurred in February, the \$7.2 million on-book loan should be reported as a TDR on the lender's March, June, September, and December regulatory reports. The TDR reporting could cease on the lender's following March regulatory report if the borrower</p>

		continues to perform according to the modified terms.
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**SCENARIO 4:** Current financial statements indicate the borrower and the guarantor have minimal other resources available to support this credit. The lender restructured the \$10 million loan into a new single note of \$10 million at a market rate of interest that provides for the incremental credit risk and is on an amortizing basis. The project's projected cash flow reflects a 0.88x debt service coverage ratio as the borrower has been unable to lease space. A recent appraisal on the shopping mall reports an "as is" market value of \$9 million, which results in a LTV of 111 percent. Based on the property's current market value of \$9 million, the lender charged-off \$1 million immediately after the renewal.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard	Nonaccrual	TDR
Even though the project's cash flow indicated a 1.05x debt service coverage ratio when just considering the on-book balance, the \$9 million is Substandard due to the borrower's marginal financial condition, lack of guarantor support, and uncertainty over the source of repayment.	Because the lender restructured the debt into a single note and had charged-off a portion of the loan, the repayment of the interest and principal contractually due on the entire debt is not reasonably assured. The loan can be returned to accrual status if the lender can document that subsequent improvement in the borrower's financial condition has enabled the loan to be brought fully current with respect to principal and interest and the lender expects the contractual balance of the loan (including the partial charge-off) will be fully collected. In addition, interest income may be recognized on a cash basis for the partially charged-off portion of the loan when the remaining recorded balance is considered fully collectible. However, the partial charge-off cannot be reversed.	<p>The loan should be reported as TDR because (a) the borrower is <i>experiencing financial difficulties</i> as evidenced by the high leverage, delinquent payments on other projects, and inability to meet the original exit strategy because the borrower was unable to lease the property in a reasonable timeframe; and (b) the lender granted a <i>concession</i> as evidenced by deferring payment beyond the repayment ability of the borrower.</p> <p>The charge-off indicates that the lender does not expect full repayment of principal and interest, yet the borrower remains obligated for the full amount of the debt and payments, which is at a level that is not consistent with the borrower's repayment capacity. Because the borrower is not expected to be able to comply with the loan's restructured terms, the lender would likely continue to report the loan as a TDR.</p>



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## C. Construction Loan – Single Family Residence

**BASE CASE:** The lender originated a \$400,000 construction loan on a single family “spec” residence with a 15-month maturity to allow for completion and sale of the property. The loan required monthly interest-only payments at a market rate and was based on a LTV of 70 percent at origination. During the original loan construction phase, the borrower made all interest payments from personal funds. At maturity, the home had not sold and the borrower was unable to find another lender willing to finance this property under similar terms.

**SCENARIO 1:** At maturity, the lender restructured the loan for one year on an interest-only basis at a below market rate to give the borrower more time to sell the “spec” home. Current financial information indicates the borrower has limited ability to continue to pay interest from personal funds. If the residence does not sell by the revised maturity date, the borrower plans to rent the home. In this event, the lender will consider modifying the debt into an amortizing loan with a 20-year maturity, which would be consistent with this type of income-producing investment property. Any shortfall between the net rental income and loan payments would be paid by the borrower. Due to declining home values, the LTV at the renewal date was 90 percent.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard	Nonaccrual	TDR
The loan is Substandard due to the borrower’s diminished ongoing ability to make payments and the reduced collateral position.	Though the borrower demonstrated an ability to make interest payments during the construction phase, the loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is questionable.	The should be reported as TDR because the borrower is <i>experiencing financial difficulties</i> as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A <i>concession</i> was provided by renewing the loan with a deferral of principal payments, at a below market rate (compared to the rate charged on an investment property) for an additional year when the loan was no longer in the construction phase.

**SCENARIO 2:** At maturity of the original loan, the lender restructured the debt for one year on an interest-only basis at a below market rate to give the borrower more time to sell the “spec” home. Eight months later, the borrower rented the property. At that time, the borrower and the lender agreed to restructure the loan again with monthly payments that amortize the debt over 20 years at a market rate for a residential investment property. Since the date of the second restructuring, the borrower has made all payments for over six consecutive months

Classification	Nonaccrual Treatment	TDR Treatment
Pass	Accrual	Not TDR

The lender initially assigned a Substandard grade. The loan is now considered a Pass due to the borrower’s demonstrated ability to make payments according to the modified terms for over six consecutive months.	The lender initially maintained the loan on nonaccrual, but returned it to an accruing status after the borrower made six consecutive monthly payments. Full repayment of principal and interest from the rental income is expected.	The lender reported the first restructuring as a TDR. However, the second restructuring would not be reported as a TDR. The lender determined that the borrower is <i>experiencing financial difficulties</i> as indicated by depleted cash resources and a weak financial condition; however, the lender did not grant a <i>concession</i> on the second restructuring as the loan is at market rate and terms.
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**SCENARIO 3:** The lender restructured the loan for one year on an interest-only basis at a below market rate to give the borrower more time to sell the “spec” home. The restructured loan has become 90+ days past due and the borrower has not been able to rent the property. Based on current financial information, the borrower does not have the capacity to service the debt. The lender considers repayment to be contingent upon the sale of the property. Current market data reflects few sales and similar new homes in this property’s neighborhood are selling within a range of \$250,000 to \$300,000 with selling costs equaling 10 percent, resulting in anticipated net sales proceeds between \$225,000 and \$270,000.

Classification	Nonaccrual Treatment	TDR Treatment
\$225,000 Substandard \$45,000 Doubtful \$130,000 Loss	Nonaccrual	TDR
The Loss amount results from the \$400,000 loan balance less estimated net sales proceeds of \$270,000. The Doubtful amount is based on the range in the anticipated net sales proceeds, with the remaining balance being Substandard. This classification results in the recognition of the credit risk in the collateral dependent loan based on the property’s value less costs to sell. A current valuation on the property should be obtained.	The lender placed the loan on nonaccrual when it became 60 days past due (reversing all accrued but unpaid interest) because the lender determined that full repayment of principal and interest was not reasonably assured.	The lender plans to continue reporting this loan as a TDR until the lender forecloses on the property, and transfers the asset to the other real estate owned category. The lender determined that the borrower was continuing to <i>experience financial difficulties</i> as indicated by depleted cash resources, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. In addition, the lender granted a <i>concession</i> by reducing the interest rate to a below market level.

**SCENARIO 4:** The lender committed an additional \$16,000 for an interest reserve and extended the \$400,000 loan for 12 months at a below market rate of interest with monthly interest-only payments. At the time of the examination, \$6,000 of the interest reserve had been added to the loan balance. Current financial information that the lender obtained at examiner request reflects the borrower has no other repayment sources and has not been able to sell or rent the property. An updated appraisal supports an “as is” value of \$317,650. Selling costs are estimated at 15 percent, resulting in anticipated net sales proceeds of \$270,000.



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Classification	Nonaccrual Treatment	TDR Treatment
<p>\$270,000 Substandard \$130,000 Loss</p> <p>The examiner instructed the lender to reverse the \$6,000 of capitalized interest. The loan was not restructured on reasonable repayment terms because the borrower has limited capacity to service the debt and the reduced collateral margin indicated that full repayment of principal and interest is not assured. This classification recognizes the credit risk in the collateral dependent loan based on the property's market value less costs to sell.</p> <p>The examiner also criticized management for the inappropriate use of interest reserves. The remaining interest reserve of \$10,000 is not classified because the loan should be placed on nonaccrual.</p>	<p>Nonaccrual</p> <p>The loan was not restructured on reasonable repayment terms, the borrower has limited capacity to service a below market rate on an interest-only basis, and the reduced collateral margin indicates that full repayment of principal and interest is not assured.</p> <p>The lender's decision to advance a \$16,000 interest reserve was inappropriate given the borrower's inability to repay it. The lender should reverse the capitalized interest in a manner consistent with regulatory reporting instructions and should not recognize any further interest income from the interest reserve.</p>	<p>TDR</p> <p>The loan should be reported as TDR because the borrower is <i>experiencing financial difficulties</i> as indicated by depleted cash reserves, inability to refinance this debt from other sources with similar terms, and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A <i>concession</i> was provided by renewing the loan with a deferral of principal payments, at a below market rate (compared to investment property) for an additional year when the loan was no longer in the construction phase.</p>

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## **D. Construction Loan – Land Acquisition, Condominium Construction and Conversion**

**BASE CASE:** The lender originally extended a \$50 million loan for the purchase of vacant land and the construction of a condominium project. The loan was interest-only and included an interest reserve to cover the monthly payments. The developer bought the land and began construction after obtaining purchase commitments for about a third of the planned units. Many of these pending sales were with speculative buyers who committed to buy multiple units with minimal down payments. As the real estate market softened, most of the speculative buyers failed to perform on their purchase contracts and only a limited number of the other planned units have been pre-sold.

The developer subsequently determined it was in the best interest to halt construction with the property 80 percent complete. The loan balance was drawn to \$44 million to pay construction costs (including cost overruns) and interest and the borrower estimates another \$10 million is needed to complete construction. Current financial information reflects that the developer does not have sufficient cash flow to service the debt; and while the developer does have equity in other assets, there is a question about the borrower’s ability to complete the project.

**SCENARIO 1:** The borrower agrees to grant the lender a second lien on certain assets, which provides about \$5 million in additional collateral support. In return, the lender advanced the borrower \$10 million to finish construction and the condominium was completed. The lender also agreed to extend the \$54 million loan for 12 months at a market rate of interest that provides for the incremental credit risk to give the borrower time to market the property. The borrower agreed to pay interest whenever a unit was sold with any outstanding balance due at maturity. The lender obtained a recent appraisal on the condominium building that reported a prospective “as complete” market value of \$65 million, reflecting a 24-month sell-out period and projected selling costs of 15 percent. The \$65 million prospective “as complete” market value plus the \$5 million in other collateral results in a LTV of 77 percent. The lender used the prospective “as complete” market value in its analysis and decision to fund the completion and sale of the units, and to maximize its recovery on the loan.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard	Nonaccrual	TDR
The project has limited ability to service the debt despite the 1.3x gross collateral margin	The loan should be placed on nonaccrual due to the borrower’s questionable ability to sell the units and service the debt, raising concerns as to the full repayment of principal and interest.	The loan is reported as TDR because the borrower is <i>experiencing financial difficulties</i> , as demonstrated by the insufficient cash flow to service the debt, concerns about the project’s viability, and the borrower’s inability to obtain financing from other sources. In addition, the lender provided a <i>concession</i> by advancing additional funds to finish construction and deferring payments except from sold units until the maturity date when any remaining accrued interest plus principal are due.

**SCENARIO 2:** A recent appraisal of the property reflects that the highest and best use would be conversion to an apartment building. The appraisal reports a prospective “as complete” market value

of \$60 million upon conversion to an apartment building and a \$67 million prospective “as stabilized” market value upon the property reaching stabilized occupancy. The borrower agrees to grant the lender a second lien on certain assets, which provides about \$5 million in additional collateral support.

In return, the lender advanced the borrower \$10 million, which is needed to convert the project to an apartment complex and finish construction. The lender also agreed to extend the \$54 million loan for 12 months at a market rate of interest that provides for the incremental credit risk to give the borrower time to lease the apartments. The \$60 million “as complete” market value plus the \$5 million in other collateral results in a LTV of 83 percent. The prospective “as complete” market value is used because the loan is funding the construction of the apartment building. The lender may utilize the prospective “as stabilized” market value when funding is provided for the lease-up period.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard	Nonaccrual	TDR
The project has limited ability to service the debt despite the 1.2x gross collateral margin	The borrower ability to lease the units and service the debt is untested, raising concerns as to the full repayment of principal and interest.	The loan is reported as TDR because the borrower is <i>experiencing financial difficulties</i> , as demonstrated by the insufficient cash flow to service the debt, concerns about the project’s viability, and the borrower’s inability to obtain financing from other sources. In addition, the lender provided a <i>concession</i> by advancing additional funds to finish construction and deferring payments until the maturity date without a defined exit strategy.

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## **E. Commercial Operating Line of Credit in Connection with Owner Occupied Real Estate**

**BASE CASE:** Two years ago, the lender originated a CRE loan at a market rate to a borrower whose business occupies the property. The loan was based on a 20-year amortization period with a balloon payment due in three years. The LTV equaled 70 percent at origination. A year ago, the lender financed a \$5 million interest-only operating line of credit for seasonal business operations at a market rate. The operating line of credit had a one-year maturity and was secured with a blanket lien on all the business assets. To better monitor the ongoing overall collateral position, the lender established a borrowing base reporting system, which included monthly accounts receivable aging reports. At maturity of the operating line of credit, the borrower's accounts receivable aging report reflects a growing trend of delinquency, which is causing the borrower some temporary cash flow difficulties. The borrower has recently initiated more aggressive collection efforts.

**SCENARIO 1:** The lender renewed the \$5 million operating line of credit for another year, requiring monthly interest payments at a market rate of interest. The borrower's liquidity position has tightened but remains satisfactory, cash flow to service all debt is 1.2x, and both loans have been paid according to the contractual terms. The primary repayment source is from business operations, which remain satisfactory and an updated appraisal is not considered necessary.

Classification	Nonaccrual Treatment	TDR Treatment
Pass	Accrual	Not TDR
A Pass is assigned with the understanding that the lender is monitoring the trend in the accounts receivables aging report, and the borrower's ongoing collection efforts.	The borrower has demonstrated an ongoing ability to perform, has the financial capacity to pay a market rate of interest, and full repayment of principal and interest is reasonably assured.	While the borrower has been affected by declining economic conditions, the renewal of the operating line of credit did not result in a TDR because the borrower is not <i>experiencing financial difficulties</i> and has the ability to repay both loans (which represent most of its outstanding obligations) at a market rate of interest. The lender expects full collection of principal and interest from the borrower's operating income.

**SCENARIO 2:** The lender reduced the operating line of credit to \$4 million and restructured the terms onto monthly interest-only payments at a below market rate. This action is expected to alleviate the business' cash flow problem. The borrower's company is still considered to be a going concern even though the borrower's financial performance has continued to deteriorate and sales and profitability are declining. The trend in delinquencies in accounts receivable is worsening and has resulted in reduced liquidity for the borrower.

Cash flow problems have resulted in sporadic delinquencies on the operating line of credit. The borrower's net operating income has declined, but reflects the capacity to generate a 1.08x debt service coverage ratio for both loans, based on the reduced rate of interest for the operating line of credit. The terms on the real estate loan remained unchanged. The lender internally updated the assumptions in the original appraisal and estimated the LTV on the real estate loan was 90 percent. The operating line of credit has an LTV of 80 percent with an overall LTV for the relationship of 85 percent for the relationship.

Classification	Nonaccrual Treatment	TDR Treatment
Substandard	Nonaccrual	Operating LOC: TDR Real Estate Loan: Not TDR
The classification is due to deterioration in the borrower's business operations and insufficient cash flow to repay all debt. The lender needs to monitor the trend in the business operations profitability and cash flow. The lender may need to order a new appraisal if the debt service coverage ratio continues to fall and the overall collateral margin further declines.	The operating line of credit was not renewed on market rate repayment terms, the borrower has an increasingly limited capacity to service the below market rate on an interest-only basis and there is insufficient support to demonstrate an ability to meet the new payment requirements. Since debt service for both loans is dependent on business operations, the borrower's ability to continue to perform on the real estate loan is not assured. In addition, the collateral margin indicates that full repayment of all of the borrower's indebtedness is questionable, particularly if the company fails to continue being a going concern.	The operating line of credit is reported as TDR because (a) the borrower is <i>experiencing financial difficulties</i> (as evidenced by the borrower's sporadic payment history, an increasing trend in accounts receivable delinquencies, and uncertain ability to repay the loans); and (b) the lender granted a <i>concession</i> on the line of credit through a below market interest rate. The real estate loan should not be reported as TDR since that loan had not been restructured.

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## F. Land Loan

**BASE CASE:** Three years ago, the lender originated a \$3.25 million loan to a borrower for the purchase of raw land that the borrower was seeking to have zoned for residential use. The loan had a three-year term and required monthly interest-only payments at a market rate that the borrower has paid from existing financial resources. An appraisal obtained at origination reflected an “as is” market value of \$5 million, which resulted in a 65 percent LTV. The borrower was successful in obtaining the zoning change and has been seeking construction financing for a townhouse development and to repay the land loan. At maturity, the borrower requested an extension to provide additional time to secure construction financing that would include repayment of the land loan.

**SCENARIO 1:** The borrower provided the lender with current financial information, demonstrating the ability to make principal and interest payments. Further, the borrower made a principal payment of \$250,000 in exchange for an extension of the maturity date of the loan. The borrower also pledged additional unencumbered collateral, granting the lender a first lien on an office building with an “as stabilized” market value of \$1 million. The financial information also demonstrates that cash flow from the borrower’s personal assets and the office building generate sufficient stable cash flow to amortize the land loan over a reasonable period of time. A recent appraisal of the raw land reflects an “as is” market value of \$3 million, which results in a 75 percent LTV when combined with the additional collateral and the principal reduction. The lender restructured a \$3 million loan with monthly principal and interest payments for another year at a market rate that provides for the incremental credit risk.

Classification	Nonaccrual Treatment	TDR Treatment
Pass	Accrual	Not TDR
The loan is Pass due to the adequate cash flow to pay principal and interest from the borrower’s personal assets and the office building. Also the borrower provided a curtailment and additional collateral to maintain a reasonable LTV.	The borrower has sufficient funds to cover the debt service requirements for the next year. Full repayment of principal and interest is reasonably assured from the collateral and the borrower’s financial resources	While the borrower has been affected by declining economic conditions, the level of deterioration does not warrant TDR treatment. The borrower was not <i>experiencing financial difficulties</i> because the borrower has the ability to service the renewed loan, which was prudently underwritten and has a market rate of interest.

**SCENARIO 2:** The borrower provided the lender with current financial information that indicated the borrower is unable to continue to make interest-only payments. The borrower has been sporadically delinquent up to 60 days on payments. The borrower is still seeking a loan to finance construction of the townhouse development, but has not been able to obtain a takeout commitment. A recent appraisal of the property reflects an “as is” market value of \$3 million, which results in a 108 percent LTV. The lender extended a \$3.25 million loan at a market rate of interest for one year with principal and interest due at maturity.

Classification	Nonaccrual Treatment	TDR Treatment
\$2,700,000 Substandard \$550,000 Loss	Nonaccrual	TDR
Though the loan is currently not past due and at a market rate of interest, the loan was not restructured on reasonable repayment terms because the borrower does not have the capacity to service the debt and full repayment of principal and interest is not assured. The Substandard portion is based on the current appraisal of \$3 million less estimated cost to sell of 10 percent or \$300,000). The remainder is classified Loss. This classification recognizes the credit risk in the collateral dependent loan based on the property’s market value less costs to sell.	The loans should be on nonaccrual because the loan was not restructured on reasonable repayment terms, the borrower does not have the capacity to service the debt, and full repayment of principal and interest is not assured.	The borrower is <i>experiencing financial difficulties</i> as indicated by the inability to refinance this debt and the inability to repay the loan at maturity in a manner consistent with the original exit strategy. A <i>concession</i> was provided by renewing the loan with a deferral of principal and interest payments for an additional year when the borrower was unable to obtain takeout financing.

## Questions and Answers

Source: Comptroller of the Currency, Bank Accounting Advisory Series  
October 2010

**Question 1:** (December 2008)

What are some examples of modifications that may represent troubled debt restructurings?

**Staff Response:**

SFAS 15 provides the following examples of modifications that may represent troubled debt restructurings:

- Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt.
- Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk.
- Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
- Reduction (absolute or contingent) of accrued interest.

Said another way, the modification is a TDR if the borrower cannot go to another lender and qualify for and obtain a loan with similar modified terms.

**Question 2:** (December 2008)

How should a bank evaluate TDR loans for impairment?

**Staff Response:**

Loans whose terms have been modified in troubled debt restructuring transactions should be evaluated for impairment, with the appropriate allowance for loan and lease losses (ALLL) adjustments under SFAS 114. This includes loans that were originally not subject to SFAS 114 prior to the restructuring, such as individual loans that were included in a large group of smaller-balance homogeneous loans collectively evaluated for impairment (i.e., retail loans).

A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due according to the original contractual terms of the loan agreement. Usually, a commercial restructured troubled loan that had been individually evaluated under SFAS 114 would already have been identified as impaired because the borrower's financial difficulties existed before the formal restructuring. For a restructured troubled loan, all amounts due according to the contractual terms means the contractual terms specified by the original loan agreement, not the contractual terms in the restructuring agreement. Therefore, if impairment is measured using an estimate of the expected future cash flows, the interest rate used to calculate the present value of those cash flows is based on the original effective interest rate on the loan (the original contractual interest rate adjusted for any net deferred loan fees or cost or any premium or discount existing at the origination or acquisition of the loan) and not the rate specified in the restructuring agreement.

**Facts:**

A bank makes a construction loan to a real estate developer. The loan is secured by a project of new homes. The developer is experiencing financial difficulty and has defaulted on the construction loan. To assist him in selling the homes, the bank agrees to give the home buyers permanent financing at a rate that is below the market rate being charged to other new home buyers.

**Question 3:**

Must a loss be recorded on the permanent loan financings?

**Staff Response:**

Yes. The bank is granting a concession it would not have allowed otherwise, because of the developer's financial condition. Therefore, this transaction is a troubled debt restructuring. Furthermore, it represents an exchange of assets. The permanent loans provided to the home buyers must be recorded at their fair value. The difference between fair value and recorded value in the loan satisfied is charged to the allowance for loan and lease losses.

**Facts:**

Assume that the real estate developer in question 3 has not yet defaulted on the construction loan. He is in technical compliance with the loan terms. However, because of the general problems within the local real estate market and specific ones affecting this developer, the bank agrees to give the home buyers permanent financing at below market rates.

**Question 4:**

Must a loss be recorded on these permanent loan financings?

**Staff Response:**

Yes. Even though the loan is not technically in default, the staff believes that the concession was granted because of the developer's financial difficulties. SFAS 15 does not require that a debtor's obligations be in default for a troubled debt restructuring to occur. It only requires that concession it would not have permitted otherwise. Therefore, this restructuring would be accounted for as an exchange of assets under the provisions of SFAS 15. Again, the permanent loans provided to the home buyers must be recorded at their fair value.

**Facts:**

A borrower owes the bank \$100,000. The debt is restructured because of the borrower's precarious financial position and inability to service the debt. In satisfaction of the debt, the bank accepts preferred stock of the borrower with a face value of \$10,000, but with only a nominal market value. The bank agrees to reduce the interest rate from 10% to 5% on the remaining \$90,000 of debt. The present value of the combined principal and interest payments due over the next five years, discounted at the effective interest rate in the original loan agreement, is \$79,000.

**Question 5:** (December 2008)

How should the bank account for this transaction?

**Staff Response:**

Securities (either equity or debt) received in exchange for cancellation or reduction of a troubled loan should be recorded at fair value. The recorded amount of the debt (\$100,000) is reduced by the fair value of the preferred stock received. Any impairment in the remaining recorded balance of the restructured loan would be measured according to the requirements of SFAS 114. In this case, if the securities have a fair value of \$1,000, the remaining loan balance of \$99,000 would be compared with the present value of the expected future payments, discounted at the effective interest rate in the original loan agreement. An allowance of \$20,000 is established through a provision for loan and lease losses. This represents the difference between the recorded balance (\$99,000) and the present value of the expected future payments (\$79,000), discounted at 10% (the original effective interest rate).

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**Facts:**

Assume a borrower owes the bank \$100,000, which is secured by real estate. The loan is restructured to release the real estate lien and requires no principal or interest payments for 10 years. At the end of the tenth year, the borrower will pay the \$100,000 principal. No interest payments are required.

As security, the borrower pledges a \$100,000 zero coupon bond that matures at the same time the loan is due (10 years). The borrower purchased the bond with funds borrowed from another financial institution. The real estate released in this restructuring was used as security to obtain those funds.

The current fair value of the zero coupon bond is \$40,000.

**Question 6:**

How should the bank account for this restructuring?

**Staff Response:**

In essence, the bank has received the security (zero coupon bond) as satisfaction of the loan. Because loan repayment is expected only from the proceeds of the security, the bank has effectively obtained control of the collateral. Accordingly, the loan should be removed from the books of the bank, and the security should be recorded in the investment account at its fair value (\$40,000). The \$60,000 difference is charged to the allowance for loan and lease losses. This conclusion is consistent with FASB Emerging Issues Task Force Consensus No. 87-18.

**Facts:**

A \$10 million loan is secured by income producing real estate. Cash flows are sufficient to service only a \$9 million loan at a current market rate of interest. The loan is on nonaccrual. The bank restructures the loan by splitting it into two separate notes. Note A is for \$9 million. It is collateral dependent and carries a current market rate of interest. Note B is for \$1 million and carries a below-market rate of interest. The bank charges off all of Note B, but does not forgive it.

**Question 7:**

Can the bank return Note A to accrual status?

**Staff Response:**

Yes, but only if all of the following conditions are met:

- The restructuring qualifies as a troubled debt restructuring (TDR) as defined by SFAS 15. In this case, the transaction is a TDR, because the bank granted a concession it would not consider normally, a below market rate of interest on Note B.
- The partial loan charge off is supported by a good faith credit evaluation of the loan(s). The charge off should also be recorded before or at the time of the restructuring. Under SFAS 5, a partial charge off may be recorded only if the bank has performed a credit analysis and determined that a portion of the loan is uncollectible.
- The ultimate collectability of all amounts contractually due on Note A is not in doubt. If such doubt exists, the loan should not be returned to accrual status.
- There is a period of satisfactory payment performance by the borrower (either immediately before or after the restructuring) before the loan (Note A) is returned to accrual status.

If any of these conditions are not met, or the terms of the restructuring lack economic substance, the restructured loan should continue to be accounted for and reported as a nonaccrual loan.

**Question 8:**

What constitutes a period of satisfactory performance by the borrower?

**Staff Response:** (December 2008)

AICPA Practice Bulletin 5 (PB 5) requires some period of performance for loans to troubled countries. The staff generally believes this guidance should also apply to domestic loans. Accordingly, the bank normally may not return Note A to accrual status until or unless this period of performance is demonstrated, except as described in Question 7.

However, neither PB 5 nor regulatory policy specify a particular period of performance. This will depend on the individual facts and circumstances of each case. Generally, we believe this period would be at least six months for a monthly amortizing loan.

Accordingly, if the borrower was materially delinquent on payments prior to the restructure, but shows potential capacity to meet the restructured terms, the loan would likely continue to be recognized as nonaccrual until the borrower has demonstrated a reasonable period of performance; again, generally at least six months (removing doubt as to ultimate collection of principal and interest in full).

If the borrower does not perform under the restructured terms, the TDR probably was not appropriately structured, and it should be recognized as nonaccrual. In this case the decision regarding accrual status would be based solely on a determination of whether full collection of principal and interest is in doubt.

**Question 9:** (September 2001)

The previous response indicates that performance is required before a formally restructured loan can be returned to accrual status. When can a restructured loan be returned to accrual status without performance?

**Staff Response:**

The staff continues to believe that evidence of performance under the restructured terms is one of the most important considerations in assessing the likelihood of full collectability of the restructured principal and interest. However, in rare situations, the TDR may coincide with another event that indicates a significant improvement in the borrower's financial condition and ability to repay. These might include substantial new leases in a troubled real estate project, significant new sources of business revenues (i.e., new contracts), and significant new equity contributed from a source not financed from the bank, etc. A preponderance of this type of evidence could obviate the need for performance or lessen the period of performance needed to assure ultimate collectability of the loan.

**Question 10:**

Given that evidence of performance under the restructured terms will likely be relied upon to determine whether to place a TDR on accrual status, can performance prior to the restructuring be considered?

**Staff Response:**

Performance prior to the restructuring should be considered in assessing whether the borrower can meet the restructured terms. Often the restructured terms reflect the level of debt service that the borrower has already been making. If this is the case, and the borrower will likely be able to continue this level of performance and fully repay the new contractual amounts due, continued performance after the restructuring may not be necessary before the loan is returned to accrual status.

**Question 11:** (September 2001)

How would the absence of an interest rate concession on Note B affect the accrual status of Note A?

**Staff Response:**

If the bank does not grant an interest rate concession on Note B nor make any other concessions, the restructuring would not qualify as a TDR. Accordingly, SFAS 15 would not apply. In substance, the bank has merely charged down its \$10 million loan by \$1 million, leaving a \$9 million recorded loan

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balance. The remaining balance should be accounted for and reported as a nonaccrual loan. Partial charge off of a loan does not provide a sufficient basis by itself for restoring the loan to accrual status. Furthermore, the bank should record loan payments as principal reductions as long as any doubt remains about the ultimate collectability of the recorded loan balance. When that doubt no longer exists, interest payments may be recorded as interest income on the cash basis.

## **Question 12:**

Assume the bank forgives Note B. How would that affect the accounting treatment?

### **Staff Response:**

Forgiving debt is a form of concession to the borrower. Therefore, a restructuring that includes the forgiveness of debt would qualify as a TDR and SFAS 15 would apply. It is not necessary to forgive debt for SFAS 15 to apply, as long as some other concession is made.

## **Question 13:** (September 2001)

Assume that Note B was not charged off, but was on nonaccrual. How would that affect the accrual status and call report TDR disclosure for Note A?

### **Staff Response:**

When a loan is restructured into two or more notes in a TDR, the restructured loans should be evaluated separately. However, since the restructured loans are supported by the same source of repayment, both would be reported as nonaccrual. Additionally, because the interest rate on Note B was below a market rate, both notes would be reported in the TDR disclosures on the call report.

### **Facts:**

Assume, as discussed in question 13, that Note B was not charged off prior to or at the time of restructuring. Also, expected cash flows will not be sufficient to repay Notes A and B at a market rate. The cash flows would be sufficient to repay Note A at a market rate.

## **Question 14:** (September 2001)

When appropriate allowances, if necessary, have been established for Note B, would Note A be reported as an accruing market-rate loan and Note B as nonaccrual?

### **Staff Response:**

No. Even after a TDR, two separate recorded balances, supported by the same source of repayment, should not be treated differently for nonaccrual or TDR disclosure. All loans must be disclosed as nonaccrual, unless the combined contractual balance and the interest contractually due is expected to be collected in full.

### **Facts:**

A bank negotiates a troubled debt restructuring on a partially charged-off real estate loan. The borrower has been unable to make contractually owed payments, sell the underlying collateral at a price sufficient to repay the obligation fully, or refinance the loan. The bank grants a concession in the form of a reduced contractual interest rate. In the restructuring, the bank splits the loan into two notes that require final payment in five years. The bank believes that market conditions will improve by the time the loan matures, enabling a sale or refinancing at a price sufficient to repay the restructured obligation in full. The original interest rate was 9 percent. Note A carries a 9 percent contractual interest rate. Note B, equal to the charged off portion, carries a zero percent rate. Note A requires that interest be paid each year at a rate of 5 percent, with the difference between the contractual rate of 9 percent and the payment rate of 5 percent capitalized. The capitalized interest

and all principal are due at maturity. Additionally, interest on the capitalized interest compounds at the 9 percent rate to maturity.

## **Question 15:** (April 2005)

If the borrower makes the interest payments at 5 percent as scheduled, can Note A be on accrual status?

### **Staff Response:**

No. The terms of the restructured loan allow for the deferral of principal payments and capitalization of a portion of the contractual interest requirements. Accordingly, these terms place undue reliance on the balloon payment for a substantial portion of the obligation. Generally, capitalization of interest is precluded when the creditworthiness of the borrower is in question. Other considerations about the appropriateness of interest capitalization are:

- Whether interest capitalization was included in the original loan terms to compensate for a planned temporary lack of borrower cash flow, or;
- Whether similar loan terms can be obtained from other lenders.

In a TDR, the answer to each of these considerations is presumed to be negative. First, the bank, in dealing with a troubled borrower, must overcome the doubt associated with the borrower's inability to meet the previous contractual terms. To do this, objective and persuasive evidence must exist for the timing and amount of future payments of the capitalized interest.

In this case, the repayment of the capitalized interest is deferred contractually until the underlying loan is refinanced or sold. A refinancing, or sale at a price adequate to repay the loan, was not possible at the time of restructuring. The bank has offered no objective evidence to remove the doubt about repayment that existed prior to the restructuring. It is relying solely on a presumption that market conditions will improve and enable the borrower to repay the principal and capitalized interest. Accordingly, the timing and collectability of future payments of this capitalized interest are uncertain.

Second, the temporary lack of cash flow is generally the reason for a TDR. Thus, capitalization of interest was not provided for in the original loan terms. Finally, the concession was granted, because of the borrower's inability to find other market financing to repay the original loan. Some loans, such as this example, are restructured to reduce periodic payments by deferring principal payments, increasing the amortization term relative to the loan term, and/or substantially reducing or eliminating the rate at which interest contractually due is periodically paid. These provisions create or increase the balloon payment significantly. Sole reliance on those types of payments does not overcome the doubt as to full collectability that existed prior to the restructuring. Other evidence should exist to support the probability of collection before return to accrual status.

In this example, the conditions for capitalization of interest were not met, and sole reliance for the full repayment was placed on the sale/refinancing. Accordingly, Note A should be maintained on nonaccrual status. To the extent that the recorded principal remains collectible, interest may be recognized on a cash basis.

### **Facts:**

A bank restructures a loan by forgiving a portion of the loan principal due and charging it off. Additionally, the bank requires that, should the borrower's financial condition recover, the borrower must pay a sum in addition to the principal and interest due under the restructured terms.

## **Question 16:**



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For the restructured loan to be eligible for return to accrual status, must the contingent payment also be deemed fully collectible?

## **Staff Response:**

No. Contingent cash payments should not be considered in assessing the collectability of amounts contractually due under the restructured terms.

## **Facts:**

A \$10 million loan is secured by income-producing real estate. As a result of a previous \$1 million charge-off, the recorded balance is \$9 million. Cash flows are sufficient to service only \$9 million of debt at a current market rate of interest. The loan is classified as nonaccrual and is restructured. However, the bank protects its collateral position by restructuring the loan into two separate payment “tranches,” rather than two separate notes. Tranche A requires \$9 million in principal payments and carries a current market rate of interest. Tranche B requires \$1 million in principal payments and carries a below-market rate of interest.

## **Question 17:**

Can the bank return Tranche A to accrual status?

## **Staff Response:**

The use of one note with two payment tranches, instead of two separate notes, does not prevent Tranche A from being returned to accrual status, as long as it meets the conditions set forth in the staff response to question 7.

## **Facts:**

A bank has a commercial real estate loan secured by a shopping center. The loan, which was originated 13 years ago, provides for a 30-year amortization with interest at Prime plus 2 percent. Two financially capable guarantors, A and B, each guarantee 25 percent of the debt. The shopping center lost its anchor tenant two years ago and is not generating sufficient cash flow to service the debt. The guarantors have been providing funds to make up the shortfall. Because of the decrease in the cash flow, the borrower and guarantors asked the bank to modify the loan agreement. The bank agrees to reduce the interest rate to Prime, and in return, both guarantors agreed to increase their guarantee from 25 percent to 40 percent each. The guarantors are financially able to support this guarantee. However, even with the increased guarantee, the borrower could not have obtained similar financing from other sources at this rate. The fair market value of the shopping center is approximately 90 percent of the current loan balance.

## **Question 18:** (September 2002)

Should the debt modification be reported as a troubled debt restructuring (TDR) since only the interest rate was reduced?

## **Staff Response:**

SFAS 15 states that a restructuring of a debt is a TDR if a creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession that it would not otherwise consider. This may include a reduction of the stated interest rate for the remaining original life of the debt. However, no single characteristic or factor taken alone determines whether a modification is a TDR.

The following factors, although not all inclusive, may indicate the debtor is experiencing financial difficulties:

- Default.
- Bankruptcy.
- Doubt as to whether the debtor will continue as a going concern.
- De-listing of securities.

- Insufficient cash flows to service the debt.
- Inability to obtain funds from other sources at a market rate for similar debt to a non-troubled borrower.

In this case, the borrower was experiencing financial difficulties, because the primary source of repayment (cash flows from the shopping center) was insufficient to service the debt, without reliance on the guarantors. Further, it was determined that the borrower could not have obtained similar financing from other sources at this rate, even with the increase in the guarantee percentage. The capacity of the guarantor to support this debt may receive favorable consideration when determining loan classification or allowance provisions. However, since the borrower was deemed to be experiencing financial difficulties and the bank granted an interest rate concession it normally would not have given, this restructuring would be considered a TDR.

## **Facts:**

Bank A made a \$95 million term loan with a maturity of June 2006 to a power company in 2001. The loan was secured by all of the property, plant, and equipment of the power plants and had an estimated fair value of \$98 million. Under the terms of the note, periodic interest payments were required. Principal payments were based on a cash flow formula.

The power plants did not generate sufficient cash flows in 2002 or 2003 to fully service the interest payments. The parent company of the power company funded the deficiencies in 2002 and 2003. In April 2004, the power company failed to make the required interest payment because of its inability to generate sufficient cash flows. Principal payments, based on the contractual cash flow formula, had not been required in any period between 2001 and 2004.

In July 2004, the parent paid \$10 million of the principal, plus all outstanding interest and fees, thereby bringing the loan fully current. This reduced the outstanding loan balance from \$95 million to \$85 million. The loan was then restructured and the remaining \$85 million was split into two notes.

- Note A is for \$45 million, with interest at current market rates. Periodic interest payments are required, and the principal is due at maturity in 2010. The bank received a first lien on the collateral. The bank maintained this note on accrual status.
- Note B is for \$40 million, with interest at current market rates capitalized into the loan balance. All principal and interest is due at maturity in 2010. The bank received a second lien on the collateral. This loan was placed on nonaccrual status.

The parent agreed to inject \$4 million in new equity into the power company in July 2005 and July 2006 to pay the required interest on Note A for two years. While the company continues to experience net losses in 2005, it is expected that cash flows will be sufficient to cover interest by the third quarter of 2006. Further, the parent has indicated that it will continue to cover interest payments on Note A until the company can generate sufficient cash flows. In addition, the fair value of the collateral is estimated at \$98 million, exceeding the combined amount of the restructured notes by approximately \$13 million.

## **Question 19:** (October 2005)

Should this restructuring be accounted for as a troubled debt restructuring (TDR)?

## **Staff Response:**

Yes. SFAS 15 states that the restructuring of a debt is a TDR if a creditor for economic or legal reasons related to the debtor’s financial difficulties grants a concession that it would not otherwise consider. The company was experiencing financial difficulties as demonstrated by the default on the interest

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payments. Further, while there was no forgiveness of interest or principal, a concession was granted by extending the maturity date and agreeing to capitalize interest on Note B.

**Question 20:** (October 2005)

Should both Notes A and B be on a nonaccrual status?

**Staff Response:**

Not necessarily, while the nonaccrual rules would normally require that both notes be on nonaccrual status, Note A has a unique structure and financial backing that distinguishes it from most restructured loans. Although both notes are supported by the same cash flows and secured by the same collateral, these unique structural differences result in different conclusions for each note regarding the appropriateness of interest accrual. These structural differences also result in a different conclusion than was reached in certain of the previous examples in this Topic. The parent paid \$10 million (plus interest and fees) to bring all past due amounts current and has demonstrated the intent and ability to continue to support the power company by its commitment to inject \$4 million capital into the company in 2005 and 2006. The parent has also indicated that additional financial support will be provided, as necessary. This capital injection and future support is sufficient to meet all required payments on Note A. Further, the previous actions of the parent sufficiently demonstrate its intent to support the borrowing. In addition, after the \$10 million payment by the parent, the collateral value exceeds all current outstanding balances by approximately \$13 million and exceeds the balance of Note A by approximately \$53 million. Based on these factors, the collection of all principal and interest is deemed reasonably assured for Note A. Accordingly accrual status is appropriate for Note A.

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**Facts:**

A bank executes short-term modifications (i.e., 12 months or less) to troubled borrowers that meet the definition of a TDR. The bank has stated that the duration of the short-term modification results in an "insignificant delay" in payment.

**Question 21:** (October 2010)

Is the bank required to apply TDR accounting to these short-term modifications?

**Staff Response:**

Yes, TDR accounting should apply to such short-term modifications. If, however, the bank determines the short-term modification meets the definition of a TDR but the impact (both quantitative and qualitative) is immaterial, the TDR accounting need not be applied. A blanket, unsupported statement that such short-term modifications are immaterial to a bank's financial reporting without a documented materiality analysis is inappropriate.

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**Facts:**

A bank executes short-term modifications (i.e., 12 months or less) to troubled borrowers that meet the definition of a TDR. The bank has stated that the duration of the short-term modification results in an "insignificant delay" in payment.

**Question 22:** (October 2010)

How should Bank B account for the second lien mortgage under FAS 114 after the first lien mortgage was modified?

**Staff Response:**

SFAS 114 specifically scopes out large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Those loans may include but are not limited to credit card, residential mortgage, and consumer installment loans. As a result, residential mortgage loans are generally evaluated for impairment as part of a group of homogenous loans under SFAS 5. The only time a residential mortgage loan is required to be analyzed for impairment under SFAS 114 is when the residential mortgage loan is modified and classified as a TDR. In the scenario described above, Bank B will include the second lien mortgage loan in its SFAS 5 allowance methodology; the second loan has not been modified and is therefore not a TDR subject to SFAS 114.

In addition, while the borrower's first lien mortgage has been modified by Bank A, Bank B may not be aware of this action. However, when Bank B becomes aware of a first lien modification, Bank B should recognize that the second lien mortgage loan borrower is facing financial difficulties and that the second lien mortgage has different risk characteristics than other second lien mortgage loans that have not had their first lien mortgage modified or are not suffering financial difficulties. Following the modification of the first lien mortgage, Bank B should consider segmenting the loan into a different SFAS 5 group that reflects the increased risk associated with this loan. Alternatively, the bank may consider applying additional environmental or qualitative factors to this loan pool to reflect the different risk characteristics.

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All questions and answers in this section were selected, based on their relevance, from the Comptroller of the Currency's Bank Accounting Advisory Series, October 2010. For more questions and answers, view the original document at:

<http://www.occ.gov/publications/publications-by-type/other-publications-reports/BAAS.pdf>