WILARY WINN LLC

Advice to Strengthen Financial Institutions

Troubled Debt Restructurings (TDRs) Under the Current Expected Credit Loss (CECL) Standard

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INTRODUCTION

Financial institutions that have adopted CECL can account for TDRs using the methods it uses to estimate its credit losses under CECL. Estimation methods include static pool, vintage, and roll rate analyses. Discounted cash flow methods can also be used and in some cases are required.

Wilary Winn notes that in March 2022, FASB eliminated the TDR accounting for financial institutions that have adopted CECL. Please see our April 2022 blog post.

KEY TAKEAWAY

Wilary Winn provides turnkey TDR calculations using the discounted cash flow method.

HOW CAN WE HELP YOU?

Founded in 2003, Wilary Winn LLC and its sister company, Wilary Winn Risk Management LLC, provide independent, objective, fee-based advice to nearly 600 financial institutions located across the country.

We provide the following services:

CECL & ALM

Holistic solutions to measure, monitor and mitigate interest rate, liquidity, and credit risk on an integrated basis.

MERGERS & ACQUISITIONS

Independent, fee-based determinations of fair value for mergers and acquisitions.

VALUATION OF LOAN SERVICING

Comprehensive and cost-effective valuations of servicing arising from the sale of residential mortgage, SBA 7(a), auto, home equity and commercial loans.

ADDITIONAL SERVICES

Services to support our CECL, ALM, Fair Value and Loan Servicing product offerings.

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TDRs Under the CECL Standard

The timeframe is fast approaching for the implementation of the new Current Expected Credit Loss (CECL) standard, beginning with the early adoption period in the start of 2019. The CECL standard requires a significant change to how financial institutions account for and calculate their loan reserves. Among the details in the new standard is the provision that expected credit losses be measured over the expected life of the loan and recorded on day one. However, there has been much discussion in the industry over the estimating of losses on troubled debt restructurings, or “TDRs” under CECL. How are these loans different when estimating losses? Are there certain methods that institutions will be required to use when calculating losses on TDRs? This white paper will address these questions along with highlighting the effect CECL will have on troubled debt restructurings.

What is a TDR?

A troubled debt restructuring occurs when the original contractual terms of a loan are modified, or concessions are made to accommodate a borrower who is experiencing financial duress. Loan modifications/concessions can include reduction of interest rates, reduced payment amounts, extension of the loan term, etc. Lenders engage in the restructuring of debts in the hopes of minimizing potential losses and/or acquiring a higher return an investment than would be received if the troubled loans resulted in bankruptcy or if a foreclosure or repossession occurred.

“Reasonably Expected” TDRs

As stated previously, CECL requires expected credit losses to be measured over the expected life of the loan. An institution is encouraged to include expected prepayment speeds when considering the term, however it should not include any delays/modifications to the loan terms unless it *reasonably expects* to initiate a TDR with the borrower. However, the meaning of the term “reasonably expects” is not thoroughly defined in the accounting guidance. Financial institutions should use their best judgement in determining the likeliness of executing a TDR on particular loan or groups of loans.

Generally speaking, “the determination that there is a reasonable expectation of a TDR at the reporting date would be made after the bank has knowledge that the borrower is experiencing financial difficulty, but prior to the bank granting a concession to the borrower.[1]” Thus, an institution is expected to evaluate the likeliness of initiating a TDR on each loan/group of loans and factor in that knowledge when estimating credit losses.

Measuring Expected Credit Losses for TDRs

COLLATERAL IMPLICATIONS

In many TDR situations, repayment is largely expected to be covered through the sale of collateral. In these circumstances, an institution should measure the credit loss on the basis of the fair value of the collateral as of the reporting date. It should take into consideration any costs associated with selling the

[1] *Bank Accounting Advisory Series*. Credit Losses Section 12B: Troubled Debt Restructurings, p. 259. Office of the Comptroller of the Currency. Released August 2018.

collateral and deduct the amount from the fair value of the item(s). The OCC states that any expected ***future*** changes in the collateral's fair value should not be accounted for when measuring the credit loss. These changes should instead be recognized in the period that they occur.

INDIVIDUAL VS. POOLS

When determining whether to measure credit losses on an individual or pooled basis, the OCC recommends that the risk characteristics of each loan be analyzed. If a particular loan shares similar risk characteristics with other loans in the portfolio, these loans should be pooled together and credit losses measured on the entire portfolio. In cases where a loan's risk attributes are unique and cannot be grouped with other similar loans, the institution should measure losses on an individual basis.

METHODS

Various methods that can be used to measure credit losses under CECL, including static pool, vintage analysis, roll-rate, and discounted cash flow, among others.

An institution may choose to use any of these methods when estimating losses on individual or pooled loans. However, there are certain scenarios in estimating losses for troubled debt restructurings under the CECL standard that require the use of the *discounted cash flow (DCF) method.*

In the August 2018 publication of its *Bank Accounting Advisory Series*, the OCC states that "the DCF method must be used to measure the value of a concession given to a borrower in a TDR if the value of that concession cannot be measured under any other method.[2]" For example, when an institution makes a concession on a loan that affects cash flows, such as interest rate concessions or term extensions, the DCF method *must* be used to measure losses on that particular loan. To clarify, the institution is allowed to use a different method to measure losses on other loans in the portfolio, however it is required by the standard to use the DCF method on loans where a concession is made (or is reasonably expected to be made) that affects cash flow.

Conclusion

Overall, the implementation of CECL indicates a significant change to how institutions account for and calculate their loan reserves. Estimating losses for TDRs is no exception. Institutions will have to determine the probability of executing a TDR on a loan and will factor that knowledge in when determining losses. Also, a credit union or bank may use whichever method it prefers when measuring losses, however it must be aware that it will have to implement the discounted cash flow method on loans where it has, or reasonably expects to, grant a concession that affects cash flows.

[2] *Bank Accounting Advisory Series*. Credit Losses Section 12B: Troubled Debt Restructurings, p. 260. Office of the Comptroller of the Currency. Released August 2018.