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New FASB guidance helps to clarify TDR accounting

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Seeing a significant uptick in the number of loan modifications over the past few years, regulators and external auditors alike have been putting increased pressure on credit unions to become compliant with troubled debt restructuring rules. As a result, many institutions are receiving documents of resolution from the National Credit Union Administration for failing to properly identify and account for TDRs.

There are two primary reasons why credit unions are struggling: (1) TDRs are subjective, which means there are not always clear and concise answers, and (2) until now, there have been no regulatory or industry best practice guidelines on this issue, making it that much more challenging to properly identify, monitor and report troubled debt restructurings.

To clarify, a TDR occurs when a credit union grants a concession to a member because the member is experiencing financial difficulties. Both elements must be present for a loan modification to qualify as a TDR. The credit union must have granted a concession and the member must be experiencing financial difficulty. Concessions can be as simple as lowering the interest rate on the loan or extending the payoff date.

Seeing a need for specific industry guidelines, the Financial Accounting Standards Board has recently issued an Accounting Standards Update specifically for TDR accounting. This new guidance, ASU 2011-02, for the first time provides four specific guidelines to assist with identifying a TDR.

Guideline No. 1: This guideline focuses on the "market rate" for loan modifications and provides clarification on what constitutes a concession. It states that if the borrower does not otherwise have access to funds at a market rate for debt with similar characteristics as the restructured debt, the restructuring will be considered to be at a below-market rate, which may indicate a concession has been granted. For example, if the credit union is currently offering a 30-year, fixed-rate mortgage at 6 percent to its members, but modifies an existing 30-year, fixed-rate mortgage from 7 percent to 5 percent, then a concession has been granted because the "market rate" for the loan is 6 percent.

Guideline No. 2: A concession usually means giving something up, decreasing the interest rate or reducing the amount of principal or interest owed, but this is not necessarily always true. Under the new guidelines, a temporary or permanent *increase* in the contractual interest rate could still be considered a concession if the new interest rate on the restructured debt is below the market interest rate for new debt with similar characteristics.

As an example, a credit union may modify a loan by extending it by several years. Since the credit union is taking on more risk by extending the loan, it might increase the rate of a loan. Using the same example as above, but modifying the example so that the credit union increases the loan from 4 percent to 5 percent, even though the current market rate is 6 percent, the credit union in this example has still granted a concession by increasing to a rate lower than the current market rate.

Guideline No. 3: The third guideline states that a restructuring that results in a delay in payment that is insignificant is not considered a concession. The example provided is if a seven-year loan was extended by three months, this would not be considered a concession because the extension is not significant enough. Credit unions are encouraged to refine their loan modification policies to define by loan product type what would be considered an insignificant concession.

Guideline No. 4: The last guideline focuses on the member's future ability to service the debt. A credit union may conclude that a borrower is experiencing financial difficulties, even though the debtor is not currently in payment default. The bar has been raised on this issue and now credit unions will be required to perform more due diligence on the member at the time of modification. A credit union should evaluate whether it is probable that the borrower would be in payment default on any of its debt in the foreseeable future (the next three to six months) without a modification.

Because identifying a TDR is so subjective, it can be extremely difficult for credit unions to ensure they have properly identified and accounted for all TDRs. Unfortunately, regulators and external auditors still expect the credit union to properly identify and account for them. The new FASB guidance will hopefully ease some of the confusion when it comes to TDR identification. The two main points are:

(1) It is all about the market rate. How does the rate we are giving in the modification compare to what we would give the member if this were a new loan and the borrower was not experiencing financial hardship; and

(2) No longer can credit unions simply rely on whether the member is currently delinquent at the time of modification to determine if the member is having financial difficulty. The credit union must perform additional due diligence and determine if the member is gong to be in default in the near future.

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