A Bittersweet Goodbye to Troubled Debt Restructurings

There were lots of smiles and high-fives when ASU 2022-02 Financial Instruments – Credit Losses (Topic 326): *Troubled Debt Restructurings and Vintage Disclosures* eliminated the requirement for creditors to recognize and measure certain modifications as troubled debt restructurings (TDRs). However, this new standard does not stop at the removal of the term "troubled debt restructurings" from the FASB codification. The standard significantly expands disclosures related to loan modifications involving borrowers experiencing financial difficultly which will require institutions to modify their existing processes and controls in order to track information required for disclosure under ASU 2022-02.

Current TDR Accounting Compared to ASU 2022-02

In general, the ASU eliminates TDR recognition and measurement guidance and requires the entity to evaluate whether the modification represents a new loan or is a continuation of an existing loan. If the modification is not deemed to be a new loan, it is accounted for consistent with other loan modifications under the CECL model.

TDR Accounting	ASU 2022-02 Accounting
Two different models for loan modifications: one that applies when a lender grants concessions to a borrower experiencing financial difficulty and a second that applies to all other loan modifications.	Applies the general loan modification guidance to all loan modifications, including modifications made for borrowers experiencing financial difficulty.
Loan modifications in connection with a TDR are accounted for as the continuation of an existing loan rather than an extinguishment of the original loan and the issuance of a new loan.	Under the general loan modification guidance, a modification is treated as a new loan only if the following two conditions are met: 1. The terms of the new loan are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks. 2. Modifications to the terms of the original loan are more than minor. If either condition is not met, the modification is accounted for as the continuation of the old loan with any effect of the modification treated as a prospective adjustment to the loan's effective interest rate.
Explicitly requires a discounted cash flow approach that considers the timing of both principal and interest payments.	The CECL model does not require use of a discounted cash flow method. It does not require the method used to consider the timing of payments, and it permits institutions to project only expected principal losses.
The discount rate used is the original effective rate in the loan, not the effective rate of the modified loan.	If a discounted cash flow method is used in the CECL model, it requires the use of the loan's effective interest rate.
TDRs may not be accounted for as a new loan, and the estimate of future cash flows may consider extensions and renewals beyond the contractual term of the loan in certain circumstances.	Loan modifications may be accounted for as a new loan in certain circumstances, and it limits the estimate of future cash flows to the contractual term of the loan.

As noted above, in order to be treated as a new loan, the terms of the new loan must be at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks. Therefore, most restructurings that would have been classified as TDRs will now be accounted for as modifications.

ASU 2022-02 carries forward the existing criteria for determining whether a borrower is experiencing financial difficulty.

Financial Statement Disclosures

ASU 2022-02 adds disclosure requirements that provide information about the type and magnitude of modifications of receivables made to debtors experiencing financial difficulty, the financial effect of those modifications, and the degree of success of the modifications in mitigating potential credit losses. Included in **Appendix A** is a comparison of the TDR disclosures which are replaced by the disclosure requirements in ASU 2022-02.

The new disclosure requirements are only for modifications of receivables in the form of an interest-rate concession, principal forgiveness, or term extension to borrowers experiencing financial difficulty. Consequently, modifications in some other form (for example, a debt covenant violation waiver) are not required to be disclosed.

For a restructuring that results in only a delay in payment that is deemed insignificant, the modification made to the borrower experiencing financial difficulty is not required to be disclosed. The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

- The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.

- The delay in timing of the restructured payment period is insignificant relative to (1) the frequency of payments due under the debt, (2) the debt's original contractual maturity, or (3) the debt's original expected duration.

If the debt has been previously restructured, consideration should be given to the cumulative effect of the past restructurings made within the 12-month period prior to the current restructuring when determining whether a delay in payment resulting from the most recent current restructuring is insignificant.

Changes to Current Internal Controls and Processes

Institutions will need to document their definition of a significant modification. Identifying a complete listing of modifications to borrowers experiencing financial difficulties is key. In addition to identifying these loans, institutions need to be able to track the type of significant modification(s) made to borrowers experiencing financial difficulties. An institution may need to add flags within the loan system to identify each type of modification, which could include items such as:

1. Term extension (individual extensions greater than 3 months)
2. Rate reduction (any rate reduction)
3. Principal forgiveness (any principal forgiveness unless all payments are cured at the end of 6-month period)
4. Payment delay (greater than 6 months over the life of the loan)
5. Combination of modifications above

The date at which the modification was made needs to be tracked to disclose the performance (payment defaults, past due status, etc.) of the modified loans to borrowers experiencing financial difficulty during the last 12 months.

Current internal controls related to TDR identification and tracking will need to be adjusted to capture the new disclosure requirements of this standard. Additional controls are likely needed in order to review data inputs for the new disclosures. Changes to controls and process need to be finalized prior to adoption.

Effective Dates and Transition

The amended guidance in ASU No. 2022-02 is effective as follows:

- For institutions that have adopted CECL, for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.
- For institutions that have not yet adopted CECL, the effective dates are the same as those for CECL.

For transition relating to the recognition and measurement of TDRs, an entity may apply the amended guidance either prospectively or using a modified retrospective transition method by way of a cumulative-effect adjustment to retained earnings in the period of adoption.

For institutions who have not yet adopted CECL, the expectation is the effect of ASU 2022-02 would be recorded through equity in conjunction with the effect of CECL adoption. The table below explains how each transition method works for institutions that have already adopted CECL.

Transition Method	TDRs existing at the date of adoption	Future loan modifications after the date of adoption
Prospective	At the date of adoption, continue to account for existing TDR loans under the TDR accounting model. The allowance for credit losses is determined using a discounted cash flow approach.	Apply the general loan modification guidance in ASC 310-20-35-9 to 35-11. The allowance for credit losses is determined using the CECL model.
Modified retrospective	At the date of adoption, apply the CECL model to determine the allowance for credit losses on any existing TDR loans. The difference, if any, between a) the allowance previously determined under the TDR accounting model and b) the allowance determined under CECL is recorded through equity as a cumulative effect adjustment.	Apply the general loan modification guidance in ASC 310-20-35-9 to 35-11. The allowance for credit losses is determined using the CECL model.

Under either transition method, an entity will apply the new modification disclosure requirements on a prospective basis. In addition, upon adoption of ASU 2022-02, an entity will no longer provide the TDR disclosures, even if the entity uses the prospective transition method and has TDR loans existing at the date of adoption.

As we say our goodbyes to TDRs, let's not underestimate the new disclosure requirements and the need to evaluate and modify current processes and controls to meet the standard.

Appendix A

Included below is a comparison of TDR disclosures which are replaced by the disclosure requirements in ASU 2022-02.

	TDR Disclosures	ASU 2022-02 Disclosures
	Disclosure is dependent on if the entity has provided concession to a borrower experiencing financial difficulty.	Disclosure is dependent on whether a modification or restructuring with a borrower experiencing financial difficulty results in principal forgiveness, an interest rate reduction, an other-than-insignificant-payment delay, or a term extension. These disclosures are required regardless of whether the refinancing or restructuring is accounted for as a new loan.
For each period for which a statement of income is presented:	Troubled debt restructurings that occurred during the period:	For modifications to borrowers experiencing financial difficulty that are in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension that occurred during the period:
	a. By class of the receivable, qualitative and quantitative information, including both how the receivables were modified and the financial effects of the modifications; and	a. By class of the receivable, qualitative and quantitative information about: i. The types of modifications utilized, including the total period end amortized cost basis of the modified receivables and the percentage of modifications of receivables made to borrowers experiencing financial difficulty relative to the total period end amortized cost basis of the class of receivables; ii. The financial effect of the modifications by type, including information about the changes to contractual terms, the incremental effect of principal forgiveness on the amortized costs basis, or the reduction in weighted average interest rates (versus a range for interest rate reductions); and iii. The receivable's performance in the 12 months after a modification to a borrower experiencing financial difficulty.
	b. By portfolio segment, qualitative information about how such modifications are factored into the determination of the allowance.	b. By portfolio segment, qualitative information about how such modifications and the borrower's subsequent performance are factored into the determination of the allowance. In instances where receivables are modified in more than one manner (e.g. an interest rate reduction and term extension), the institution should provide disclosures sufficient for users of the financial statements to understand the different types of modifications provided to the borrowers. This may result in multiple separate combination categories being presented, if significant.
For each period for which a statement of income is presented:	For troubled debt restructurings within the previous 12 months and for which there was a payment default during the period:	For modifications to borrowers experiencing financial difficulty that are in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension within the previous 12 months and for which there was a payment default during the period
	a. By class of the receivable, qualitative and quantitative information about those defaulted receivables, including both the types and amount of receivables that defaulted; and	a. By class of the receivable, qualitative and quantitative information about those defaulted receivables, including: i. The type of contractual change that the modification provided; and ii. The amount of financing receivables that defaulted, including the period end amortized cost basis.
	b. By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance.	b. By portfolio segment, qualitative information about how such defaults are factored into the determination of the allowance.
As of the date of each balance sheet presented:	The amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in troubled debt restructurings.	The amount of any commitments to lend additional funds to debtors experiencing financial difficulty for which the creditor has modified the terms of the receivables in the form of principal forgiveness, an interest rate reduction, an other-than-insignificant payment delay, or a term extension (except for covenant waivers and modifications of contingent acceleration clauses) in the current reporting period.

Example disclosures are included on page 17-19 of ASU 2022-02.