COVID-19 Impacts to Troubled Debt Restructuring Accounting for Financial Institutions
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In response to the global pandemic from COVID-19, along with the worldwide disruption of the economy and daily life, financial institutions are looking for ways to do whatever they can to assist their customers.

In the U.S., federal regulators have encouraged financial institutions to take prudent actions, including allowing payment delays, to assist borrowers who may be impacted by COVID-19 mitigation efforts. After issuing the initial guidance, many in the industry pointed out that the programs suggested by the regulators might result in financial institutions having to evaluate all modified loans to determine whether they were Troubled Debt Restructurings (TDRs). In response to this concern, the federal regulatory agencies, after consultation with the FASB, issued updated guidance on March 22, 2020, which is discussed in more detail below (click to see guidance here).

Guidance

A TDR is defined in U.S. Generally Accepted Accounting Principles (GAAP) as follows: “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.”

Further guidance is provided in Accounting Standards Codification (ASC) 310-40-15-5 through 20. There are numerous factors that creditors should consider when determining whether a concession has been granted and whether the borrower is experiencing financial difficulties.

First, entities should consider whether the borrower is experiencing financial difficulty. On March 22, 2020, the federal banking regulators issued guidance that stated a financial institution may presume that a borrower not past due at the time of a modification as part of a COVID-19 assistance program is not experiencing financial difficulty. They indicate that such programs offer temporary payment relief and give an example of six months as a modification that may qualify as temporary. Many institutions may consider programs that offer three months of deferral initially, with an option to extend another three months if needed. If the additional deferral is related to the macroeconomic conditions at the end of the first deferral period (for example, customers in the financial institution’s geographic footprint are still under government imposed restrictions on movement), we think it
may be reasonable to continue to presume that the customer is experiencing only a temporary disruption. If, however, at the time of the second deferral, government restrictions have been lifted and the customer is unable to resume normal payments due to their specific financial situation, an institution should consider whether the borrower is now experiencing financial difficulty and proceed to the next step of evaluating for a TDR, determining whether a concession has been made.

For loans that are not current at the time of a modification, a financial institution may conclude that the borrower is experiencing financial difficulty and should proceed to analyze whether or not the modification is a concession. Particularly relevant for many COVID-19 response programs is the guidance in ASC 310-40-15-7 that indicates that “insignificant” payment delays are not concessions. This part of the accounting standards codification provides guidance on how a creditor should determine whether or not a payment delay is “insignificant” as noted below:

The following factors, when considered together, may indicate that a restructuring results in a delay in payment that is insignificant:

a. 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.

b. The delay in timing of the restructured payment period is insignificant relative to any one of the following:
   1. The frequency of payments due under the debt
   2. The debt’s original contractual maturity
   3. The debt’s original expected duration

Using the guidance above, a three-month deferral of payments might be treated differently depending on the pre-modification loan terms. For instance, if a three-month payment deferral is granted on a ten-year, amortizing loan, such deferral would likely be considered insignificant. However, a three-month deferral on a one-year, amortizing loan would not be considered insignificant. (As noted above, however, a short-term modification of a loan that is current does not result in a TDR). In addition to the term, the financial institution should analyze other relevant factors, such as the interest rate, as to whether they are similar to those that are offered to customers not experiencing financial difficulty.

What Should a Financial Institution Do?

The first step in qualifying for the presumption of no financial difficulty is to implement an assistance program to “mitigate credit risk through prudent actions consistent with safe and sound practices,” as noted by the federal regulatory agencies in their guidance. This should involve key stakeholders, including a Company’s external accountants. Consideration should be given to how the program will be implemented, how the program will impact the financial institution’s liquidity, and how the program could impact capital. The regulatory guidance indicates that an evaluation of payment status is done as of the date that a program is implemented. This date may vary depending on the approach taken by each institution. For institutions that announce a broad program that offers standard modifications and advertise it to all their customers, the date may be the point at which such communication is made internally to lending teams. For institutions that do not communicate a broad program, or whose program does not offer standard terms, the date might be when the customer approaches the institution asking for relief. Compliance considerations for all programs implemented need to be evaluated.

A financial institution considering such a program should also make sure that its loan officers and lending operations have been educated on the new guidance and how it impacts the Company’s financial reporting.

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