
**Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency**

**Interagency Supervisory Guidance Addressing
Certain Issues Related to Troubled Debt Restructurings**

October 24, 2013

Purpose

This supervisory guidance for financial institutions¹ addresses certain issues related to the accounting treatment and regulatory credit risk grade or classification² of commercial and residential real estate loans that have undergone troubled debt restructurings (TDRs).³ This document reiterates key aspects of previously issued regulatory guidance and discusses the definition of collateral-dependent loans and the circumstances under which a charge-off is required for TDRs. The guidance for these two concepts is included to provide further clarification and ensure consistent treatment.

Background

When conducted in a prudent manner, modifications of problem loans are generally in the best interest of both the institution and the borrower and can lead to improved loan performance and reduced credit risk. Such modifications may occur before, at, or after the maturity date of a loan. The Federal Reserve, the FDIC, the NCUA and the OCC (collectively, the agencies) encourage financial institutions to work constructively with borrowers and view

¹ For purposes of this guidance, the term “financial institution” or “institution” includes national banks, federal savings associations, and federal branches and agencies supervised by the Office of the Comptroller of the Currency (OCC); state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Board of Governors of the Federal Reserve System (Federal Reserve) is the primary federal supervisor; state nonmember banks, state savings associations, and insured state branches of foreign banks for which the Federal Deposit Insurance Corporation (FDIC) is the primary federal supervisor; and federal credit unions and all other institutions for which the National Credit Union Administration (NCUA) is the federal insurer.

² Financial institutions are expected to develop and apply an internal loan grading system consistent with supervisory guidance. Banks and savings associations should maintain documentation that translates their system, if different, into the uniform regulatory classifications of substandard, doubtful, and loss. The NCUA does not require credit unions to adopt a uniform regulatory credit grading system. A credit union should apply an internal loan grade based on its evaluation of credit risk. The term “classify” within the credit union industry has typically meant “individually review to apply a percentage reserve” for allowance for loan and lease losses (ALLL) purposes. As used in this document, “classify” and “classification” in relation to a credit union’s evaluation of a credit for risk mean “grade” and “assign a credit risk grade.”

³ According to U.S. generally accepted accounting principles (GAAP), a restructuring of a 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.

prudent modifications as positive actions when they mitigate credit risk. The agencies generally will not criticize financial institutions for engaging in prudent workout arrangements, even if the modified loans result in adverse credit classifications or constitute TDRs.

This guidance is consistent with the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* and GAAP.⁴ The principal source of guidance on accounting for TDRs under GAAP is Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 310-40, *Receivables – Troubled Debt Restructurings by Creditors*.⁵ Impairment measurement for TDRs is addressed in ASC Subtopic 310-10, *Receivables - Overall*.⁶ For banks and savings associations, the Glossary section of the Federal Financial Institutions Examination Council's (FFIEC) Instructions for the Consolidated Reports of Condition and Income (Call Report), together with the Call Report Supplemental Instructions, provides additional guidance on accounting and regulatory reporting for TDRs.⁷ Similar guidance for holding companies can be found in the Glossary section of the Instructions for the Preparation of Consolidated Financial Statements for Holding Companies (FR Y-9C) and its associated Supplemental Instructions.⁸ For credit unions, the 5300 Call Report includes revised schedules and additional instructions capturing enhanced TDR data collections beginning with the quarter that ended December 31, 2012.⁹

Supervisory Policy

Accrual Treatment

A loan that is modified and determined to be a TDR in accordance with GAAP can be in either accrual or nonaccrual status at the time of the modification. A loan modified in a TDR that is on nonaccrual at the time of the loan's modification need not be maintained for its remaining life in nonaccrual status, but can be restored to accrual status if the loan meets the return-to-accrual conditions set forth in the Call Report Glossary (for banks and savings associations) or 12 CFR 741.3(b)(2) and Appendix C to Part 741 (for credit unions).

To restore a nonaccrual loan that has been formally restructured in a TDR to accrual status, an institution must perform a current, well-documented credit analysis supporting a return to accrual status based on the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the TDR must remain in nonaccrual status. The analysis must consider the borrower's sustained historical repayment performance for a reasonable period prior to the return-to-accrual date, but may take into account payments made for a reasonable period

⁴ For credit unions, this guidance complements and is consistent with recently revised 12 CFR Part 741 and new Appendix C as well as Letter to Credit Unions No. 13-CU-03 (April 2013), which transmitted Supervisory Letter No. 13-02 (March 2013), *Examiner Review of Loan Workouts and Nonaccrual*.

⁵ The former reference is FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*.

⁶ The former reference is FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*.

⁷ FFIEC Call Report materials are available at www.ffiec.gov/forms031.htm and www.ffiec.gov/forms041.htm.

⁸ FR Y-9C materials are available at <http://www.federalreserve.gov>.

⁹ 5300 Call Report materials are available at www.ncua.gov/DataApps/Pages/CRForm.aspx.

prior to the restructuring if the payments are consistent with the modified terms. A sustained period of repayment performance generally would be a minimum of six months and would involve payments in the form of cash or cash equivalents.¹⁰

An accruing loan that is modified in a TDR can remain in accrual status if, based on a current, well-documented credit analysis, collection of principal and interest in accordance with the modified terms is reasonably assured, and the borrower has demonstrated sustained historical repayment performance for a reasonable period before the modification.

Historical repayment performance in the form of interest-only payments may well raise questions about whether collection of loan principal is reasonably assured. Furthermore, a restructuring must improve collectibility of the loan in accordance with a reasonable repayment schedule.

Regulatory Credit Risk Grade or Classification

A modified loan's regulatory credit risk grade or classification and its TDR analysis are separate and distinct decisions, but the processes are related. A TDR designation means the loan is impaired for accounting purposes, but it does not automatically result in an adverse classification or credit risk grade. However, at the time of the modification, an assessment of the credit risk grade or classification should be made. All relevant factors, including the extent of the borrower's financial difficulty, should be considered when making the risk-rating assessment.¹¹ Further, a TDR designation does not automatically mean that a loan should remain adversely credit risk graded or classified for its remaining life if it already was or becomes adversely credit risk graded or classified at the time of the modification. A TDR loan should be adversely credit risk graded or classified if the loan, as modified, is inadequately protected by the current sound worth and paying capacity of the borrower or the collateral pledged, if any. In determining the credit risk grade or classification of a TDR loan at the time of a modification or at a subsequent evaluation date, a well-documented assessment of the cash flows available to service the modified loan and the extent of any collateral protection and guarantor support should be performed to form the basis for determining whether an adverse credit risk grade or classification is warranted.¹²

¹⁰ For federally insured credit unions, a demonstrated period of repayment performance is defined as six consecutive payments and is limited to Member Business Loan restructurings. For further information, see Appendix C to 12 CFR Part 741.

¹¹ For banks and savings associations, adversely classified loans are those rated substandard, doubtful, or loss under the regulatory asset classification system. For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system (that is, those loans that tend to be included on the credit union's "watch lists"). The NCUA does not require credit unions to adopt a uniform regulatory credit risk grading schematic of substandard, doubtful, and loss. See footnote 2.

¹² According to the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, cash flows should be assessed on a global basis that considers the borrower's total debt obligations.

Collateral-Dependent Loan Definition

Under GAAP, any loan modified in a TDR is an impaired loan.¹³ Impaired loans must be evaluated to determine if they are collateral dependent. Evaluating whether an impaired loan is collateral dependent is important because, for regulatory reporting purposes, an institution must measure impairment on impaired collateral-dependent loans based on the fair value of the collateral rather than the present value of expected future cash flows. An impaired loan is collateral dependent if “repayment is expected to be provided solely by the underlying collateral,”¹⁴ which includes repayment from the proceeds from the sale of the collateral,¹⁵ cash flow from the continued operation of the collateral, or both. Whether the underlying collateral is expected to be the sole source of repayment for an impaired loan is a matter requiring judgment as to the availability, reliability, and capacity of sources other than the collateral to repay the debt. Generally, repayment of an impaired loan would be expected to be provided solely by the sale or continued operation of the underlying collateral if cash flows to repay the loan from all other available sources (including guarantors) are expected to be no more than nominal. For example, the existence of a guarantor is one factor to consider when determining whether an impaired loan, including a TDR loan, is collateral dependent. To assess the extent to which a guarantor provides repayment support, the ability and willingness of the guarantor to make more-than-nominal payments on the loan should be evaluated.¹⁶

The repayment of some impaired loans collateralized by real estate may depend on cash flow generated by the operation of a business or from sources outside the scope of the lender’s security interest in the collateral, such as cash flows from borrower resources other than the collateral. These loans are generally not considered collateral dependent due to the more-than-nominal payments expected to come from these other repayment sources. For such loans, even if a portion of the cash flow for repayment is expected to come from the sale or operation of the collateral (but not solely from the sale or operation of the collateral), the loan would not be considered collateral dependent.

For example, an impaired loan collateralized by an apartment building, shopping mall, or other income-producing property where the anticipated cash flows for loan repayment are expected to be derived solely from the property’s rental income, and there are no other available and reliable repayment sources, would be considered collateral dependent because repayment is expected to be provided only from the continued operation of the collateral. However, an impaired loan secured by the owner-occupied real estate of a business (such as a manufacturer or retail store) where the anticipated cash flows to repay the loan are expected to be derived from the borrower’s ongoing business operations and activities would not be considered collateral

¹³ Under GAAP, a loan modified in a TDR is always considered impaired for impairment measurement purposes (even if the modified loan is no longer required to be disclosed as a TDR) because, based on current information and events, it is probable that the lender will be unable to collect all principal and interest due as scheduled according to the contractual terms specified by the original loan agreement.

¹⁴ See ASC Section 310-10-20.

¹⁵ The sale of the collateral can be by the borrower or, after foreclosure or repossession, by the lender.

¹⁶ For further guidance on evaluating guarantees, see the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*.

dependent because the loan is not expected to be repaid solely from cash flows from the sale or operation of the collateral. Nevertheless, if the borrower's condition worsens so that any payments from the operation of the business are expected to be nominal and repayment instead is expected to depend solely on the sale or operation of the underlying collateral, the loan would then be considered collateral dependent.

Impairment Measurement: Impaired Loan that is Collateral Dependent

Pursuant to the FFIEC Call Report instructions and interagency guidance,¹⁷ for regulatory reporting purposes an impaired collateral-dependent loan must be measured for the amount of impairment based on the fair value of the collateral regardless of whether foreclosure is probable. When the fair value of the collateral is used to measure impairment on an impaired collateral-dependent loan and repayment or satisfaction of the loan is dependent on the sale of the collateral, the fair value of the collateral must be adjusted to consider estimated costs to sell. If repayment is dependent only on the operation of the collateral, the fair value of the collateral would not be adjusted for estimated costs to sell.

Classification and Charge-Off Treatment: Impaired Loan that is Collateral Dependent

Under GAAP, a credit loss on a loan, which may be for all or part of a particular loan, should be deducted from the ALLL, and the related loan balance should be charged off in the period in which the loan is deemed uncollectible.¹⁸ The following discussion of the classification and charge-off treatment for impaired collateral-dependent loans is consistent with GAAP.

Repayment from the Sale of the Collateral

As a general regulatory credit risk grading or classification principle, for an impaired loan that is dependent solely on the sale of the collateral for repayment, any portion of the recorded investment in the loan exceeding the amount adequately secured by the fair value of the collateral less the estimated costs to sell¹⁹ is deemed to be uncollectible and, therefore, should be credit risk graded or classified loss and promptly charged off.

Any portion of the recorded investment in the loan not charged off generally should be adversely credit risk rated or classified no worse than substandard. The amount of the loan exceeding the fair value of the collateral, or portions thereof, should be adversely graded or classified doubtful when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of loss cannot be reasonably determined. If warranted by the underlying circumstances, a doubtful classification or credit risk grade may be used on the entire loan balance. However, as discussed in the October 2009

¹⁷ For example, see the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* and the December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses*.

¹⁸ See ASC paragraph 310-10-35-41.

¹⁹ This regulatory credit risk grading and charge-off treatment is consistent with the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* and supersedes the discussion of the treatment of selling costs in the answer to Question 10 in the December 2006 interagency *Questions and Answers on Accounting for Loan and Lease Losses*.

interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, a doubtful classification or credit risk grade should be used infrequently and for a limited time to permit the pending events to be resolved.

Repayment from the Operation of the Collateral

A regulatory credit risk grade or classification of loss with partial charge-off requires judgment and may not be warranted for a collateral-dependent TDR loan if repayment is dependent only on the operation of the collateral provided the modification is in accordance with a prudent workout strategy,²⁰ which includes modified terms that are reasonable for the type and risk of the credit,²¹ and the best estimate of the expected future cash flows supports the full collection of the recorded investment in the loan. In this case, the collateral-dependent TDR loan might not be adversely credit risk graded or classified depending on the facts and circumstances of the cash flow analysis.

In other circumstances, a regulatory credit risk grade or classification of loss with a partial charge-off is warranted on a collateral-dependent TDR loan for which repayment is dependent only on the operation of the collateral. For example, this treatment may be warranted for such a loan when well-defined weaknesses exist in the credit that jeopardize full, orderly repayment, such as the modified terms are not reasonable for the type and risk of the credit or the expected cash flows do not support full collection of the recorded investment in the loan.

While the amount of impairment for regulatory reporting purposes on a collateral-dependent TDR loan where repayment is dependent on the operation of the collateral represents the difference between the recorded investment in the loan and the fair value of the collateral, the charged-off amount should be based on the amount of impairment deemed uncollectible. For such a collateral-dependent TDR, when determining the amount deemed uncollectible, and therefore credit risk rated or classified loss and charged off, the institution should use the collateral's market value²² conclusion that corresponds to the workout plan, provided it

²⁰ A loan workout is in accordance with a prudent workout strategy when current financial information supports the ultimate collectibility of the debt under reasonable modified terms, which means the best estimate of the expected future cash flows is sufficient to repay or otherwise satisfy the loan (both principal and interest). The expected future cash flows should be fully supported by a complete analysis and underwriting of the financial capacity and willingness of the borrower to repay the debt as defined in the credit policy of the institution.

²¹ See Attachment 1 of the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts* for examples that address the reasonableness of the modified terms for specific workout scenarios.

²² The term "market value" as used in an appraisal is based on similar valuation concepts as "fair value" for accounting purposes under GAAP. For both terms, these valuation concepts about the real property and the real estate transaction contemplate that the property has been exposed to the market before the valuation date, the buyer and seller are well informed and acting in their own best interest (that is, the transaction is not a forced liquidation or distressed sale), and marketing activities are usual and customary (that is, the value of the property is unaffected by special financing or sales concessions). The market value in an appraisal may differ from the collateral's fair value if the values are determined as of different dates or the fair value estimate reflects different assumptions from those in the appraisal. This may occur as a result of changes in market conditions and property use since the "as of" date of the appraisal.

represents a prudent strategy.²³ For example, if the workout plan will bring a construction project for an income-producing property to completion, but not to a stabilized occupancy, the amount assigned a regulatory credit risk grade or classification of loss, if any, should be based on the collateral's prospective "as complete" market value using a new or updated appraisal or evaluation, as appropriate. If the workout plan will bring the construction project to completion and stabilization based on a reasonable lease-up period and market expectations, the regulatory credit risk grade or classification of loss, if any, should be based on the prospective "as stabilized" market value.²⁴ Any portion of the recorded investment in the loan not charged off generally should be adversely credit risk graded or classified no worse than substandard.²⁵

Impairment Measurement: Impaired Loan that is Not Collateral Dependent

When measuring impairment on an impaired loan (including a TDR loan) that is not collateral dependent, an institution must use the present value of expected future cash flows method, except that as a practical expedient, the creditor may measure impairment based on the loan's observable market price.²⁶ An institution should determine its best estimate of these cash flows based on reasonable and supportable assumptions and projections. An institution should not presume that the contractual payment amounts required under the newly modified loan terms are the best estimate of the expected future cash flows. When making this estimate, an institution should consider default and prepayment assumptions, as well as existing environmental factors (for example, existing industry, geographical, economic, and political factors), relevant to the collectibility of the loan.

When a contractual balloon payment is required at maturity under the modified terms of a TDR loan that is not collateral dependent, significant uncertainty may exist regarding the borrower's ability to refinance or repay the debt at maturity. When estimating expected future cash flows for impairment measurement purposes, all available evidence should be considered, with greater weight given to evidence that can be objectively verified. When no sources of cash flows are reasonably expected to be available to support the assumption that the borrower will be able to repay or refinance a secured loan at maturity, an acceptable approach for estimating expected future cash flows can be to base the expected payment at maturity on the current fair value of the collateral, less estimated costs to sell. If the contractual balloon payment at maturity is lower than the fair value of the collateral, less estimated costs to sell, the balloon payment amount should be used as the final cash flow in the impairment analysis.

²³ As discussed in the October 2009 interagency *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, collateral valuations of commercial properties typically contain more than one value conclusion and could include an "as is" market value, a prospective "as complete" market value, and a prospective "as stabilized" market value. It is presumed that an "as completed" or "as stabilized" market value would be greater than the current "as is" market value.

²⁴ In contrast, as previously noted, if the workout plan envisions an immediate sale or foreclosure, the amount of a regulatory credit risk grade or classification of loss should be based on the "as is" market value to determine the collateral's fair value less costs to sell.

²⁵ A doubtful classification may be used in certain circumstances for a limited period.

²⁶ GAAP permits an entity to measure impairment of an impaired secured loan based on the fair value of the collateral only if the loan is collateral dependent.

Classification and Charge-Off Treatment: Impaired Loan that is not Collateral Dependent

Consistent with GAAP and as a general regulatory credit risk grading or classification principle, for an impaired loan (including a TDR loan) that is not collateral dependent, when available information confirms that a specific loan, or a portion thereof, is uncollectible, this amount should be classified loss and promptly charged off against the ALLL.

Capitalized Costs

Disbursements by an institution to protect its collateral position on a loan, such as payments of real estate taxes or hazard insurance premiums, may be capitalized (that is, added to the loan's recorded investment rather than expensed) provided the applicable loan agreement authorizes such capitalization. Capitalized protective advances on an impaired loan, including a TDR loan, increase the recorded investment in the loan. Therefore, the measurement of impairment on the loan and, accordingly, any valuation allowance (as well as any regulatory credit risk grade or classification of loss and partial charge-off, when appropriate) will be based on this higher recorded investment.

Loan Renewals, Extensions, and Modifications Before a Payment Reset Date

Loan renewals, extensions, and modifications that occur before a payment reset date or conversion to amortizing status are not automatically considered TDRs, but should be evaluated to assess whether they meet the criteria for a TDR under GAAP.²⁷ For example, a modification of the terms of a home equity line of credit before it approaches the date of a payment shock²⁸ should be evaluated to determine whether the modification meets the TDR criteria. In determining whether a borrower is experiencing financial difficulties, an institution generally should perform and document a current credit analysis. This analysis should include an evaluation of the borrower's willingness and ability to meet the loan terms assuming no modification takes place and the loan resets to the higher payment.²⁹ If the borrower is experiencing financial difficulties, an institution should also assess and document whether it has granted a concession to the borrower.

²⁷ See ASC paragraphs 310-40-15-5 and 310-40-15-13 through 20.

²⁸ Payment shock refers to a significant increase in the amount of a monthly or other regularly scheduled payment due to a contractual interest rate reset or payment reset.

²⁹ See ASC paragraphs 310-40-15-20(a) and (e).