Accounting for Troubled Debt Restructurings

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Introduction

It is widely accepted that the mortgage-lending standards during the 2000s contributed to the 2008-9 financial crisis. As borrowers began to default on their mortgages, the firms holding the paper began to fail. Almost two years on from the depths of the crisis, many mortgages are delinquent or underwater. The banks servicing the mortgages usually have only two choices, to foreclose on the loan and sell the asset, or to restructure the debt. Politicians have placed immense pressure on banks to restructure these loans to allow the borrower to remain in the home. What these politicians overlook are the rules the banks must apply under U.S. Generally Accepted Accounting Principles (GAAP) when restructuring the loans. In most cases when restructuring a loan the parties involved follow the accounting guidelines classifying the process as a troubled debt restructuring (TDR).

Purpose

The purpose of this paper is to highlight the U.S. GAAP related to troubled debt restructurings and their evolution, to discuss the issues creditors and debtors face when performing a TDR, and to discuss why the standards make creditors reluctant to restructure loans en mass.

What is a Troubled Debt Restructuring (TDR)?

The Financial Accounting Standards Board (FASB) states, “A restructuring of debt constitutes a troubled debt restructuring if the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. That concession either stems from an agreement between the creditor and the debtor or is imposed by law or a court” (FASB ASC 310-40-15-5). This says that if a borrower is unable to
pay on their loan and the creditor grants a concession to the debtor, then the parties account for the restructuring as a troubled debt restructuring. “Whatever form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor’s objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it” (FASB ASC 310-40-15-7).

**Issues related to TDRs**

Creditors are in the business of making money and if they can increase the possibility of collecting on a debt by making concessions, they will do so. Statement of Financial Accounting Standard (SFAS) No. 15 “Accounting by Debtors and Creditors for Troubled Debt Restructurings,” issued in 1977, has been characterized by Steven Zeff in his paper “The Evolution of U.S. GAAP: The Political Forces Behind Professional Standards” as one of the worst accounting standards ever issued by FASB. Zeff discusses why FASB issued the standard and why it is considered substandard. He writes:

By a 5-2 vote, FASB issues SFAS 15, on accounting by debtors and creditors for troubled debt restructurings, which, in effect, allows financial institutions that agree with debtors to modify the terms of their long-term loan agreements (lengthening the term and reducing the interest rate) to avoid recording a loss on the restructuring. The banking industry argued that a requirement to recognize a loss in such circumstances would lead to reluctance by banks to renegotiate such loans, thus leading to a higher rate of business failure. The standard was heavily criticized because it ignored the economic reality of the transaction altogether (Zeff 23).
In effect, the standard said that under a troubled debt restructuring the creditor did not have to record any loss on the concessions given if the terms under restructuring at least equal the recorded investment in the receivable. Therefore, if the sum of future payments of the restructured loan at least equaled the principal investment remaining on the books, the creditor did not have to book any loss or impairment of the loan. This is an issue for Zeff since creditors record all other loan receivables as assets at the present value of expected future cash flows, and in most cases when a TDR restructuring takes place the present value of the restructured loan is less than it was previously. This allowed banks to avoid writing down their receivables, and not actually record any loss on those receivables, even with the known reduction in the true value of the asset being documented in the restructuring. The accounting rule as it was written said “if the sum of the undiscounted interest and principal payments that the creditor expected to receive in the future equaled or exceeded the current loan balance, [the creditor did not record a loss]” (Fitzsimons and Thompson 63). The problem with accounting for a transaction in this manner is that the rule says that if an undiscounted amount is larger than a discounted amount the creditor is not required to record a loss.

During the Savings and Loan crisis of the late eighties and early nineties, many lenders simply restructured loans as TDRs making sure the future undiscounted payments were higher than the present value of the receivable. The Savings and Loan institutions did not report losses on the restructurings or disclose them in their financial statements. To outsiders, the Savings and Loan institutions appeared healthy, while in reality they were either already insolvent or on a one-way street towards insolvency. The Savings and Loan crisis brought to light the problem with the TDR accounting rules.
Recognizing this flaw in the standard, FASB set out to update the accounting rules for TDR’s. They issued two additional standards, SFAS No. 114 “Accounting by Creditors for Impairment of a Loan,” in 1993 and SFAS No. 118 “Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures” in 1994. These standards changed the accounting for creditors, requiring them to show losses when economic losses had in fact occurred. These did not change the accounting for borrowers, who continue accounting as before and do not record gains, when in fact a restructuring technically provides them with an economic gain. It seems more important for accounting to require disclosure of losses than of gains.

Specifically, SFAS No. 114 outlines three methods for creditors to determine a loan’s value under a TDR. The first method requires calculating losses on impaired loans using the present value of expected future cash payments discounted at the loan’s original effective interest rate (Fitzsimons and Thompson 66). Therefore, the difference between the present value of future cash flows originally expected and the new present value of future cash flows is what the creditor records as a loss. The effective interest rate is the rate of return implicit on the loan; that is, the contractual interest rate adjusted for any net deferred loan fees or cost, premium, or discount existing at the origination or acquisition of the loan (66). The other two methods allow creditors to use the observable market price or the fair value of collateral instead of estimating and discounting cash flows. If foreclosure is probable then the creditor must measure impairment of the loan at the fair value of the collateral (67).
SFAS No. 118 updated the disclosure requirements for loans modified under a TDR. The standard states that information about previously impaired loans in a TDR need not be included in the new disclosures in years after a restructuring if:

1. 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 the restructuring for a new loan with comparable risk, and
2. the loan is not impaired based on the terms specified by the restructuring agreement (Kitchens 35).

A new Accounting Standards Update (ASU) that is slated to go into effect June 15, 2011 requires banks to disclose more information about the credit quality of financing receivables and any allowances they make for credit losses (Whitehouse 26). ASU No. 2010-20 requires reporting entities to disclose the nature and extent of TDRs that occurred during the period and their effect on the allowance for credit losses, and the nature and extent of financing receivables modified as TDRs within the previous 12 months that defaulted during the reporting period and their effect on the allowance for credit losses (ASU2010-20).

Due to the different ways creditors determine loans that fall under the TDR standard, the comparability of financial statement disclosures is adversely affected. FASB has issued ASU No. 2011-02 in order to clarify how firms evaluate whether a restructuring constitutes a troubled debt restructuring. It says, “a creditor must separately conclude that both of the following exist, the restructuring constitutes a concession and the debtor is experiencing financial difficulties, in order to classify a restructuring as a TDR” (ASU2011-02).

Additionally it clarifies the guidance on a creditor’s evaluation of whether it has granted a concession as follows:
(1) If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that circumstance, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring.

(2) A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession because the new contractual interest rate on the restructured debt could still be below the market interest rate for new debt with similar risk characteristics. In such situations, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a troubled debt restructuring.

(3) A restructuring that results in a delay in payment that is insignificant is not a concession. However, an entity should consider various factors in assessing whether a restructuring resulting in a delay in payment is insignificant. The amendments include examples illustrating the assessment of whether a restructuring results in a delay in payment that is insignificant (ASU2011-02).
The ASU also clarifies the guidance on a creditor’s evaluation of whether a debtor is experiencing financial difficulties. It states, “A creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default. A creditor should evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification” (ASU2011-02).

TDR accounting rules are evolving in order to reflect the economic reality of the restructuring transaction. FASB issued the original standard with heavy influence from banks because the banks did not want to record or disclose losses on TDRs. Now that the standard aligns itself more closely with the economic reality of the transaction, creditors are very reluctant to modify loans when they must immediately take a loss on the modification. Even though many banks will record impairment of non-performing loans in an allowance account, they are not required to disclose the actual amount of loans that they feel they will never collect. Performing a TDR makes an estimated amount become a permanent amount. With the new disclosure rules taking effect, creditors must disclose more information related to those transactions. Firms also use their allowance accounts to smooth or otherwise manage their earnings. Now, when firms perform TDRs and disclose the amount of restructured loans, some of their ability to engage in earnings management is lost.

**Residential Mortgage Restructurings**

One factor that may explain why banks are reluctant to restructure residential mortgages is that through disclosure rules, financial institutions must list TDRs on their financial statements and this could suggest a greater number of loans that might become defaults in the future (Whitehouse 52). In my opinion, however the main reason banks are reluctant to perform loan
modifications of residential mortgages is because they will be required to record a loss on the restructurings. Since many banks are beginning to emerge from the huge losses they faced during the financial crisis, they seem to be putting off doing TDRs. Lenders appear to be taking other paths to resolve loans that are in default. The first option they use is to simply foreclose on the borrower and take the collateral or perform a short sale. This results in a loss, but they rid themselves of the potential for the borrower to default in the future. The second option is they allow the borrower to make a modified payment agreement to catch up the loan, this does not classify as a TDR since they are adding the missed payments to future payments. For example, if a borrower has missed two payments, the lender allows them to add a fourth of those payments to the next four payments due. However, they are merely putting off the restructuring or foreclosure to a later period, since in most cases a borrower who cannot afford the payments will not be able to afford the increased payment. Banks would be more willing to restructure loans in the current environment under the original rules where they did not have to record the loss in many cases. However, this would merely put many of those banks into future financial trouble, because by not being required to write down loans they would appear solvent while hiding huge losses.

**Conclusion**

The TDR standards as updated give the best opportunity for banks to restructure troubled mortgages, but the amount of losses they would need to record to do so would only put them into a worse financial position in the eyes of investors. Not only would firms record losses, but also through their disclosures, the firms’ investors would be able to predict future losses since many TDR loans have an increased potential to default in the future. Many banks are currently trying
to clear their books of these bad mortgage loans by foreclosing on the borrower and selling the collateral in order to emerge from the mortgage crisis and to be able to reduce the provisions they must make for future loan losses.
Works Cited


