

Department of the Treasury

# Thrift Bulletin

# TB 85

Handbook: **Examination**Sections: **212, 240, 261**Subjects: **One- to Four-Family Residential Real Estate Lending,  
Troubled Debt Restructurings, Adequacy of Valuation Allowances**

## Regulatory and Accounting Issues Related to Modifications and Troubled Debt Restructurings of 1-4 Residential Mortgage Loans

**Summary:** This bulletin discusses loan modification and troubled debt restructuring (TDR) of 1-4 residential mortgage loans from the perspective of loan servicers and portfolio lenders. It provides guidance on the regulatory treatment and accounting for modified loans. It addresses when such modifications constitute TDRs, and how to classify, as well as, risk weight for regulatory capital purposes.

*For Further Information Contact:* Your Office of Thrift Supervision (OTS) Regional Accountant. You can access this bulletin at our web site: [www.ots.treas.gov](http://www.ots.treas.gov).

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### Background

OTS has had a longstanding policy of encouraging thrifts to work constructively with delinquent borrowers who demonstrate a willingness and ability to repay their mortgage loans. In issuing the interagency *Statement on Subprime Mortgage Lending*, the OTS reiterated its policy of encouraging thrifts to work constructively with borrowers who are delinquent, in default, or whose default is reasonably foreseeable. OTS stresses that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interests of both thrifts and borrowers.

Loan modifications include extending repayment terms, reducing interest rates, or forgiving principal and/or accrued interest. It is critical for the thrift and examiners to ensure that modified loans are properly identified, classified, risk weighted, and accounted for and reported in accordance with generally accepted accounting principles (GAAP) and regulatory reporting requirements. Otherwise, modifying loan terms for borrowers experiencing financial difficulties may have the effect of masking the level of troubled loans, and possibly lead to inappropriate and inadequate allowance for loan and lease loss (**ALLL**) estimates. Each loan modification should be reviewed by appropriate thrift management to determine if the modification is a TDR.

Appendix A lists questions and answers prepared by OTS staff to assist report preparers in determining which loan modifications are TDRs and the appropriate accounting and reporting of these transactions and loans in the Thrift Financial Report (TFR). OTS staff recommends that thrifts discuss the accounting and financial reporting with their independent public accountants.

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## Loan Modifications

Thrifts may modify loans for a number of reasons. Not all loan modifications constitute TDRs. If the modified terms are consistent with market conditions and represent terms the borrower could obtain from another lender in the current market, the modified loan is **not** a TDR. For example, in periods of declining interest rates, a thrift may be willing to reduce the interest rate on a well-secured loan to a creditworthy borrower whose contractual interest rate is higher than current market interest rates in order to retain the customer relationship.

However, during periods of market deterioration (e.g., declining housing prices and tightening credit standards), loan modifications should be presumed to be TDRs, unless that presumption can be overcome by a preponderance of evidence to the contrary. Thrifts must document the analysis performed for each loan modification to support whether the modification is or is not a TDR. In order to support that a loan modification is not a TDR, the borrower's file must include new underwriting documentation (updated property value, credit report, and income analysis) as evidence that the modification reflects market rates and terms for a new loan with comparable risk.

Thrifts may also modify loans to assist borrowers who are unable to meet the original terms of their loans, in an effort to minimize loss on the loan (maximize recovery). When a thrift services loans for others, modifications are generally governed by the provisions in the servicing agreement with the holder of the loan. The holder is often a trust operating on behalf of a group of investors who own pieces of a mortgage-backed security collateralized by a pool of loans.

A thrift acting as the servicer of a loan is contractually obligated to find the solution to payment problems that will minimize loss. The lowest-cost solution is dependent on many factors, including borrower ability and willingness to repay, the loan to value ratio (**LTV**) or conversely, the amount of borrower equity in the property, and the time and cost of foreclosure. If a foreclosure would generate significantly reduced losses for the investors, the servicer will likely foreclose. Refer to the OTS Examination Handbook Section 750 - Mortgage Banking for a more detailed description of a servicer's rights and responsibilities.

As noted, another factor in the loan modification decision is the willingness of the borrower to agree to modification terms acceptable to the servicer and investors. When a thrift renegotiates loan terms, it should consider whether:

- The borrower will be able to make the payments under the modified loan terms, and
- Losses are minimized, or recovery is maximized, for the holder / investors.

Most loan servicing agreements have been structured under the assumption that modifications of loan terms were infrequent. Historically, servicers often foreclosed on the underlying collateral when it was evident the borrower could or would no longer pay under the loan's contractual terms. Loan modifications were the exception, and only used when the modification was in the best interest of the investor, and the borrower demonstrated a willingness and ability to repay the loan under its modified terms.

It is important that the thrift establish policies, procedures, and controls for implementing loan modifications. These should address underwriting considerations, including review and analysis of the borrower's creditworthiness and repayment capacity. A thrift should determine whether, and under what terms, to undertake a loan modification, based on the borrower's willingness and ability to repay the modified loan and considering the fair value of the collateral, less cost to hold and sell. A thrift should maintain sound internal controls over granting and reporting of its modifications, such as dual authorization of modifications and monitoring of modified loans closely by a senior committee.

## Troubled Debt Restructurings

A loan modification may constitute a troubled debt restructuring (**TDR**). TDRs are compromises of indebtedness designed to improve collection or reduce losses on problem loans. A TDR results when:

- The debtor (borrower) is experiencing financial difficulties; and
- The creditor (thrift) grants a concession that it would not otherwise grant in order to collect a loan. This may include one or a combination of: lowering the contractual interest rate, extending the loan term, or forgiving a portion of principal or accrued interest.

Sometimes a thrift determines that it is in its best interest to grant a concession rather than to foreclose on the collateral property. If so, the thrift should perform and document its determination through a realistic assessment of the value of the collateral, including foreclosure, holding, and resale costs. Documentation in the borrower's loan file for each TDR decision should include: (1) an analysis of data considered when granting the TDR, and (2) evidence that the TDR has been properly authorized. A thrift may choose to perform this assessment on pools of homogeneous loans<sup>1</sup> rather than on a loan-by-loan basis when the volume of similar loan modifications is large<sup>2</sup>.

## Classification of Modified Loans

Thrifts should evaluate modified loans and TDRs for asset classification purposes pursuant to 12 CFR § 560.160, OTS Examination Handbook Section 260 – Classification of Assets, and the Uniform Retail Credit Classification and Account Management Policy (**Retail Credit Policy**) under cover of CEO Memo #128 (July 2000). The Retail Credit Policy provides standards for classification and account management of retail credit in banks and thrifts. The Retail Credit Policy generally requires that loans 90-days or more past due be classified Substandard. For closed-end and open-end credits secured by homes, any outstanding loan balance in excess of the value of the property, less cost to sell, should be charged-off when 180 days past due.

For TDRs, impairment is measured and recognized when the loans are modified and asset classification is reviewed. If the borrower was performing satisfactorily when the loan was modified<sup>3</sup>, the TDR does not necessarily have to be adversely classified. However, if a Substandard loan is restructured in a TDR, it should continue to be classified Substandard until the borrower has demonstrated a sustained period of satisfactory performance which is generally considered six consecutive months of timely payments.

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<sup>1</sup> Assessing impairment on a pool of homogeneous loans requires that the risk characteristics of the loans in the pool be very similar. A thrift should define and document each pool of loans clearly.

<sup>2</sup> See Appendix A, *Question and Answer 8* of this document for more detailed information.

<sup>3</sup> An example is a borrower who has been performing in accordance with the contractual terms during the period of a low introductory / teaser rate; however, the thrift determines that default is reasonably foreseeable when the interest rate resets to a much higher, fully-indexed interest rate and the payment increases significantly (i.e., payment shock). See Appendix A, *Introduction* and *Question and Answer 3* of this bulletin.

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## Nonaccrual

For regulatory reporting purposes, loans that are performing satisfactorily prior to restructuring are generally not required to be placed on nonaccrual, as long as the restructured payments are not significantly higher than the pre-modification payments. Loans that are in default (e.g., 90 or more days past due) are generally placed on nonaccrual status. If the loan was on nonaccrual prior to restructuring or if the new payment amount increases significantly, the loan should continue on nonaccrual status until the borrower has demonstrated a willingness and ability to make the restructured loan payments.

For TFR reporting, a thrift may remove a TDR from nonaccrual status when:

- The loan has performed according to the modified terms for a sustained period and the thrift is reasonably assured of repayment; and
- The restructured loan is well secured and collection of principal and interest under the modified terms is probable.

To determine probability of collection, the thrift should consider the borrower's historical repayment performance for a reasonable period of time. This determination may take into account performance prior to restructuring the loan and generally requires a period of at least six months of sustained performance as agreed to under the modified terms.

## TFR reporting

Loans that have undergone a TDR are reported as TDRs (on Schedule VA, if in compliance with the restructured terms; or on Schedule PD, if past due or on nonaccrual) until the loans are repaid in full. However, a restructured 1-4 residential mortgage loan that is in compliance with its modified terms and yields a market rate at the time of restructuring need not continue to be reported as a TDR beyond the first year after the restructuring.

## Risk weighting for regulatory capital purposes

One to four residential mortgages are risk weighted at 50 percent for determining risk-based capital requirements, provided they meet the definition of "Qualifying mortgage loans" under 12 CFR § 567.1. Such loans must be:


- Fully secured by a first lien on 1-4 residential property and maintain an appropriate loan to value<sup>4</sup> ratio (<90%) based on the amortized principal balance of the loan<sup>5</sup>;
- Underwritten in accordance with prudent underwriting standards; and
- Performing and not more than 90 days past due.

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<sup>4</sup> "Value," the denominator in the LTV calculation, represents the lesser of sales price or appraised value at origination of the loan. In certain circumstances, an updated appraised value may be used for purposes of the LTV calculation, subject to OTS approval.

<sup>5</sup> "Amortized principle balance of the loan," the numerator in the LTV calculation, will decline over time for an amortizing loan. As a result, amortizing loans that have LTVs > 90% at origination may become eligible for the 50% risk-weighting over time. Conversely, loans that experience negative amortization may initially meet the 50% risk-weighting criteria but become ineligible over time.

Any loan that is modified and meets the qualifying mortgage loan requirements may be risk weighted at 50 percent. One to four residential mortgage loans that do not meet the requirements are risk weighted at 100 percent.



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## **Appendix A**

### **Questions and Answers**

#### **INTRODUCTION**

Associated with 1-4 residential mortgage loan modifications and restructurings are a number of accounting and reporting questions.

A thrift may modify a loan's terms for a number of reasons. For example, thrifts may modify impaired ARM loans originated with an initial low introductory / "teaser" interest rate when the rate resets at a much higher rate. Often, the original loan products are based on an index (U. S. Treasury, LIBOR, prime, or COFI) plus a spread (e.g., LIBOR plus 5%). When the low introductory / teaser period terminates and the interest rates on these loans reset to the fully-indexed interest rates, some borrowers will be unable to keep their loans current due to a significant increase in the monthly payments ("payment shock").

In an effort to avoid foreclosure, thrifts may grant concessions to borrowers experiencing financial difficulty by reducing the interest rate below the rate which the borrowers may obtain in the current market, extending the repayment terms, and/or forgiving a portion of principal or accrued interest. These loan modifications generally constitute TDRs.

A loan modification is not necessarily a TDR. An example of a modification that would **not** be considered a TDR is when a thrift reduces the interest rate on a loan primarily to reflect a decrease in market interest rates in order to maintain a relationship with a borrower that can readily obtain a loan from another lender under similar loan terms.

A loan modification constitutes a TDR when both of the following conditions are met:

- A borrower is experiencing financial difficulties, and
- The thrift grants a concession it would not otherwise consider but for the borrower's financial difficulties.

By restructuring or modifying the loan terms, the thrift is trying to make the best of a difficult situation.

The following questions and answers are in response to inquiries made by examiners and thrifts. These answers reflect the **OTS staff's understanding of current accounting** for modified loans and those considered troubled debt restructurings based on our research, experiences, and discussions with other accounting professionals. Practice continues to evolve and guidance interpreting generally accepted accounting principles (**GAAP**) may be issued subsequent to the release of this bulletin. Users of this guidance should closely monitor developments in this area. Thrifts must follow GAAP for regulatory and financial reporting.

**The Financial Accounting Standards Board (FASB) codified GAAP; FASB's codification replaces all authoritative GAAP listed and discussed in this document. Therefore, effective September 15, 2009 accounting for TDRs is found at FASB Accounting Standards Codification (ASC) 310-40 *Receivables – Troubled Debt Restructurings by Creditors* (ASC 310-40) and 470-60 *Debt – Troubled Debt Restructurings by Debtors* (ASC 470-60).**

The accounting guidance applicable to accounting for TDRs includes:

- Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (**SFAS 15**)
- SFAS 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (**SFAS 91**)
- SFAS 114, *Accounting by Creditors for Impairment of a Loan* (**SFAS 114**)
- SFAS 118, *Accounting by Creditors for Impairment of a Loan, Income Recognition and Disclosures* (**SFAS 118**)
- AICPA Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (**SOP 03-3**)
- FASB Technical Bulletin No. 80-2, *Classification of Debt Restructuring by Debtors and Creditors* (**FTB 80-2**)
- EITF No. 02-4, *Whether a Debtor's Modification or Exchange of Debt Instruments is within the Scope of FASB Statement No. 15* (**EITF 02-4**)

This EITF includes a decision tree model which is to be applied by a debtor (borrower) when determining whether a loan modification is within the scope of SFAS 15. While written in the context of a debtor's assessment of whether a modification meets the definition of a TDR, OTS staff encourages thrifts to use this framework in assessing loan modifications. The decision tree is included as Appendix B of this document.

- EITF Topic D-80, *Application of FASB Statements No. 5<sup>6</sup> and No. 114 to a Loan Portfolio* (**EITF D-80**)

### **Question 1:**

Is a TDR an impaired loan?

### **Answer:**

Yes. TDRs are defined as impaired loans under SFAS 114, ¶8, which states: A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (both principal and interest) according to the contractual terms of the loan agreement. SFAS 114, ¶9 notes that although this impaired condition usually will have existed before a loan's terms are modified in a TDR, a loan may not have been accounted for under the provisions of SFAS 114 because of certain scope exceptions in ¶6, such as the exception for smaller balance homogeneous loans, which may include

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<sup>6</sup> SFAS 5, *Accounting for Contingencies*.

residential mortgage loans. However, SFAS 114, ¶9 clarifies that creditors must apply the provisions of SFAS 114 to all TDRs, including residential mortgage loans.

### Question 2:

For a residential mortgage loan that has undergone a TDR, how is impairment measured?

#### Answer:

SFAS 114 provides three methods - **discounted cash flow**, the primary measurement methodology; plus two practical expedient methodologies: **observable market price** and the **fair value of the collateral**, if the loan is **collateral dependent**<sup>7</sup>. (SFAS 114, ¶13).

(1) **Discounted cash flow** - A thrift measures impairment based on the present value of expected future cash flows discounted at the loan's **original** effective interest rate<sup>8</sup>.

(2) **Observable market price** - In an environment where loans are difficult or impossible to sell, an observable market price for a specific, individual loan may not exist. Observable market prices may not exist when the supply of loans held for sale exceeds demand or when sellers and purchasers are unable to agree on an exchange price.

(3) **Collateral fair value** - It is generally accepted that, by modifying a residential mortgage loan, a thrift has acknowledged that there is an additional source of repayment for the loan, other than the underlying collateral (that is, the borrower's personal cash flows). In this case, modified residential mortgage loans do not meet the definition of "collateral dependant" and impairment should not be measured using the collateral's fair value at the time of the loan modification.

### Question 3:

Is it possible that a modification of a performing loan is a TDR?

#### Answer:

Yes. A borrower may have paid as agreed according to the contractual loan terms up to the time when the thrift modifies the loan and the modification would be a TDR, if it meets the accounting definition in SFAS 15.

This might occur, for example, when the thrift modifies a loan after concluding that a borrower will be unable to meet higher periodic payments in the near future, once the interest rate resets higher. In this example, the modification would be considered a TDR where the thrift concludes that (a) the borrower is experiencing financial difficulties, and (b) the modification is a concession to the borrower that is granted for economic or legal reasons related to the borrower's financial difficulties. A persuasive indicator that the borrower is experiencing financial difficulties would be that, absent this modification, the borrower cannot obtain funds from sources other than existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled borrower. OTS staff opinion is that during periods of market deterioration (e.g., declining housing prices and tightening credit standards), loan modifications should be presumed to be TDRs, unless that presumption can be overcome by a preponderance

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<sup>7</sup> A loan is collateral dependent if the repayment of the loan is expected to be provided **solely** by operation or sale of the underlying collateral. (SFAS 114, ¶13)

<sup>8</sup> The effective interest rate of a loan is the rate of return implicit in the **original** loan, that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan. (SFAS 114, ¶14)



of evidence to the contrary. In order to support that a loan modification is not a TDR, the borrower's file must include new underwriting documentation (updated property value, credit report, and income analysis) as evidence that the modification reflects market rates and terms for a new loan with comparable risk.

In some circumstances, a thrift may modify a performing loan by reducing the interest rate to the current market rate or making other loan term concessions in order to retain a customer who could otherwise refinance with another lender at the same reduced rates and terms. Such loan modifications are **not** considered a TDR as the borrower is not being granted loan concessions.

#### **Question 4:**

In what ways do thrifts modify loans?

#### **Answer:**

There are many ways to modify or restructure a loan. Examples include:

- Reducing the interest rate,
- Extending a teaser rate period,
- Extending the maturity date,
- Forgiving a portion of the principal or accrued interest due, and/or
- Deferring payments.

#### **Question 5:**

How is the measure of impairment recorded under SFAS 114 for a TDR of a residential mortgage loan held for investment?

#### **Answer:**

If the recorded investment in the loan exceeds the present value of expected future cash flows discounted at the original effective interest rate (or other impairment measurement, as appropriate; see Question and Answer 2 above), this excess is reported as a valuation allowance (SFAS 114, ¶13).

For regulatory reporting purposes, the OTS permits thrifts to include SFAS 114 valuation allowances in the ALLL in the same manner permitted by the other federal banking regulators (FDIC, OCC, FRB) for the banks they supervise. The ALLL is a supplementary capital component included in Tier 2 capital, subject to a limitation of 1.25% of risk weighted assets. However, when a loan has a measurement of impairment under SFAS 114, any portion of the recorded investment in the loan that is identified as uncollectible, and therefore, deemed a confirmed loss, should be charged-off or represented by a specific valuation allowance. Specific valuation allowances are not includable in Tier 2 capital. For additional information, refer to the FFIEC final action "Implementation Issues Arising from SFAS 114, *Accounting by Creditors for Impairment of a Loan*", published in the Federal Register on February 10, 1995.

Note that loans within the scope of AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, (SOP 03-3) and SFAS 141R, *Business Combinations*, are subject to different accounting methods under GAAP.<sup>9</sup> Therefore, purchased loans that are accounted for under SOP 03-3 and SFAS 141R are initially recorded at fair value. "Carrying over" or creating valuation al-

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<sup>9</sup> SOP 03-3 applies to acquired loans with evidence of deterioration of credit quality since the origination of that specific loan. SFAS 141R applies to loans acquired in a business combination.

allowances for these loans is prohibited at initial recognition. The prohibition of the valuation allowance carryover applies to the purchase of an individual loan, a pool of loans, a group of loans, and loans acquired in a business combination. Valuation allowances are recognized for impairment due to credit deterioration subsequent to acquisition on loans held for investment.

Further, loans held for sale that are accounted for at the lower-of-cost-or-market [fair value] (**LOCOM**) in accordance with SFAS No. 65 *Accounting for Certain Mortgage Banking Activities*, do not have separate valuation allowances for credit losses. Loans for which the fair value option is elected are carried at fair value, with changes in fair value recognized in earnings and no separate valuation allowance recorded for credit losses.

### Question 6:

- (a) Which expected cash flows are used to measure impairment?
- (b) Which cash flows are used to calculate the effective interest rate?

### Answer:

**(a) Expected cash flows** - Expected future cash flows used in the measurement of impairment calculation represent the thrift's best estimate based on reasonable and supportable assumptions and projections of both the timing and amount of cash flows that will be received in repayment of the loan. For a modified loan, the cash flows to be used begin at the date of the loan modification. Thrifts should **not** include cash flows that have occurred in the past. Expected cash flows should include a thrift's best estimate of future prepayments, defaults, and recoveries, which may trigger consideration of the estimated timing and amount of cash flows expected from collateral disposition (including possible future foreclosure) net of expected costs to sell. See Question and Answer 8 for additional guidance on prepayment and default assumptions.

**(b) Effective interest rate** - The effective interest rate of a loan is the rate of return implicit in the **original** loan, that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan (SFAS 114, ¶14). The effective interest rate represents the thrift's expected yield over the contractual life of the loan upon its origination or acquisition, and is the discount rate used to measure impairment using the present value of **expected future cash flows** methodology. It is inappropriate to use the teaser / introductory rate as the effective interest rate. The effective interest rate is **not** based on the interest rate charged under the modified terms of the loan and prepayments are not to be assumed.

The following examples are based on the OTS staff's interpretation of SFAS 114 and regulatory preferences. Research by OTS staff identified diversity in practice, so other reasonable practices may exist. Thrifts should **consistently** apply their internal accounting policies, follow GAAP, and when necessary, have discussions with their examiners and external auditors when questions related to accounting for TDRs arise.

### *Example*

#### Assumptions

- Original mortgage loan, \$100,000
- Net deferred origination fees and costs equal zero
- Loan Term, 30-years, fully amortizing

- Initial teaser / introductory fixed rate is 5% for 3 years
- Contractual interest rate is LIBOR plus 7%
- LIBOR at origination = 4%

The loan underwent a modification determined to be a TDR at the end of year three (termination of the teaser rate period.)

- LIBOR at date of modification / TDR = 6%

What is the effective interest rate to be used in the measurement of impairment calculation?

For purposes of the present value calculation, the effective interest rate to be used for discounting is a blend of:

- 5% for 3 years, and
- 13% (LIBOR of 6% at date of modification plus 7%) for the remaining 27 years.

The above blended effective interest rate may be fixed at the date of loan modification and used whenever the loan is assessed for impairment throughout the life of the loan; or, alternatively, the discount rate may be updated for actual changes in LIBOR over the remaining 27 years of the loan. Note that this alternative method is more burdensome and rarely used in practice. (Refer to question and answer #26 in EITF Topic D-80.)

The OTS staff's interpretation is that other methods of calculating discount rates may be acceptable under the accounting guidance. For instance, continuing with the previous example, simply using an unchanging effective interest rate of 13% (LIBOR of 6% at date of modification plus 7%) over the life of the loan could also be acceptable when the difference between the blended rate and 13% is immaterial.

### Question 7:

Assume in the Question 6 example that the loan's interest rate prior to modification is floating LIBOR plus 7% since origination; in other words, there is no teaser rate period. What is the effective interest rate at the date of modification?

### Answer:

The OTS staff interpretation includes two methods that it considers reasonable:

(1) The effective interest rate is a blend of:

- Actual historical LIBOR plus 7% over the first 3 years; and
- 13% (LIBOR of 6% at date of modification plus 7% under the terms of the **original contract**) for the remaining 27 years.
- The above blended effective interest rate may be fixed at the date of loan modification and used whenever the loan is assessed for impairment throughout the life of the loan; or, alternatively, the discount rate may be updated for actual changes in LIBOR over the remaining 27 years of the loan, or

(2) A constant 13% (LIBOR of 6% at date of modification plus 7% under the terms of the **original contract**) when the difference between the blended rate and 13% is immaterial.

### **Question 8:**

Should the thrift consider that modified loans may prepay or default when estimating expected future cash flows for the calculation of the measurement of impairment?

### **Answer:**

Yes. A thrift should consider whether loans are expected to prepay or default after a modification of terms that constitutes a TDR, for both aggregated and individual loans. See the additional discussion below. In determining the timing and amount of expected future cash flows, the thrift must use its best estimate, which may include future prepayments, defaults (including charge-offs), and expected recoveries that might occur subsequent to loan modification, but prior to contractual maturity.

Given the unique characteristics of modified loans, historical prepayment rates for performing loans may not be a reasonable basis for projecting future prepayment rates on TDRs. Borrowers granted TDRs are likely to have reduced ability and financial incentive to prepay because, by definition, they have experienced financial difficulty and were provided a concession (implying more favorable loan terms than those available in the open market).

## **AGGREGATED LOANS**

SFAS 114, ¶12 permits groups of similar impaired loans with common risk characteristics to be aggregated and impairment calculated on a pool basis assuming prepayments, as long as the prepayments are probable and the timing and amount can be reasonably estimated. When a thrift estimates prepayments, it should document the reasons prepayments were assumed and describe the basis of its assumptions in determining the prepayment rates used.

Although it has been an uncommon practice for thrifts to aggregate impaired loans when estimating future cash flows, thrifts with significant volumes of modified impaired loans may choose to aggregate their TDRs with common risk characteristics and measure impairment on an aggregate basis, using appropriate historical statistics such as average recovery period (including prepayments), average amount recovered, and a composite effective interest rate. [Refer to EITF Topic D-80, question and answer #26 (e).]

## **INDIVIDUAL LOANS**

On December 23, 2008, the Center for Audit Quality (CAQ) issued Alert 2008-90, announcing the issuance of a white paper entitled, *Application of SFAS 114 to Modifications of Residential Mortgage Loans that Qualify as Troubled Debt Restructurings*. This Alert addresses accounting issues related to TDRs and includes a discussion on the use of prepayment and default estimates in projecting the expected future cash flows of the modified loan. The Alert states "...when calculating expected future cash flows for individual loans, a lender should consider whether it would be appropriate to use default and prepayment assumptions that would be relevant to an aggregated pool of loans with similar characteristics. The objective of such a calculation is to approximate – at the individual loan level – the default and prepayment rates that would have been expected for an aggregate pool of loans with similar characteristics."

The CAQ Alert 2008-90 is available on-line at:

[http://www.thecaq.org/members/alerts/CAQAlert2008\\_90\\_12232008.pdf](http://www.thecaq.org/members/alerts/CAQAlert2008_90_12232008.pdf)

(Click on "white paper")

**Question 9:**

Does the assumption of prepayment change the measure of impairment?

**Answer:**

Generally, yes. The measure of impairment changes when a prepayment assumption is incorporated because the measure of impairment is based on the present value of expected future cash flows. Depending on the nature of the modification (e.g., short-term versus long-term reduction of the interest rate), the calculated impairment loss may be higher or lower as a result of the prepayment assumptions utilized. If prepayment is assumed, repayment of the loan principal will be projected to occur at an earlier date (the prepayment date), and the expected future cash flows will include fewer interest payments. Thus, based on the same original effective interest rate, the present value of the expected future cash flows will be different when prepayment is assumed than when it is not. (SFAS 114, ¶8). Thrifts should specify and consistently apply their accounting policies regarding prepayment assumptions.

**Question 10:**

How is impairment measured when the loan is collateral dependent, i.e., repayment of the loan is expected to come solely from the sale of the collateral by the borrower, or, when the thrift anticipates foreclosure and subsequent resale?

**Answer:**

For collateral dependent loans or when foreclosure is probable, the measure of impairment is based on the fair value of the collateral less costs to sell when those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. (SFAS 114 ¶13 and EITF Topic D-80 question and answer #27.)

**Question 11:**

Should TDRs be placed on nonaccrual?

**Answer:**

A thrift should follow its established nonaccrual policy. GAAP does not provide specific guidance as to whether a loan that has been modified in a TDR should be classified as nonaccrual or not. General revenue recognition guidance under GAAP, however, states that an entity should not recognize income unless it is both earned and realizable.

Generally, if the loan was current prior to restructuring and the new payment amount is not significantly more than the prior payment amount, nonaccrual would not be required, provided the borrower is expected to continue to repay the loan according to the modified terms.

If the loan was on nonaccrual prior to restructuring or if the new payment amount increases significantly, the loan should continue on nonaccrual status until the borrower has demonstrated a willingness and ability to make the restructured loan payments. This generally requires a period of at least six months of sustained performance as agreed to under the modified loan terms.

**Question 12:**

How are TDRs reported on the TFR?

**Answer:**

TDRs are reported on Schedule VA (Consolidated Valuation Allowances and Related Data) on lines VA940 and VA942. TDRs that are 30-days or more past due or on non-accrual status are also reported on Schedule PD (Consolidated Past Due and Nonaccrual) memoranda line items PD190, 290, and 390, as appropriate.

Loans that have undergone a TDR are reported as TDRs (on Schedule VA, if in compliance with the restructured terms; or on Schedule PD, if past due or on nonaccrual) until the loans are repaid in full. However, a restructured 1-4 residential mortgage loan that is in compliance with its modified terms and yields a market rate at the time of restructuring need not continue to be reported as a TDR beyond the first year after the restructuring.

A loss is usually recognized when a loan contract undergoes a TDR, regardless of whether the loan terms are modified or the collateral is foreclosed (i.e. recorded as REO). It is possible, however, that no TDR loss is recorded for a loan in the reporting quarter when the loan is modified/foreclosed, if the loss was charged off or reported as a specific valuation allowance in a prior period.

**Question 13:**

Is there any guidance related to modifications of securitized loans in qualifying special purpose entity<sup>10</sup> (QSPE) structures?

**Answer:**

SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, is a detailed accounting standard with many specific requirements, and its application can be complicated. SFAS 140 provides numerous conditions that must be met for a transferee to meet QSPE status and for a transfer of financial assets to qualify for sales accounting treatment. Only when the transferor has relinquished control over the transferred loans, including decision-making ability, is sales accounting treatment appropriate.

The Securities and Exchange Commission (**SEC**) addressed two issues related to the “qualifying” status of QSPEs in the following hyperlinked documents. Certain actions could violate the qualifying status of a QSPE, which could result in re-recording assets formerly considered sold on a thrift's balance sheet. Thrifts that service securitized mortgage loans are encouraged to read the documents and discuss any outstanding issues with their auditors.

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<sup>10</sup> Note that the Financial Accounting Standards Board (FASB) issued SFAS 166, *Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140*, effective for annual reporting periods beginning after November 15, 2009. SFAS 166 eliminates the concept of a “qualifying” special-purpose entity. At the same time FASB issued SFAS 166, it issued SFAS 167, *Amendments to FASB Interpretation No. 46(R)* which modifies the scope/removes the exception from applying FASB Interpretation No. 46 (Revised), *Consolidated Variable Interest Entities*, to qualifying special-purpose entities. SFAS 166 changes the requirement for derecognition of financial assets. As a result, some previously derecognized financial assets will be re-recognized on the balance sheet (i.e., through consolidation). Additionally, SFAS 167 may require the consolidation of additional variable interest entities when the transferor is deemed to be the primary beneficiary.

**Default is reasonably foreseeable – July 24, 2007 SEC letter**

<http://financialservices.house.gov/072407SEC.pdf>

The SEC stated:

*A central question that was discussed was whether the ability to modify a loan when default is 'reasonably foreseeable' would preclude off-balance sheet treatment under SFAS 140.*

*As described more fully in the enclosed memo prepared by the SEC's Office of the Chief Accountant, the Commission's professional staff believes that, consistent with general agreement in practice, such loan modifications would not result in a requirement for entities to account for those securitized assets on their balance sheets. In this case, modifications undertaken when loan default is reasonably foreseeable should be consistent with the nature of modification activities that would have been permitted if a default had occurred.*

**American Securitization Framework – January 8, 2008 SEC letter**

"Streamlined Foreclosure and Loss Avoidance Framework for Securitized Subprime

Adjustable Rate Mortgage Loans"

<http://www.sec.gov/info/accountants/staffletters/hanish010808.pdf>

The SEC stated:

*OCA has read the ASF Framework and has concluded that it will not object to continued status as a QSPE if Segment 2 subprime ARM loans are modified pursuant to the specific screening criteria in the ASF Framework. Additionally, given the unique nature of the contemplated modifications and other loss mitigation activities that are recommended in the ASF Framework, OCA expects registrants to provide sufficient disclosures in filings with the Commission regarding the impact that the ASF Framework has had on QSPEs that hold subprime ARM loans.*

**Appendix B**  
**Troubled Debt Restructuring Decision Tree from:**  
EITF Issue 02-04

