ACCOUNTING FOR LOAN MODIFICATIONS AND/OR CONCESSIONS IN THE CORONAVIRUS (COVID-19) PANDEMIC

Overview

In response to the Coronavirus (COVID-19) pandemic, the regulators have released communications that encourage banks to work with their customers and communities affected by COVID-19[1]. This has given rise to questions about accounting for the effects of modifications or concessions made to loans by banks in supporting the regulators' suggested COVID-19 pandemic response.

While the COVID-19 pandemic is new, the previous financial crisis provided some precedence related to the treatment of modifications or concessions. In the past recession, the regulators had similar guidance related to working with customers but the accounting guidance related to troubled debt restructurings (TDR) has not changed. As modifications or concessions are made, the bank must evaluate whether or not the modification or concession results in a TDR. Specifically, under the FASB TDR guidance, a modification or concession will result in a TDR classification if more than an insignificant delay is allowed and/or if below market interest rates are offered.

Below we have defined the specifics of the accounting guidance related to TDRs. The key to the analysis is evaluating if the delay is insignificant or not. The following factors when considered together, may indicate that a modification 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 any one of the following:
    - (a) The frequency of payments due under the debt agreement
    - (b) The debt's original contractual maturity
    - (c) The debt's original expected duration

---

[1] Included below are links to the information released by the FDIC, OCC, and the Federal Reserve:
https://www.fdic.gov/news/news/financial/2020/fil20017.html
https://www.occ.gov/news-issuances/bulletins/2020/bulletin-2020-15.html
https://www.federalreserve.gov/supervisionreg/srletters/SR2004.htm

ACCOUNTING FOR LOAN MODIFICATIONS AND/OR CONCESSIONS IN THE CORONAVIRUS (COVID-19) PANDEMIC, *continued*

Our Analysis and Conclusion

The guidance does not provide a bright line test or an overall calculation for determining significance. Recently issued CECL guidance and existing debt modification accounting provides a 10% test as a determination. Under this guidance, a modification would quantitatively be more than minor if the present value of the cash flows under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original debt instrument. This is not authoritative under current guidance but could be used as an analysis.

We also believe each loan should be considered individually and in the current environment, it is best to offer insignificant modifications to customers and revisit if needed to determine if a significant modification is needed, which will require the loan to be reported as a TDR.

Information Related to TDRs Considered in Our Analysis and Conclusion

Definition

A TDR occurs when a creditor, for economic or legal reasons related to the debtor's financial difficulty, grants the debtor a more than insignificant concession that it would not otherwise consider.

Analysis

Determining whether a loan modification constitutes a TDR is a two-step process:

1. Determine if the borrower is experiencing financial difficulty (i.e., is the borrower actually troubled).
2. Determine if the bank is granting a concession (i.e., modified terms are more attractive than standard market terms) that is more than insignificant.

Each of these is briefly discussed below.

Experiencing Financial Difficulty

Examples of indicators/evidence of financial difficulty include the following situations:

- The borrower is currently in default or likely to default on the loan in the future
- The borrower has insufficient cash flow to pay the debt under the initial terms
- The borrower has filed or plans to file for bankruptcy
- The borrower is unable to borrow funds from a new creditor at existing market rates.

ACCOUNTING FOR LOAN MODIFICATIONS AND/OR CONCESSIONS IN THE CORONAVIRUS (COVID-19) PANDEMIC, *continued*

While the examples above do not provide a comprehensive list of all situations that could represent indicators/evidence of financial difficulty, situations resulting from COVID-19 that place financial strain on the borrower's ability to repay should be evaluated for evidence of financial difficulty when performing the TDR analysis.

Granting a Concession

The types of concessions can take several forms including, but not limited to the following:

- Lowering the interest rate (generally, lowering the interest rate below market terms would always result in a modification being classified as a TDR)
- Forgiving principal or previously accrued interest
- Allowing interest-only payments not included in original contractual payment terms
- Extending the loan's maturity or amortization schedule

What is insignificant vs significant?

When evaluating any modifications to determine if they represent more than insignificant concessions, the biggest challenge can be determining the significance of the concession granted. This is important because a restructuring that is insignificant is not a concession and therefore the TDR guidance would not apply. The following factors when considered together, may indicate that a modification 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 any one of the following:
    - (a) The frequency of payments due under the debt
    - (b) The debt's original contractual maturity
    - (c) The debt's original expected duration

If the debt has been previously restructured, an entity shall consider the cumulative effect of the past restructurings when determining whether a delay in payment resulting from the most recent restructuring is insignificant.

Other Recommendations

Accounting Policy Review/Update

Each bank should consider reviewing its policy and make any necessary changes to define what is considered insignificant for that institution. Any institution already applying CECL should also consider the guidance therein. Notably, a modification would quantitatively more than minor if the present value of the cash flows under the terms of the new debt

ACCOUNTING FOR LOAN MODIFICATIONS AND/OR CONCESSIONS IN THE CORONAVIRUS (COVID-19) PANDEMIC, *continued*

instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original debt instrument. The guidance in ASC 470-50 (which is applicable to borrowers) should be used to calculate the present value of the cash flows for purposes of applying the 10% test. Even if the difference is less than 10%, the facts and circumstances and other relevant considerations may nevertheless indicate that the modification is more than minor.

In addition, CECL requires:

- The value of concessions made by the creditor in a TDR to be incorporated into the allowance estimate; and
- The pre-modification effective interest rate to be used to measure credit losses on a TDR when applying the discounted cash flow method

Other Information

Below is a link to an article that provides some additional information:

https://www.lexology.com/library/detail.aspx?g=6b31b4c0-b8d2-45cf-8059-4e4ff532f796

Please feel free to contact one of your Elliott Davis engagement team members with any questions.

Barbara Rushing, CPA
Financial Services Specialty Group Leader
d: 864.242.2625
e: barbara.rushing@elliottdavis.com

Mike Koupal, CPA
Practice Leader – FSG Internal Audit Services
d: 615.786.7952
e: mike.koupal@elliottdavis.com

Chad Reingardt, CPA
Shareholder
d: 864.242.2674
e: chad.reingardt@elliottdavis.com

Chris Loyd, CPA, CISA, CGMA
Shareholder
d: 615.786.7957
e: chris.loyd@elliottdavis.com

Robert Stevens, CPA
Shareholder
d: 864.552.4819
e: robert.stevens@elliottdavis.com

Chris Purvis, CPA
Shareholder
d: 704.808.5216
e: chris.purvis@elliottdavis.com

Josh White, CPA, CFIRS
Shareholder
d: 919.987.2760
e: josh.white@elliottdavis.com