

This document and any attachments are superseded by the OCC Bank Accounting Advisory Series.

Troubled Debt Restructurings

A savings association must sometimes renegotiate loan terms to assist borrowers who are unable to meet the original terms of their loans, and maximize recovery of loans to these borrowers. Such renegotiation may result in the savings association making modifications that result in loan terms it normally would not accept. These may include:

- A lower interest rate or even no interest.
- A reduction in principal.
- A lengthier term to maturity.
- A transfer of assets from the borrower.
- The substitution or addition of a new borrower.
- Some combination of these modifications.

This renegotiation, where the savings association grants concessions to the debtor/borrower, results in a troubled debt restructuring or TDR.

LINKS

[Program](#)

Troubled debt restructurings are compromises of indebtedness designed to improve collection or reduce losses on problem loans. Savings association policy and practice should require strict controls such as dual authorization requirements and monitoring by a senior committee to prevent unneeded compromises from occurring.

Generally accepted accounting principles (GAAP) for TDRs are set forth in the following Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards (SFAS):

- No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, as amended by SFAS Nos. 114 and 121 (SFAS No. 15).
- No. 114, Accounting by Creditors for Impairment of a Loan, as amended by SFAS No. 118 (SFAS No. 114).

Troubled debts also require an evaluation of the probable loss from collection, as defined by SFAS No. 5, Accounting for Contingencies, as amended by SFAS No. 114 (SFAS No. 5).

This Section of the Handbook describes the following areas:

- Troubled debt restructurings.
- Accounting for TDRs, specifically SFAS No. 114 and [Handbook Section 260, Classification of Assets](#).
- Loans to one borrower.
- Classification.

TROUBLED DEBT RESTRUCTURINGS

According to SFAS No. 15, a TDR occurs when a savings association grants a concession it would not otherwise consider because of economic or legal reasons pertaining to the debtor's financial difficulties. A TDR may include, but is not limited to, the following transactions or any combination of the following transactions:

- The transfer of assets from the debtor to the creditor to satisfy all or part of the indebtedness when the fair value of the assets received is less than the recorded investment in the receivable. The assets transferred may be receivables from third parties, real estate, or other assets.
- Issuance of an equity interest by the debtor to the creditor to satisfy all or part of a debt. The debtor must not grant the interest pursuant to existing terms for converting debt to equity.
- Modification of the terms of debt such as the following:
 - A reduction of the interest rate for the remaining term.
 - An extension of the maturity date with a stated interest rate lower than the current market rate for new debt with similar risk.
 - Reduction in the outstanding principal amount due, or a reduction in the accrued interest due.
- Substitution or addition of debtor(s) when the substitute or additional debtor(s) control, are controlled by, or are under common control with the original debtor. When substitute or additional debtor(s) has no relationship with the original debtor after the restructuring, the association should account for the restructuring as a new loan in partial satisfaction of the original borrower's loan. In this situation, recognize any losses resulting from the new financing using the fair value of the new loan.

Not all concessions granted by the creditor constitute a TDR. For example, the following situations do not constitute a TDR:

- The assets received by the creditor for full satisfaction of the debt have a fair value equal to or greater than the recorded investment in the receivable.
- The creditor reduces the interest rate on the debt to reflect a decrease in the market interest rate.

Periods of declining interest rates may make refinancing of loans appealing to borrowers whose current contractual interest rates are higher than market interest rates. However, the value of the pledged collateral may decline. OTS encourages savings associations to work constructively with creditworthy borrowers, including instances where the refinancing of real estate-related loans involves an adjustment of the existing loan rates to current market rates. OTS will not criticize a savings association solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral declined in value. OTS will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

ACCOUNTING

SFAS Nos. 5, 15, and 114 prescribe GAAP for TDRs. SFAS No. 114 significantly changed GAAP for loss recognition in a TDR involving modification of terms.

SFAS No. 114 defines as impaired a loan subject to a TDR. Impairment of a loan exists when current information and events indicate that the savings association will be unable to collect "all amounts due" according to the contractual terms of the original loan agreement. All amounts due according to the contractual terms means the savings association will collect both the contractual interest payments and the contractual principal payments of the loan as scheduled in the loan agreement. A loan is not impaired during a delay in payment of the loan, if the creditor expects to collect all amounts, including interest at the contractual rate for the period of delay. Base support for collection of all amounts due upon the cash flow from the project and/or borrower, not the fair value estimate of the collateral.

SFAS No. 114 requires measurement of impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, it allows measurement of impairment based on the loan's observable market price, or the fair value of the collateral if the loan is collateral-dependent. A collateral-dependent loan is a loan where expected repayment depends solely on the underlying collateral. An impairment occurs when the present value of expected future cash flows (or, alternatively, the observable market price of the loan or the fair value of the collateral) is less than the recorded investment in the loan. The recorded investment in the loan includes accrued interest, net deferred loan fees or costs, and unamortized premium or discount.

SFAS No. 114 and [Examination Handbook Section 260, Classification of Assets](#), require that savings associations measure impairment based on the fair value of the collateral less costs to sell when foreclosure is probable. In addition, Section 260 requires savings associations to value and classify troubled, collateral-dependent loans on the collateral's fair value. Under Section 260, associations should not use the present value of the expected future cash flows or the loan's observable market price to value troubled, collateral-dependent loans. Thus, OTS has restricted savings associations to a single option, the fair value of the collateral (less costs to sell), for troubled, collateral-dependent loans. (See

[Examination Handbook Section 260](#) for OTS policy regarding Valuation and Classification of Troubled, Collateral-Dependent Loans.)

The effective interest rate for a loan is the rate of return implicit in the loan. A savings association should consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs would likely reduce cash flows available to repay or otherwise satisfy the loan.

The cost to sell an asset generally includes the estimated incremental direct costs to transact the sale of the asset such as broker commissions, legal and title transfer fees, and closing costs. Generally, costs to sell exclude insurance, security services, and utility costs.

An association recognizes an impairment by doing one of the following:

- Creating a valuation allowance with a corresponding charge to provision for loan losses.
- Adjusting an existing valuation allowance for the impaired loan with a corresponding charge or credit to provision for loan losses.

Savings associations recognize losses for TDRs involving a modification of terms in accordance with the provisions of SFAS No. 114. Therefore, the association should base the effective interest rate for such loans on the original contractual rate, not the rate specified in the restructuring agreement.

Effective Date and Transition

SFAS No. 114 became effective for fiscal years beginning after December 15, 1994. For TDRs restructured before the effective date of SFAS No. 114, savings associations may continue to account for and disclose them in accordance with SFAS No. 15, as long as the restructured loan remains unimpaired based on the terms specified in the pre-SFAS No. 114 restructuring agreement. If such a TDR fails to perform as agreed, or if the savings association again restructures the loan, the effective interest rate reverts back to the contractual interest rate of the original loan.

The OTS policy regarding troubled, collateral- dependent loans (including collateral-dependent TDRs) is similar in many respects to certain provisions of SFAS No. 114. [Examination Handbook Section 260](#) and SFAS No. 114 may require recognition and measurement of impairment independent of any TDR.

Timing

A TDR may occur before, at, or after the stated maturity of the debt. Time may elapse between the restructuring agreement and the effective date of the new terms of the restructuring. For GAAP purposes, the date of consummation of the restructuring agreement is the recognition date for the restructuring, not necessarily the completion date of the restructuring paperwork.

OTS acknowledges a TDR's existence when there is an agreement between the savings association and the borrower consummating the restructuring. A TDR is presumed to exist if senior management of the savings association and the borrower reach an oral agreement and memorialize the agreement in written documentation, such as a memorandum to the files, setting forth the terms of the TDR.

An oral agreement may reflect the restructuring of a loan, but is not a long-term substitute for a written agreement. The association should document in writing the consummation of a TDR within a reasonable time frame. Normally, complete restructuring occurs within six months. A claim becomes dubious when negotiations continue for a long period without producing a final written agreement for a loan restructuring. The issue of timing is important when applying GAAP because it determines when and if a savings association should account for a problem loan as a TDR under SFAS No. 15.

Receipt of Assets

The association should record assets transferred in partial or total repayment of indebtedness, including an equity interest in the debtor, at their fair value less cost to sell. Fair value is the amount the debtor could reasonably expect to receive from a current sale between a willing buyer and a willing seller; that is, other than a forced or liquidation sale.

Savings associations should measure the fair value of an asset by the market value if an active market exists. If no market exists for the assets transferred, the association should use a forecast of expected cash flows from the asset, discounted at a rate commensurate with the risk involved to arrive at the fair value.

Repossession in Substance

A creditor cannot avoid accounting for an asset at its fair value by simply avoiding a formal foreclosure. In accordance with SFAS No. 114, a savings association treats an impaired collateral-dependent real estate loan as a repossession in substance (reported as REO) once it takes possession of the collateral. This treatment stands even if the lender has not obtained legal title. Examples of taking possession include managing the collateral, proceeding with the foreclosure process, and marketing the project for sale. Savings associations base loss recognition for other troubled collateral-dependent loans on the fair value of the collateral less costs to sell if they do not anticipate full payment of the amounts due. Such loans remain in the loan category.

If a repossession in substance occurs, you should consider whether an independent appraisal is necessary. Regulation 12 CFR § 563.170 empowers OTS officials to obtain independent appraisals.

Disclosure

A savings association must disclose a loan modified and accounted for as a TDR in its audited financial statements and on reports to OTS. Audited financial reports should disclose the following information pertaining to all impaired loans including TDRs, as required in SFAS Nos. 15 and 114, if material:

- The total recorded investment in the impaired loans at the end of each period, and (1) the amount of that recorded investment for which there is a related allowance for credit losses, and (2) the amount of that recorded investment where there is no allowance.
- The creditor's interest income recognition policy including the method of recording cash receipts.

- The activity in the allowance for credit losses account, including the balance in the allowance for credit losses account at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off.

There is an exception to these disclosure requirements. There is no need to include a TDR involving a modification of terms in the disclosures in the years after the restructuring if both of the following conditions exist:

- 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.
- The loan is not impaired based on the terms specified by the restructuring agreement.

Returning Nonaccrual Loans to Accrual Status

A 1993 interagency policy statement outlines a program of interagency initiatives to reduce impediments to the availability of credit to businesses and individuals.

TDR Multiple Note Structure

The agencies conformed their reporting requirements for TDR structures involving multiple notes.

A typical example of a TDR multiple note structure is where the savings association restructures the original troubled debt with the borrower and splits the debt into two notes. The first note, or the “A” note, represents the portion of the original loan principal amount that the savings association expects to collect in full, along with contractual interest. The second note, or the “B” note, represents the portion of the original loan that the savings association charges off.

Under interagency guidance, a lender may return the “A” note to accrual status conditioned on satisfaction of the following:

- The restructuring qualifies as a TDR, as defined by SFAS No. 15, and there is economic substance to the restructuring.
- The association must charge-off the portion of the original loan represented by the “B” note before or at the time of the restructuring. The association must support the charge-off by a current, well-documented credit evaluation of the borrower’s financial condition and prospects for repayment under the modified terms.
- There is reasonable assurance of repayment and of performance in accordance with the modified terms of the “A” note.

- There is a sustained period of repayment performance (generally a minimum of six months), either immediately before or after restructuring, in accordance with the modified terms, involving payments of cash or cash equivalents.

The savings association would initially disclose the “A” note as a TDR. The savings association could eliminate such disclosure in the year following the restructuring, provided the “A” note meets the following additional conditions:

- The “A” note yields a market rate of interest. To be considered a market rate of interest, the interest rate on the “A” note at the time of the restructuring must be equal to or greater than the rate the savings association is willing to accept for a new receivable with comparable risk.
- The “A” note performs in accordance with the modified terms.

Past Due Loans

Under interagency guidance, past due loans may be returned to accrual status, even though the loans are not fully current, and any previous charge-offs not fully recovered, provided the past due loans meet the following conditions:

- There is reasonable assurance of repayment within a reasonable period, of all principal and interest amounts contractually due (including amounts past due).
- There is a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms, involving payments of cash or cash equivalents.

However, savings associations would continue to disclose past due loans that meet the above conditions, until they are fully current.

LOANS TO ONE BORROWER

The restructuring of a troubled loan constitutes a renewal, but is not a new loan for purposes of the loans-to-one-borrower (LTOB) rule, 12 CFR § 560.93, provided that the savings association advances no additional funds to the borrower. In the case of a non-conforming loan, the savings association should take reasonable efforts, consistent with safety and soundness, to make the loan conforming. In addition, the savings association should document its efforts to bring the loan into conformance. If the efforts are unsuccessful, the savings association may renew, restructure, or modify the nonconforming loan with the following provisions:

- The transaction is not done with the purpose of evading the lending limits.
- There can be no substitution of borrowers.
- The association cannot advance additional funds.

CLASSIFICATION

As with all assets of savings associations, TDRs are subject to the classification requirements of 12 CFR § 560.160, Asset Classification. Restructured loans will not automatically result in adverse classification. Conversely, a loan accounted for as a TDR is not exempt from the classification process. When evaluating TDRs for possible classification, you should use the same criteria as for all other loans. TDRs are probable candidates for adverse classification. As a practical matter, TDRs have demonstrated weakness and often require some loss recognition.

OTS will not criticize a savings association solely for refinancing or renegotiating a loan to a current market rate, even if the pledged collateral has declined in value. You will evaluate refinanced and renegotiated loans based on the borrower's creditworthiness and repayment capacity.

REFERENCES

Code of Federal Regulations (12 CFR)

§ 560.93	Lending Limitations
§ 560.160	Asset Classification
§ 560.172	Re-evaluation of Real Estate Owned
§ 563.170	Examinations and Audits; Appraisals, Establishment and Maintenance of Records
Part 564	Appraisals

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies (as amended by No. 114)
No. 15	Accounting by Debtors and Creditors for Troubled Debt Restructurings (as amended by Nos. 114 and 121)
No. 114	Accounting by Creditors for Impairment of a Loan (as amended and superseded in part by No. 118; also amends Nos. 5 and 15, in part)
No. 118	Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures (amends and supersedes, in part, No. 114)
No. 121	Accounting for Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of (amends No. 15)

EITF 96-22 Applicability of Disclosures Required By FASB Statement No. 114 When a Loan is Restructured in a Troubled Debt Restructuring Into Two (or More) Loans

American Institute of Certified Public Accountants (AICPA)

AICPA Audit and Accounting Guide for Banks and Savings Institutions (April 1, 1996).

Statement of Position (SOP) 92-3, Accounting for Foreclosed Assets (SFAS No. 121 supersedes significant portions of this SOP).

Other References

Revised Interagency Guidance on Returning Non-accrual Loans to Accrual Status (June 10, 1993)

RESCINDED