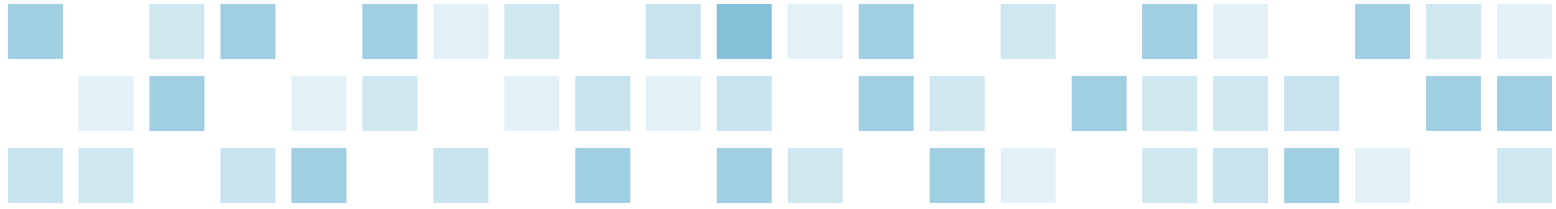
Troubled debt restructuring

Not just an accountant's problem



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With all the fanfare surrounding the recent NCUA final rule on troubled debt restructuring (TDR) reporting and monitoring, it's worth evaluating if your credit union is adequately addressing the slew of other risks involved with these impaired loans. Not only should auditors and CPAs be satisfied with your program, but internal control considerations must be addressed before they become a problem. Significant modifications made on troubled loans can expose the credit union to credit, compliance, transaction, interest rate and liquidity risk, all of which must be managed as warranted depending on the unique circumstances at your credit union.

Compliance risk

The Interpretive Ruling and Policy Statement (IRPS) on NCUA Rule 741 surrounding TDRs was voted on by the NCUA Board during its May 24 meeting, and the comments received led to a presumably final IRPS containing many positive changes related to TDRs. These changes include:

1. A requirement for a written policy addressing loan modifications and troubled debt restructurings
2. A requirement for reasonable controls in place for monitoring and controlling the modification program
3. The possibility of reporting TDRs that are delinquent based on calculations consistent with the contractual loan terms, including amendments made to loans by a *formal restructure*

As it relates to the policy, the IRPS suggests that the policy address areas consistent with the FFIEC Uniform Retail Credit Classification and Account Management Policy, which is a good starting point for credit unions in need of policy development. As credit unions have different philosophies for their modification program and approach, they will and should have different policies outlining program goals, objectives, controls and monitoring. Monitoring controls is addressed in detail in the Transaction risk section that follows, but controls could include those that help identify all loans meeting the definition of either impaired or TDRs, system access controls limiting the number of individuals who can perform maintenance to critical loan fields (i.e., rate, term, payment amount, accrued interest, maturity date), and controls over file maintenance report reviews to ensure modified terms are adequately supported by written documentation.

Credit risk

As the name suggests, TDRs can create increased credit risk exposure for the credit union. The recent updates to the credit quality disclosures for annual audit footnotes helped highlight this important fact, as the users

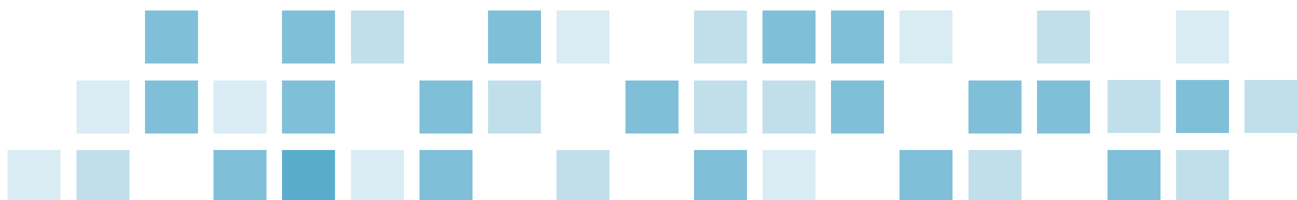
of the financial statements can now gauge the level of credit risk in a loan portfolio partly by analyzing the extent and types of loan modifications and troubled debt restructurings that occurred. Two portfolios of substantially similar loans, one with zero modifications and another with 10 percent modifications, exhibit significantly different payment behavior and likelihood of loss. The Office of Thrift Supervision, in its March 28, 2012 Mortgage Metrics Report, indicated that re-default rates after 12 months of mortgage loans modified in 2008 ranged from 40 to 67 percent, in 2009 ranged from 24 to 55 percent, and in 2010 ranged from 17 to 40 percent (http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2011/mortgage-metrics-q4-2011.pdf). Ranges vary based on loan type and given that modified loans have not had a chance to season as have loans in the 2008 vintage pool, the lower rates exhibited in recent years are not too comforting. It's worth noting how the extent of modifications and TDRs change the concentration makeup of your loan portfolio. And, if the credit union's tolerance for credit risk is such that some lower creditworthy borrowers are acceptable, these values and limits may warrant a revisit if the extent of TDRs begins to approach 3 to 5 percent of total loans outstanding. Perhaps the credit union may decide to curtail credit extension into lower credit tiers for a time period in order to help reduce the credit risk concentration created by significant levels of loan modifications.

Finally, the NCUA, in its 2010 Letter to Credit Unions 10-CU-03, speaks about concentration risk and the need to develop policies with concentration limits. This could not be more applicable than with TDRs – understanding what your TDR pool's re-default rate is, and how large your TDR pool may be, can help you understand what type of value of risk exposure you may have as it relates to the allowance for loan loss plus net worth. Concentration risk policies should include triggering limits for TDRs as a percentage of net worth, commensurate with the credit union's risk appetite for loss. While these numbers may be difficult to develop at first, monitoring them could help uncover some underlying credit risks that warrant some type of remediation.

Interest rate risk

In addition to the IRPS for Part 741, the NCUA recently adopted changes to Part 741 as it relates to interest rate risk management. TDRs create a unique interest rate risk. This is especially true for mortgage-secured TDRs where the credit union may have written long-term loans with below-market interest rates in the name of loss mitigation, which now will exist on the balance sheet for a presumably longer duration than their non-modified counterparts. For example, some credit unions may experience an effective duration of 10 years for their fixed-rate, 30-year mortgage loan portfolio. This assumes home value forecasts and refinances, along with other behavioral assumptions. If the credit union's TDR program included modifying mortgage loans down to 2 percent for the remainder of the loan, this loan will probably not re-price as quickly, as the borrower may not refinance given the incredibly low interest rate. If you have multiple loans such as this, with long-term low rates, these loans must be treated differently for ALM modeling purposes, and the credit union may have more net interest income (NII) exposure (and subsequently, more net economic value (NEV) exposure) in the long term in a rising rate environment.

To help mitigate this risk, we advocate that credit unions take a *firm but fair* approach to modifications, with options to be used to help prevent foreclosure losses and address the extent of the hardship experienced by the borrower. A temporary loss of employment may warrant a modification period that differs from an unexpected medical expense that has now passed and the borrower is simply playing catch-up. In the former, perhaps two years of reduced payments, with a gradual re-pricing option, makes sense, whereas in the latter, a credit union may simply receive a re-age modification after consecutive payments are made, demonstrating willingness and ability to repay. A general rule of thumb is that one size does not fit all when it comes to



deciding what modification approach to take. A balancing act must occur between the interests of the member and those of the credit union, particularly respecting interest rate risk.

Liquidity risk

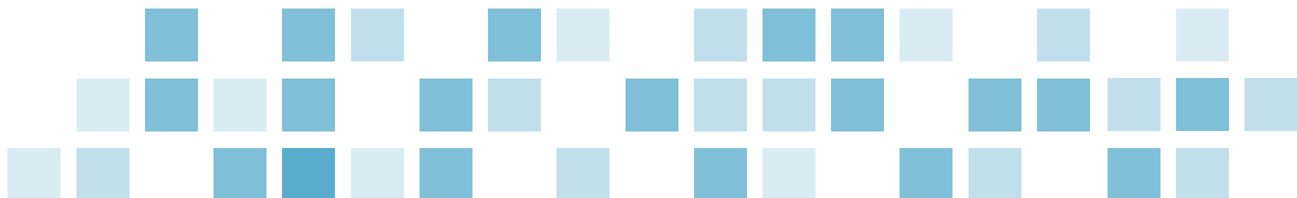
Many credit unions perform capital adequacy assessments and have liquidity contingency plans in place to address cash forecast needs under various circumstances. In the many cases we have seen, these plans involve selling mortgage loans on the secondary market or pledging loans as collateral with the Federal Home Loan Bank. However, loans that were underwritten as conforming loans but have since been modified are no longer conforming. Most cannot be pledged as collateral or sold to the government-sponsored enterprises as planned. While other financial institutions may purchase these modified loans if the circumstances arise, they typically purchase at a discount and the level of due diligence involved may extend the timeframe beyond what was expected. A credit union should assess its capital adequacy planning in light of the level of modifications made to loans in the portfolio, and ensure that, if refinements are required for contingency purposes, other sources of funding are explored proactively.

Transaction risk

The final risk exposure created by TDRs lies in the transactions executed and documented for the modifications being performed. Typically, we see collection department employees able to perform some variations of skip-a-pay or deferments, with a loan workout committee or senior lending personnel needed to approve formal troubled debt restructuring. But while the definition of a TDR did not change with the issuance of the Accounting Standards Update in April 2011, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, the reporting requirements in the financial statement footnotes did change, and the NCUA IRPS will require controls to be in place to monitor TDRs. How does a credit union ensure that actions performed by collection department personnel are not creating TDRs? There are cases where a lengthy deferment may be a concession and the borrower may be experiencing financial difficulties. How are these tracked and identified? If your credit union has a policy whereby the borrower is on a trial *modification* for 6-12 months and must pay a new amount in a timely manner before the loan modification becomes permanent, is this agreement in writing? If so, delinquency reporting could be based on the modified terms; if not, the credit union must continue to report the loan delinquent under its *original* contractual terms (since the modification agreement is not in writing). Ensuring controls are in place to capture file maintenance activities and ad-hoc payment arrangements will become more important than ever, to ensure compliance with the IRPS (as written as of May 2012), and the new credit quality disclosures.

Conclusion

There are specific risks outside of the accounting domain that are affected by TDRs, including compliance, credit, interest rate, liquidity and transaction risks. While there may already be poorly written, documented or constructed TDRs on your books, now is the time to ensure your credit union is prepared to address these risks going forward. Collaboration between accounting, lending, collections and risk management is more important than ever to help address the various risks present in a TDR program. Take care in developing policies, review the interagency memo for key considerations and analyze the current management of the TDR program to ensure that the ancillary fallout that could occur as a result of modifying a troubled debt is identified and addressed.



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