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# APPLICATION OF STATEMENT 114 TO MODIFICATIONS OF RESIDENTIAL MORTGAGE LOANS THAT QUALIFY AS TROUBLED DEBT RESTRUCTURINGS

## Objective

The objective of this paper is to assist preparers and auditors by discussing questions related to the application of existing generally accepted accounting principles (GAAP) associated with the application of FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan—an Amendment of FASB Statements No. 5 and 15* (Statement 114). Although this nonauthoritative paper highlights certain issues that have arisen about the accounting for loan modifications, it does not establish new GAAP and is not intended to serve as a substitute for relevant authoritative accounting standards. Rather, it is intended to articulate certain existing requirements of GAAP literature as well as common accounting practices related to the specific issues discussed, with the objective of helping preparers and auditors understand the application of existing GAAP to residential mortgage loans.

## Background – Loan Modifications

Many residential mortgage loans originated during 2004—2007 have commonly been referred to as *non-traditional loans*. The features of such loans that may make them 'non-traditional' include, but are not limited to, (a) an initial interest rate that is below the market interest rate for the initial period of the loan term and that may increase significantly when that period ends; (b) terms that permit principal payment deferral (interest-only payments) or payments smaller than interest accruals (negative amortization); (c) terms that provide the borrower with the option to choose from several payment amounts each month (for a specified period of the loan term), which may include an option for negative amortization; and, (d) a high loan-to-value ratio.Many borrowers with such mortgage products are able to make their mortgage payments based on the introductory interest rate. However, borrowers may be unable to make their higher payments after the interest rate on their mortgage loan resets to a higher rate. To address this situation, the U.S. Department of the Treasury, bank regulatory agencies and others have encouraged lenders to work with borrowers to modify loan terms so that borrowers can avoid default and foreclosure.

As a result of current market conditions, a growing number of loan modifications have been observed and are expected to continue in the near future to make mortgage loans more affordable to certain borrowers and may include, but are not limited to: (a) interest rate concessions (for example, reducing the contractual interest rate or modifying the terms of an adjustable rate mortgage to change the basis upon which future interest rates are calculated); (b) forgiving a portion of the original contractual interest and/or principal amounts (including payments that are in arrears); and (c) extending the life of the loan beyond the original contractual life.

The expected increase in loan modifications will result in Statement 114 being applied to residential mortgage loans, on a large scale, for the first time. This guidance is being provided to assist in this first time application of Statement 114 on a large scale. Lenders may undertake modifications of residential mortgage loans held on-balance sheet in their loan portfolios, or off- balance sheet in a securitization trust that is intended to be a qualifying special purpose entity (QSPE). Issues associated with the modification of loans held by a QSPE are not the subject of the guidance in this paper.

**Accounting Literature**

FASB Statement No. 5, *Accounting for Contingencies* (Statement 5)

FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings* (Statement 15)

FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases—an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17* (Statement 91)

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan—an Amendment of FASB Statements No. 5 and 15* (Statement 114)

FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures* (Statement 118)

FASB Staff Position SOP 94-6-1, *Terms of Loan Products That May Give Rise to a Concentration of Credit Risk* (FSP SOP 94-6-1)

FASB Technical Bulletin No. 80-2, *Classification of Debt Restructurings by Debtors and Creditors* (FTB 80-2)

DIG Issue, F-4, "Fair Value Hedges: Interaction of Statement 133 and Statement 114"

EITF No. 01-7, “Creditor’s Accounting for a Modification or Exchange of Debt Instruments” (EITF 01-7)

EITF No. 02-4, “Determining Whether a Debtor’s Modification or Exchange of Debt Instruments Is within the Scope of FASB Statement No. 15” (EITF 02-4)

EITF No. D-80, “Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio” (EITF D-80)

AICPA Statement of Position No. 94-6, *Disclosure of Certain Significant Risks and Uncertainties* (SOP 94-6)

AICPA Statement of Position No. 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer* (SOP 03-3)

**Application Guidance**

1) *Is there a basic principle underlying Statement 114 that should guide the answer to the application questions discussed in this paper?*

Statement 114 includes a principle regarding the measurement of impairment and the resulting recorded value for the loan. The basic principle is "that a loan that becomes impaired should continue to be carried at an amount that considers the present value of all expected future cash flows, in a manner consistent with the loan's measurement before it became impaired. The Board concluded that because loans are recorded originally at discounted amounts, the ongoing assessment for impairment should be made in a similar manner." (Statement 114, paragraph 42)

This principle in Statement 114 is further explained in Question 20 of EITF D-80, which states:

> "The Board observed that a creditor's recorded investment in a loan at origination and during the life of the loan, as long as the loan performs according to its contractual terms, is the sum of the present values of the future cash flows that are designated as interest and the future cash flows that are designated as principal discounted at the effective interest rate implicit in the loan. The Board concluded that a loan that becomes impaired (because it is probable that the creditor will be unable to collect all the contractual interest payments and contractual principal payments as scheduled in the loan agreement) should continue to be carried at an amount that considers the discounted value of all expected future cash flows in a manner consistent with the loan's measurement before it became impaired."

Statement 114 also includes the following principles that will be discussed in further detail in the following sections of this paper:

- *Impairment*—"a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement." Where "...*all amounts due according to the contractual terms* means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the [original] loan agreement." (Statement 114, paragraph 8)

- *Discount Rate*—"the Board concluded that a loan impairment measurement should reflect only a deterioration of credit quality, which is evidenced by a decrease in the estimate of expected future cash flows to be received from the loan. The Board believes that the measure of an impaired loan should recognize the change in the net carrying amount of the loan based on new information about expected future cash flows rather than record a new direct measurement. The Board, therefore, concluded that the loan impairment measurement should not reflect changes in market rates of interest that may cause a change in the fair value of an impaired loan" (Statement 114, paragraph 51).

2) *Are residential mortgage loans within the scope of Statement 114?*

*Not usually, except when they are restructured in a Troubled Debt Restructuring (TDR).* Statement 114 applies to all loans, except those discussed in paragraphs 6(a)-6(d). Paragraph 6(a) excludes from the scope of Statement 114 "large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment. Those loans may include but are not limited to credit card, residential mortgage, and consumer installment loans." Additionally, paragraph 6(b) excludes from the scope of Statement 114 "loans that are measured at fair value or at the lower of cost or fair value, for example, in accordance with FASB Statement 65, *Accounting for Certain Mortgage Banking Activities,* or other specialized industry practice."

However, paragraph 9 clarifies that a loan that is initially excluded from the scope of Statement 114 (under paragraph 6(a)) whose terms are subsequently modified in a TDR is subject to the provisions of Statement 114 when the loan is restructured. Therefore, residential mortgage loans that (1) meet the definition of a TDR or (2) are not loans that are included in "larger groups of smaller-balance homogeneous loans that are collectively evaluated for impairment" are within the scope and are subject to the impairment testing as prescribed in Statement 114. Loans that are measured at fair value or at the lower of cost or fair value are excluded from the scope of Statement 114 (under paragraph 6(b)) and do not become subject to the provision of Statement 114 on modification.

This position—that residential mortgage loans that have been modified in a TDR are within the scope of Statement 114—was affirmed by the FASB at its Board meeting on January 30, 2008. At that meeting the Board declined to add a project to its agenda to further consider providing relief from the impairment testing requirements specific to TDRs for residential mortgage loans under Statement 114.

The determination of whether a residential mortgage loan is within the scope of Statement 114 should be consistently applied to acquired loans that were previously accounted for in accordance with SOP 03-3. With regard to loans not accounted for as debt securities, paragraph 8 of SOP 03-3 states that if "...it is probable that the investor is unable to collect all cash flows expected at acquisition plus additional cash flows expected to be collected arising from changes in estimate after acquisition ... The loan should be considered impaired for purposes of applying the measurement and other provisions of FASB Statement No. 5 or, if applicable, FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan.*" Additionally, footnote 15 to paragraph 10 of SOP 03-3 states that "...loans whose terms have been modified in TDRs are accounted for under the provisions of FASB Statement No. 114…".

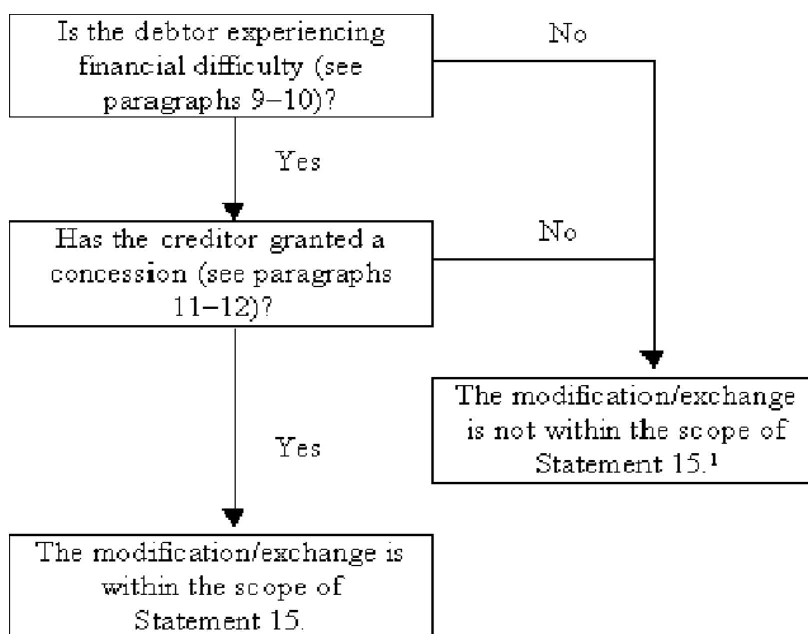
3) *How should an entity determine if a modification of the terms of a residential mortgage loan would be considered a troubled debt restructuring under Statement 15?*

In accordance with paragraph 2 of Statement 15, "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." Paragraph 3 of Statement 15 goes on to state, "whatever the form of concession granted by the creditor to the debtor in a troubled debt restructuring, the creditor's objective is to make the best of a difficult situation. That is, the creditor expects to obtain more cash or other value from the debtor, or to increase the probability of receipt, by granting the concession than by not granting it."

Statement 114 applies to the accounting by creditors for *all* loans that are restructured in a troubled debt restructuring involving a modification of terms. Based on the definition of a TDR as provided in Statement 15, a lender is required to assess whether (a) the borrower is experiencing financial difficulties, and (b) the lender has granted a concession. In performing this assessment, a lender may find the indicators that a borrower is experiencing financial difficulties and the guidance related to whether or not a lender has granted a concession provided in EITF 02-4 beneficial. EITF 02-4, while written in the context of a debtor's (borrower's) assessment of whether a modification meets the definition of a TDR, provides a framework for assessing whether a loan modification is within the scope of Statement 15 that can be analogized to by a creditor (lender).

Paragraph 5 of EITF 02-4 states "that under the provisions of Statement 15, the determination of whether a modification or exchange of a debt instrument should be accounted for as a troubled debt restructuring requires consideration of all specific facts and circumstances surrounding the transaction. The Task Force reached a consensus that no single characteristic or factor, taken alone, is determinative of whether a modification or exchange is a troubled debt restructuring under Statement 15. ... The Task Force noted that determining whether a transaction is within the scope of Statement 15 requires the exercise of judgment."

The guidance in EITF 02-4 also provides "that the following model should be applied by a debtor when determining whether a modification or an exchange of debt instruments is within the scope of Statement 15:"




EITF 02-4, Footnote 1: The Task Force noted that if an entity concludes that the modification or exchange is not within the scope of Statement 15, the entity would apply the provisions of Issue No. 96-19, "Debtor's Accounting for a Modification or Exchange of Debt Instruments."

As discussed in EITF 02-4 (and detailed in the flow chart above), the assessment of whether a loan modification represents a TDR requires an assessment of whether (a) the borrower is experiencing financial difficulties, and (b) the lender has granted a concession. Therefore, the remainder of this question focuses on the assessment of these two requirements.

*(a) How should an entity determine whether a borrower is experiencing financial difficulties?*

EITF 02-4, paragraph 9, provides that "if the debtor's creditworthiness (for example, based on its credit rating or equivalent, the effects of the original collateral or credit enhancements in the debt, or its sector risk) has deteriorated since the debt was originally issued, the debtor should evaluate whether it is experiencing financial difficulties." The guidance also provides a list of factors that "are indicators that the debtor is experiencing financial difficulties." The indicators relevant to the assessment of residential mortgage loans include:

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a nontroubled debtor.
- Based on estimates and projections that encompass the debtor's current capabilities, the debtor's cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.

Additionally, the guidance in EITF 02-4 provides specific factors that, if met, would indicate that the borrower <u>is not</u> experiencing financial difficulty. Paragraph 10 of EITF 02-4 states:

> The Task Force reached a consensus that notwithstanding the above, the following factors, if *both* are present, provide determinative evidence that the debtor is *not* experiencing financial difficulties, and, thus, the modification or exchange is not within the scope of Statement 15 (the presence of either factor individually would be an indicator, but not determinative, that the debtor is not experiencing financial difficulty):
>
> - The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors (without regard to the current modification) at an effective interest rate equal to the current market interest rate for a nontroubled debtor, and
> - The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued.

In performing an assessment of whether the borrower is experiencing financial difficulties, the lender should exercise professional judgment in determining the nature of the assessment required to ascertain whether or not the factors above have been met and provide evidence that the modification or exchange is not within the scope of Statement 15. For example, consistent with existing policies and procedures surrounding a credit assessment for the extension of credit to a non-troubled debtor with a similar credit profile, the assessment performed by the lender may include obtaining an updated credit score to validate the eligibility for and capacity of the

debtor to perform under the proposed terms and, determining the current value of the collateral to evaluate whether the loan is adequately secured. The assessment of the borrower's credit profile would not be expected to require procedures that exceed the credit risk practices a lender would perform for nontroubled borrowers.

*(b) How should an entity determine whether the lender has granted a concession?*

The guidance in paragraph 11 of EITF 02-4 provides "that a creditor is deemed to have granted a concession if the debtor's effective borrowing rate on the restructured debt is less than the effective borrowing rate of the old debt immediately prior to the restructuring. The effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's current carrying amount of the old debt."

Additionally, when determining the effective borrowing rate "if an entity has recently restructured the debt and is currently restructuring that debt again, the effective borrowing rate of the restructured debt (after giving effect to all the terms of the restructured debt including any new or revised options or warrants, any new or revised guarantees or letters of credit, and so forth) should be calculated by projecting all the cash flows under the new terms and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's previous carrying amount of the debt immediately preceding the earlier restructuring. In addition, the effective borrowing rate of the restructured debt should be compared with the effective borrowing rate of the debt immediately preceding the earlier restructuring for purposes of determining whether the creditor granted a concession (that is, whether the effective borrowing rate decreased)." (EITF 02-4, paragraph 12)

When assessing whether a concession has been provided it is important to note that the guidance in EITF 02-4 is written from the perspective of the debtor. That is, the issue is whether the borrower has been granted a concession, which is assessed by analyzing the borrower's effective interest rate based on the "debtor's previous carrying amount of the debt immediately preceding the earlier restructuring." When assessing whether the modification constitutes a TDR from the creditor's perspective Statement 15 references the "recorded investment in the receivable" instead of the "carrying amount of the receivable". This distinction is explained in footnote 17 of Statement 15 as:

> *Recorded investment in the receivable* is used in paragraphs 28–41 instead of *carrying amount of the receivable* because the latter is net of an allowance for estimated uncollectible amounts or other "valuation" account, if any, while the former is not. The recorded investment in the receivable is the face amount increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous direct write-down of the investment.

Additionally, when applying the guidance in EITF 02-4, which is written from the perspective of the debtor, it should be noted that FTB 80-2 specifically notes that "a debtor may have a troubled debt restructuring under Statement 15 even though the related creditor does not have a troubled debt restructuring. The debtor and creditor must individually apply Statement 15 to the specific facts and circumstances to determine whether a troubled debt restructuring has occurred."

The evaluation of whether the lender has granted a concession for modifications of loans accounted for in accordance with SOP 03-3 should be assessed relative to the effective interest rate used for accretion of interest income (see paragraphs .08(a) and .08(b) of SOP 03-3) and the lenders recorded investment in the loan. Paragraph 61 of Statement 15 states that a lender "...participates in a troubled debt restructuring because it no longer expects its investment in the receivable to earn the rate of return expected at the time of investment..." Footnote 11 of SOP 03-3 states that, "When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan." The following example of the assessment of a concession for a lender that purchased the loan at less than the total principle amount outstanding is provided in FTB 80-2:

> Creditor A makes a $10,000 interest-bearing loan to Debtor X and, when Debtor X later encounters financial difficulties, sells its receivable from Debtor X to Creditor B for $4,000 on a nonrecourse basis. Following the sale, the carrying amount of the loan payable by Debtor X would still be $10,000 and the recorded investment of the loan by Creditor B would be $4,000. If Debtor X subsequently transfers to Creditor B assets with a fair value of $5,500 in full settlement of the loan, that transaction would be a troubled debt restructuring for Debtor X because the fair value of the assets is less than the carrying amount of the loan, whereas Creditor B would not have a troubled debt restructuring because the fair value of the assets received exceeds its recorded investment in the loan.

Although the detailed accounting guidance in the literature focuses on a loan-by-loan assessment to determine whether a modification of terms is a TDR, both Statement 114 and EITF 02-4 require consideration of all of the available evidence. Some lenders have engaged in large loss mitigation programs or strategies that, by design, provide concessions to borrowers that are currently experiencing or are expected to experience financial difficulty (e.g., when the interest rate on a loan "resets" at a future date). In those situations, it may be appropriate for a lender to conclude that modifications made pursuant to those programs meet the definition of a TDR at a program level. Similarly, depending on the facts and circumstances, it may be appropriate for the lender to presume that loan modifications made pursuant to certain loss mitigation strategies meet the definition of a TDR.

Finally, if an entity concludes that the modification does not meet the definition of a TDR, the guidance in Statement 91, as supplemented by EITF 01-7, should be considered in determining whether the lender should account for the modification as (a) the creation of a new loan and the extinguishment of the original loan or (b) the continuation of the original loan (as modified).

*4) How should an entity measure impairment under Statement 114?*

Statement 114 provides guidance on how an entity should measure impairment. Specifically, paragraph 13 of Statement 114 states:

> "...a creditor shall measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. ... The creditor may choose a measurement method on a loan-by-loan basis. A creditor shall consider estimated costs to sell, on a discounted basis, in the measure of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan."

Paragraph 14 of Statement 114 adds "...the effective interest rate of a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan). The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement."

Paragraph 11 of Statement 114 states "measuring impairment of a loan requires judgment and estimates, and the eventual outcomes may differ from those estimates. Creditors should have latitude to develop measurement methods that are practical in their circumstances."

Paragraph 54 of Statement 114 adds "...the Board concluded that impairment of a loan is not an event that should result in a new direct measurement of the loan at fair value at the date impairment is recognized. Under that approach, an impaired loan's expected future cash flows would be discounted at a market interest rate commensurate with the risks involved to arrive at a measure of the loan's fair value. Noting that unimpaired loans are not carried at fair value after origination, the Board concluded that loan impairment should be recognized based solely on deterioration of credit quality evidenced by a decrease in expected future cash flows rather than on changes in both expected future cash flows and other current economic events, such as changes in interest rates."

Based on this guidance, it is widely expected that the application of Statement 114 to residential mortgage loans generally will result in a measurement of impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as described in paragraph 13 of Statement 114, the following practical expedients are available:

*(a)* *Observable market price of the loan*—The measurement of impairment based on the loan's observable market price is available to lenders as a practical expedient. However, obtaining an "observable market price" for an impaired loan may be difficult.

*(b)* *Collateral fair value*—Lenders also have the option, as a practical expedient, to measure impairment based on the fair value of the collateral if the loan is collateral dependent.

Paragraph 13 of Statement 114 states that "a loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral" and "...regardless of the measurement method, a creditor shall measure impairment based on the fair value of the collateral when the creditor determines that foreclosure is probable." This provision is meant to ensure that loss recognition is not delayed until actual foreclosure.

By modifying a residential mortgage loan, a lender has acknowledged that there is an additional source of repayment for the loan, other than the underlying collateral (that is, the borrower's personal cash flows). Therefore, at the time of the modification a residential mortgage loan would generally not meet the definition of "collateral dependent."

The position that the application of Statement 114 generally will result in a measurement of impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate was acknowledged in the letter dated December 5, 2007 from the Mortgage Banker's Association to the FASB that states "...a mortgage lender would likely be required to measure impairments of the loans using discounted cash flow analyses because, in many

cases, the values of the underlying collateral and observable market prices for the loans would be unobtainable or unavailable timely." Therefore, the remainder of this document focuses on the application of Statement 114 when measuring impairment based on the present value of expected future cash flows.

*5) How should an entity calculate the present value of expected future cash flows for a residential mortgage loan?*

As part of its measurement guidance, Statement 114 acknowledges that entities will need to use judgment and estimates to measure impaired loans and the eventual outcomes may vary from those estimates (paragraph 11). Statement 114 also provides entities with the flexibility to develop measurement methods that are practical in their circumstances. For example, paragraph 12 of Statement 114 states that in situations where the impaired loans have risk characteristics that are unique to the individual borrower, the lender should apply the measurement guidance on a loan-by-loan basis. However, if an impaired loan has risk characteristics in common with other impaired loans, the lender can aggregate those loans and may use historical statistics along with a composite effective interest rate as a means of measuring those impaired loans. Although Statement 114 allows lenders to select the measurement method on a loan-by-loan or aggregated basis, Q&A 25 of EITF D-80 clarifies that "the Board expects that the measurement method for an individual impaired loan would be applied consistently to that loan and that a change in method would be justified by a change in circumstances."

If an entity is measuring impairment based on the present value of expected future cash flows, paragraphs 14 and 15 of Statement 114 provide guidance on how the expected future cash flows of the modified loan should be calculated. Paragraph 14 of Statement 114 states that the lender must "calculate the present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate." Therefore, the questions below are intended to assist preparers and auditors to determine (1) the expected future cash flows of the impaired loan and (2) the loan's effective interest rate under Statement 114. These two inputs into the estimate of the "present value of expected future cash flows" are considered separately as there are differences in the application of the guidance for each item.

*(a) How should an entity determine the "**expected future cash flows**" of a residential mortgage loan?*

Paragraph 15 of Statement 114 states that "if a creditor measures an impaired loan using a present value calculation, the estimates of expected future cash flows shall be the creditor's best estimate based on reasonable and supportable assumptions and projections." Q&A 26(d) of EITF D-80 states that "the estimate of future cash flows should be a creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing those estimates. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. The likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows." In addition, Q&A 16 of EITF D-80 requires that entities take into account "all available information," as of the measurement date, "reflecting past events and current conditions when developing the estimate of expected future cash flows. All available information would include existing

"environmental" factors (for example, existing industry, geographical, economic, and political factors) that are relevant to the collectibility of that loan and that indicate that it is probable that an asset had been impaired at the date of the financial statements...."

As the projected future cash flows should be based on all cash flows expected to be received **in the future**, a lender should include all of the interest and principal payments that are expected to occur subsequent to the loan being modified. That is, future cash flows begin on the date of the loan modification.

Certain lenders may wish to determine the expected future cash flows using a beginning date other than the loan modification date, such as: (1) cash flows related to the original term of the loan or (2) cash flows related to the term of the loan remaining after a future predicted default (which would be estimated to be the date of interest rate reset). Because the phrase "expected future cash flows" is used in Statement 114, it appears that the Board was looking for the estimate of cash flows that will occur in the future, therefore it is not supportable for a lender to include cash flows that have already occurred, and have been accounted for in past periods, in the determination of expected *future* cash flows. In addition, Statement 114 does not support determining the expected future cash flows of the loan using only cash flows expected to be received after the predicted default date because such an approach would exclude certain "future cash flows."

Statement 114 provides specific guidance related to the interest rate to be used in estimating the expected future cash flows of a loan if the interest rate on the loan is based on an index or rate that varies based on subsequent changes in an independent factor (such as the prime rate or LIBOR). Paragraph 14 of Statement 114 requires that "if a loan's contractual interest rate varies based on subsequent changes in an independent factor...", the "...loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraph 8." As clarified in paragraph 52 of Statement 114, as a practical expedient, the Board allows lenders "... to fix the rate at the rate in effect at the date the loan meets the impairment criterion." However, lenders have the option to recalculate the effective interest rate as the interest rate (index) changes in subsequent periods. Lenders should consistently apply the method chosen for all loans that have a contractual interest rate that varies based on changes in an independent factor.[1] Additionally, this guidance regarding the use of a fixed or variable interest rate is applicable for purposes of determining the expected future cash flows as well as the effective interest rate of a modified loan (further discussed in Question 5(c)) and an entity's accounting policy choice is expected to be applied consistently.

Finally, paragraph 14 of Statement 114 is clear that "projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimating expected future cash flows." Based on this guidance, it is expected that when estimating the expected future interest cash flows most lenders will fix the value of the variable interest rate (e.g., LIBOR) at the single rate in effect on the date of the loan modification and use that single fixed interest rate in their projection of expected future cash flows.

[1] The method is required to be consistent for all loans. Therefore, lenders will need to determine whether they have previously selected a method that would dictate the method that must be used for residential mortgage loans subject to modification (for example, a method previously selected for modified non-residential loans or modified non-mortgage loans).

For example, assume that a 30-year loan has an initial interest rate that is below the fully indexed market interest rate (often referred to as a "teaser" rate) of 3% for the first 3 years and then resets on a yearly basis to LIBOR + 4% for each of the next 27 years. Assume that at the beginning of the third year the loan is restructured and the terms are modified such that the loan will have a rate of 3% for the next 3 years (extending the fixed period to 5 years) and will then reset on a yearly basis to LIBOR + 4% for each of the next 25 years. Assume that LIBOR on the date of the loan modification is 7%. Under Statement 114, the expected future cash flows of the modified loan could not exceed the next 3 years of interest payments at 3%, the following 25 years of interest payments at 11% (LIBOR at 7% + 4%), plus principal payments over the life of the loan.

b) *What assumptions and projections should entities include in the determination of the "**expected future cash flows**"?*

Statement 114 requires an entity to consider all available information in projecting the expected future cash flows of the modified loan. Therefore, in terms of both amount and timing of occurrence, the assumptions and projections developed by the lender (related to principal and interest payments under the modified loan) may include the potential effect of future prepayments, defaults (including charge-offs), expected recoveries, and other assumptions that are reasonable and supportable. Paragraph 15 of Statement 114 states that a lender's estimate of future cash flows shall be "based on reasonable and supportable assumptions and projections."

Paragraph 12 of Statement 114 does not provide additional guidance on how to assess whether assumptions and projections are "reasonable and supportable" or whether this assessment is affected by a lender's election to apply the measurement guidance in Statement 114 on a loan-by-loan basis or on an aggregated basis. However, Q&A 26(d) of EITF D-80 states that "the estimate of future cash flows should be a creditor's best estimate based on reasonable and supportable assumptions and projection .... The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. The likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows." For example, given the reasons for loan modifications (i.e., a borrower with financial difficulties and/or declining collateral value), a lender will need to consider whether modified loans are likely to perform differently than was originally expected. For example, for loans modified in a troubled debt restructuring, the use of unadjusted historical prepayment speeds may not be a reasonable basis for projecting future prepayment speeds because the economic factors that affect the borrower's motivation and ability to refinance or payoff a loan may have changed significantly.

As a practical expedient, Statement 114 allows the use of aggregation techniques in measuring impairment at the present value of the expected future cash flows. Additionally, when calculating expected future cash flows for individual loans, a lender should consider whether it would be appropriate to use default and prepayment assumptions that would be relevant to an aggregated pool of loans with similar characteristics. The objective of such a calculation is to approximate – at the individual loan level – the default and prepayment rates that would have been expected for an aggregate pool of loans with similar characteristics.

(1) *Would prepayment assumptions be included in the estimate of "**expected future cash flows**"?*

*Yes.* Under the guidance in Statement 114 it is necessary to include all available information on the expected future cash flows. As the loans being discussed are residential mortgage loans, it may be expected that some percentage of the loans could be refinanced, repaid, or default and go to loss subsequent to modification but prior to contractual maturity, which would cause the prepayment of the loan from the lender's perspective. The prepayment of the loan is part of the expected recovery of the loan, which should be included by the lender in the determination of the amount and timing of expected future cash flows.

As previously discussed, depending on the risk characteristics of the impaired loans, lenders may apply the measurement guidance in Statement 114 on a loan-by-loan basis or on an aggregated basis. Additionally, paragraph 15 of Statement 114 states that the estimates of future cash flows shall be the lender's best estimate based on reasonable and supportable assumptions and projections. Therefore, if a lender has prepayment assumptions that are reasonable and supportable, it would need to include those assumptions when applying the measurement guidance (either at the individual loan level or the aggregated loan level) under Statement 114.

Finally, in assessing the reasonableness of prepayment assumptions a lender should consider the unique characteristics of the loans subject to modification. Given the unique characteristics of such loans, unadjusted historical prepayment rates may not be a reasonable basis for projecting future prepayment rates for loans subject to modification. Lenders are also reminded that the weight given to the prepayment assumption should be commensurate with the extent to which the assumption can be verified objectively.

(2) *Would default (and recovery) assumptions be included in the estimate of "**expected future cash flows**"?*

*Yes—a lender should include their best estimate of defaults (and recoveries) in projected cash flows.* While the objective of a loan modification, at least in part, is to maximize the recovery to the lender, there could be future defaults (and recoveries) experienced on modified loans. Consequently, estimates of defaults (and recoveries) should be included in a lender's estimate of future cash flows. Not including estimates of future defaults (and recoveries) would understate the measured impairment and result in subsequent losses on the actual default date, which is not consistent with the expected cash flow model.

Consistent with the assessment of prepayment assumptions (and other assumptions used to estimate the expected future cash flows), estimates of defaults (and recoveries) "shall be the creditor's best estimate based on reasonable and supportable assumptions and projections."

*c) When calculating the "**effective interest rate**" of the loan, what rate should an entity use if the loan is a variable rate loan (for example, based on LIBOR)?*

*The original contractual interest rate terms existing as of the date of loan modification including, as discussed further below, contractual adjustments tied to a variable-rate index.* Paragraph 14 of Statement 114 states that "if a creditor measures an impaired loan using a present value amount, the creditor shall calculate that present value amount based on an estimate of the expected future cash flows of the impaired loan, discounted at the loan's effective interest rate." The effective interest rate is defined as the rate of return implicit in the loan, which is the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan. Statement 114 also clarifies that "the effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement."

In addition, paragraph 14 of Statement 114 states that "if the loan's contractual interest rate varies based on subsequent changes in an independent factor, such as an index or rate (for example, the prime rate, the London interbank offered rate, or the U.S. Treasury bill weekly average), that loan's effective interest rate may be calculated based on the factor as it changes over the life of the loan or may be fixed at the rate in effect at the date the loan meets the impairment criterion in paragraph 8." As clarified in paragraph 52 of Statement 114, as a practical expedient, the Board allows lenders "... to fix the rate at the rate in effect at the date the loan meets the impairment criterion." However, lenders have the option to recalculate the effective interest rate as the interest rate (index) changes in subsequent periods. Lenders should consistently apply the method chosen for all loan that have a contractual interest rate that varies based on changes in an independent factor.[2]

In addition, paragraph 14 clarifies that "...Projections of changes in the factor should not be made for purposes of determining the effective interest rate or estimated expected future cash flows." As such, most lenders are expected to fix the value of the variable rate (e.g., LIBOR) on the date of the loan modification (or on each assessment date going forward) and use that fixed value in the determination of the effective interest rate of the loan.

However, questions related to the guidance in paragraph 14 have been raised with relation to adjustable rate mortgages, which would include those loans that are adjustable from day one and those loans with initial fixed rates that become adjustable in the future. Paragraph 14 states that loans with contractual interest rates that vary based on subsequent changes in an independent factor may calculate the loan's effective interest rate based on the factor as it changes over the life of the loan or it may be fixed at the rate in effect at the date the loan meets the impairment criteria. Loans that have initial fixed rates that adjust in the future related to subsequent changes in an independent factor (e.g., LIBOR) would be included in this guidance.

Therefore, for adjustable rate mortgages with initial fixed interest rates, lenders must calculate the loan's effective interest rate using a blend of the initial fixed interest rate over the fixed period and the variable rate of the loan on the date of loan modification over the variable period. However, lenders have the choice[3] when subsequently measuring the loan for impairment of either:

[2] Refer to footnote 1.

[3] In accordance with paragraph 14 of Statement 114, an entity's choice "shall be applied consistently for all loans whose contractual interest rate varies based on subsequent changes in an independent factor."

- Holding the effective interest rate at the rate used in the initial measurement, (fixing the rate of the variable component at the date the loan meets the impairment criteria) or
- Calculating a new effective interest rate as the variable rate index "changes over the life of the loan," which would be a blend of the initial fixed interest rate over the fixed period, the actual variable rate(s) of the loan (based on the previous changes in the index) and the rate in effect as of the date of the remeasurement.

This guidance is particularly relevant for adjustable rate loans with an initial interest rate that is below the fully indexed market interest rate, often referred to as a "teaser" rate. If a residential mortgage loan is modified under a TDR during the initial teaser rate period, it would **not** be appropriate to use the single teaser rate as the effective interest rate for calculating the present value of the expected future cash flows of the modified loan at the impairment date. The effective interest rate used under Statement 114 should reflect the fact that the lender has made a concession to the borrower; therefore, the teaser rate cannot be used as the effective interest rate since it would not reflect the concession made (the lost interest from the lender's perspective).

Generally, it is expected that lenders will choose to hold the effective interest rate fixed at the rate used in its initial measurement of impairment in order to simplify the operational issues related to measurement under Statement 114.

(1) *Would prepayment or default assumptions be included when determining the period over which to calculate the "**effective interest rate**"?*

*No.* The guidance in Statement 114 related to calculating the effective interest rate requires the use of the "rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan.) The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement."

The references to the balances "existing at the origination or acquisition of the loan" and the "original contractual rate" require that the contractual maturity of the loan is used when calculating the effective rate. The basic principle in Statement 114 is to measure impairment based on the effective interest rate inherent in the original loan contract. Therefore, the loan's contractual maturity should not be reduced to consider estimated prepayment or default.

(2) *Should the original **contractual** interest rate of loans accounted for in accordance with SOP 03-3 be used when determining the "**effective interest rate**"?*

*No.* Footnote 3 to Statement 114 states, "A loan may be acquired at a discount because of a change in credit quality or rate or both. When a loan is acquired at a discount that relates, at least in part, to the loan's credit quality, the effective interest rate is the discount rate that equates the present value of the investor's estimate of the loan's future cash flows with the purchase price of the loan." Therefore, the effective rate is not the contractual rate, but the rate calculated in accordance with SOP 03-3 and used for accreting interest income under the provisions of that SOP.

When assessing the lender's effective rate on a loan within the scope of SOP 03- 3, the effective rate should be the same as the rate used for accretion of interest income. For example, if in a previous period the effective rate had been revised because it had been determined that it was probable that there was a significant increase in cash flows expected to be collected, the revised effective rate determined in accordance with paragraph .08(b) should be used (which would be an effective rate *higher* than the effective rate on acquisition).

*(3) Because fair value hedge accounting under Statement 133 requires the carrying amount of a hedged loan to be adjusted for changes in fair value attributable to the hedged risk, does Statement 133 implicitly affect the measurement of impairment under Statement 114 by requiring the present value of expected future cash flows to be discounted by the "**new effective interest rate**" (based on the adjusted recorded investment) rather than by the "old effective interest rate"?*

*Yes.* As set forth in DIG F-4, "Statement 133 has implicitly affected the measurement of impairment under Statement 114 by requiring the present value of expected future cash flows to be discounted by the new effective rate based on the adjusted recorded investment in a hedged loan. When the recorded investment of a loan has been adjusted under fair value hedge accounting, the effective rate is the discount rate that equates the present value of the loan's future cash flows with that adjusted recorded investment. The adjustment under fair value hedge accounting of the loan's carrying amount for changes in fair value attributable to the hedged risk under Statement 133 should be considered to be an adjustment of the loan's recorded investment."

*6) Is the measure of impairment a one-time event?*

*Not necessarily.* Paragraph 16 of Statement 114 addresses the need to recalculate the impairment of a loan if certain circumstances occur. It states that "subsequent to the initial measurement of impairment, if there is a significant change (increase or decrease) in the amount or timing of an impaired loan's expected future cash flows, or if actual cash flows are significantly different from the cash flows previously projected, a creditor shall recalculate the impairment by applying the procedures specified in paragraphs 12-15 and by adjusting the valuation allowance. Similarly, a creditor that measures impairment based on the observable market price of an impaired loan or the fair value of the collateral of an impaired collateral-dependent loan shall adjust the valuation allowance if there is a significant change (increase or decrease) in either of those bases. However, the net carrying amount of the loan shall at no time exceed the recorded investment in the loan."

*7) How should a lender recognize interest income on impaired loans?*

Q&A 29 of EITF D-80 states that "Statement 118 amends paragraph 17 of Statement 114 to allow a creditor to use existing methods for recognizing interest income on impaired loans. While the two income recognition methods in paragraph 17 of Statement 114 (cost-recovery or cash-basis method) are no longer required, Statement 118 does not preclude a lender from using either of those methods."

8) *What disclosures and documentation should be provided by an entity that performs troubled debt restructurings of residential mortgage loans?*

Paragraph 20 of Statement 114, as amended by Statement 118, requires that lenders disclose, either in the body of the financial statements or in the accompanying notes, the following information about loans that meet the definition of an impaired loan:

a. As of the date of each statement of financial position presented, the total recorded investment in the impaired loans at the end of each period and (1) the amount of that recorded investment for which there is a related allowance for credit losses determined in accordance with Statement 114 (as amended) and the amount of that allowance and (2) the amount of that recorded investment for which there is no related allowance for credit losses determined in accordance with Statement 114 (as amended).

b. The creditor's policy for recognizing interest income on impaired loans, including how cash receipts are recorded.

c. For each period for which results of operations are presented, the average recorded investment in the impaired loans during each period, the related amount of interest income recognized during the time within that period that the loans were impaired, and, unless not practicable, the amount of interest income recognized using a cash- basis method of accounting during the time within that period that the loans were impaired.

For each period for which results of operations are presented, the activity in the allowance for credit losses related to loans, including the balance in the allowance at the beginning and end of each period, additions charged to operations, direct write-downs charged against the allowance, and recoveries of amounts previously charged off. The total allowance for credit losses related to loans includes those amounts that have been determined in accordance with Statement 5 and with Statement 114.

In addition, paragraph 40(b) of Statement 15 requires that lenders disclose the amount of commitments, if any, to lend additional funds to debtors owing receivables whose terms have been modified in TDRs.

The current illiquid credit market conditions, and the risks and uncertainties associated with those conditions, necessitate that lenders carefully consider the adequacy of disclosures relative to those risks and uncertainties. Particular attention should be directed to the guidance in SOP 94-6 (regarding disclosure of significant risks and uncertainties) and SEC FRR Section 501 (more specifically, Section 501.14, Critical Accounting Estimates).

The FASB also issued FSP SOP 94-6-1 in December 2005 with the stated objective of emphasizing “the requirement to assess the adequacy of disclosures for all lending products (including both secured and unsecured loans) and the effect of changes in market or economic conditions on the adequacy of those disclosures.” This guidance highlights multiple disclosure requirements which may also be relevant to loans within the scope of Statement 114.

Recently, the SEC staff has provided specific comments related to disclosures of critical accounting estimates and MD&A in the current credit environment. In the current credit environment, many companies have reported large increases in the allowance for loan losses, recorded impairment charges on impaired investments, experienced credit downgrades, or even declared bankruptcy. US GAAP requires substantial disclosure regarding fair value assumptions, concentrations of credit risk and exposure to losses. In addition, the SEC has

various disclosure requirements with respect to critical accounting estimates. Registrants are reminded that MD&A is the best place to disclose information about the most judgmental and difficult areas in financial statement preparation and that the minimum US GAAP disclosures may not provide investors with adequate information to evaluate a company's performance.

In addition the SEC staff has reiterated their longstanding view that disclosures about critical accounting estimates, such as the allowance for loan losses, have the potential to be some of the most relevant and important disclosures in a registrant's filings. For example, many registrants that identify valuation of assets or liabilities as critical accounting estimates disclose the fact that valuation becomes more subjective and involves a higher degree of judgment when market data is not available but fail to provide meaningful insight into how their fair value estimates are determined. The SEC staff also stated that when it is reasonably likely that changes in assumptions could have a material impact on a registrant's financial position, operations, liquidity, or capital resources, the registrant should consider disclosing the impact that those changes in assumptions could have on the fair value measurement or other critical accounting estimates. Further, they should consider expanding disclosures to provide insight into how the estimate could be affected by future events. In periods where the value has materially changed (either positively or negatively), registrants should consider disclosing the significant changes in methodology and/or assumptions.

Q&A 18 of EITF D-80 provides guidance on the extent of documentation and analysis necessary to support the allowance for loan losses. It states that "while the extent of documentation is not specifically addressed in Statement 114 or 5, GAAP (such as the AICPA Audit and Accounting Guide, *Banks and Savings Institutions*, Financial Reporting Release 28 for SEC Registrants, and SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, issued in July 2001) does not permit the establishment of allowances that are not supported by appropriate analyses. The approach for determination of the allowance should be well documented and applied consistently from period to period."

*9) What options are available to an entity to simplify the application of this guidance?*

As part of its measurement guidance, Statement 114 acknowledges that entities will need to use judgment and estimates to measure impaired loans and the eventual outcomes may vary from those estimates (paragraph 11). Statement 114 also provides entities with the flexibility to develop measurement methods that are practical in their circumstances. For example, entities may aggregate loans that have similar risk characteristics and may use historical statistics (such as average recovery period and average amount recovered) along with a composite effective interest rate as a means of measuring those impaired loans (paragraph 12).

Paragraph 45 of Statement 114 states that "the Board concluded that it is appropriate to use aggregation techniques in measuring those impaired loans at the present value of the expected future cash flows. Past experience with loans with similar risk characteristics may provide an indication of the average time it takes to work out an impaired loan and the average amount the creditor will recover." When a lender calculates expected cash flows at the individual loan level, default, prepayment, and other cash flow assumptions should be consistent

with assumptions that would be used for a pool of loans with characteristics similar to the individual loan. The objective of such an approach is to approximate the calculation that would have been performed for a similar pool of loans in the aggregate.

In addition, if an entity has a loan whose stated interest rate varies based on an index or rate (such as prime or LIBOR), Statement 114 allows lenders to hold the effective interest rate fixed at the rate used in its initial measurement of impairment, to simplify the application of the guidance in Statement 114.

*10) Should a modified loan be classified as accrual or nonaccrual status?*

GAAP does not provide specific guidance related to whether a loan that has been modified in a TDR should be classified as an accrual or nonaccrual loan. General revenue recognition guidance states that an entity should not recognize income unless it is realizable and earned. Therefore, income related to a loan for which collectibility is not reasonably assured would not be accrued under GAAP. However, federal banking regulators have provided more specific guidance related to whether impaired loans (which include modified loans that are troubled debt restructurings) should be considered accrual or nonaccrual loans. See, for example, the entry for "Nonaccrual Status" in the Glossary to *Instructions for Preparation of Consolidated Reports of Condition and Income as of June 2008*, pages A59-A62, or the past due instructions to the *Thrift Financial Report* (TFR), page 503, which should be applied when required. The applicable regulatory guidance generally requires that interest should only be recorded on a restructured loan when there has been a sustained period of repayment performance and collection under the revised terms is assessed as probable. In addition, the TFR instructions require that the loan be "well secured."