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ACCOUNTING FOR LOAN MODIFICATIONS
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BANK WIRE

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ACCOUNTING FOR LOAN MODIFICATIONS

Are you tracking the right information?

In 2022, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2022-02, *Financial Instruments — Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*. The ASU eliminated the accounting and reporting requirements for troubled debt restructurings (TDRs) for banks that have adopted the current expected credit losses (CECL) allowance methodology.

At the same time, ASU 2022-02 introduced enhanced disclosure requirements for loan modifications. Although the update took effect in 2023 for most banks, given the uncertain economic climate, now is a good time for banks to review their policies, procedures and controls to be sure they're tracking the information needed to fulfill their disclosure obligations.

WHAT'S CHANGING AND WHY?

Prior to ASU 2022-02, banks were required to evaluate loan modifications to determine whether they should be classified as TDRs. A modification was a TDR if the bank granted a concession to the borrower for economic or legal reasons related to a borrower's financial difficulties. Such a concession might include principal forgiveness, a lower interest rate (below the current market rate) or an extension in maturity — that the bank otherwise wouldn't have considered.

If a loan modification was classified as a TDR, the bank had to measure it for impairment and, if appropriate, recognize a valuation allowance or loss. The loan would also likely have to be placed on nonaccrual status.

> UNDER THE CECL METHODOLOGY, BANKS MUST MEASURE AND RECORD LIFETIME EXPECTED CREDIT LOSSES ON LOANS, INCLUDING MODIFIED LOANS CLASSIFIED AS TDRS.

Under the CECL methodology, banks must measure and record lifetime expected credit losses on loans, including modified loans classified as TDRs. Because these loan modifications are incorporated into the allowance for credit losses (ACL) under CECL, the FASB felt that the additional designation as a TDR, together with the related accounting requirements, was unnecessarily complex.

WHAT'S REQUIRED NOW?

Under ASU 2022-02, banks are no longer required to apply the recognition and measurement guidance for TDRs. Instead, they must apply existing loan refinancing and restructuring guidance to determine whether a modification results in a new loan or a continuation of an existing loan. Generally, a modification is treated as a new loan if 1) the terms are at least as favorable to the bank as the terms of similar loans to borrowers with

similar risk characteristics, and 2) the modifications are "more than minor." If a modification constitutes a new loan, the bank can recognize any related net deferred fees in earnings during the current period.

The ASU also prescribed new qualitative and quantitative disclosures for specific loan modifications made for borrowers experiencing financial difficulties. (See "Indicators of financial difficulties" at right.) Modifications that trigger the disclosure requirements include principal forgiveness, interest rate reduction, "other-than-insignificant" payment delays and term extensions.

WHICH DETAILS MUST BE DISCLOSED?

Required disclosures for each reporting period include:

By class of financing receivable. Qualitative and quantitative information about the types of modifications, the financial effect of the modifications (by type) and the borrower's performance in the 12 months following the modification.

By portfolio segment. Qualitative information about how modifications and the borrower's subsequent performance are factored into determining the ACL.

In addition, for each reporting period, banks should disclose the following information about payment defaults during the period on modifications granted in the 12 months preceding the default to borrowers experiencing financial difficulties, including:

By class of financing receivable. Qualitative and quantitative information about defaulted receivables, including types of modifications and amounts defaulted.

By portfolio segment. Qualitative information about how defaults are factored into determining the ACL.

Keep in mind that the systems you previously used to track TDRs won't necessarily capture the information needed to comply with the updated disclosure requirements. For example, prior to ASU 2022-02, an interest rate reduction that wasn't considered a "concession" (because it still qualified as a market rate) wouldn't have triggered a TDR classification. But under the updated guidance, an interest rate reduction for a borrower experiencing financial difficulties should be disclosed — regardless of whether it's considered a concession.

INDICATORS OF FINANCIAL DIFFICULTIES

The current accounting rules call for detailed disclosures when modifying loans for borrowers experiencing financial difficulties. (See main article.) Examples of a few situations that might require enhanced disclosures include when:

- The borrower is currently in payment default on any of its debt or would probably be in default in the foreseeable future without a loan modification,
- The borrower has declared or is in the process of declaring bankruptcy,
- There's substantial doubt whether the borrower will continue as a going concern,
- The borrower has securities that have been delisted, are in the process of being delisted or are under threat of being delisted from an exchange, or
- The bank forecasts, on the basis of current estimates and projections, that the borrower's cash flows will be insufficient to service any of its debt for the foreseeable future.

REVIEW, REVIEW, REVIEW

Banks should review their policies, procedures and controls to ensure they're tracking the information they need to meet their disclosure obligations. Contact an accounting professional to ensure you're complying with the latest accounting rules. ■

BENCHMARKING: USING KPIs TO DRIVE SUCCESS

In today's competitive environment, it's critical for banks to monitor their financial performance and address any weaknesses or red flags they discover. One useful technique is benchmarking — the process of identifying and calculating key performance indicators (KPIs) for your bank and comparing them to established standards.

Those standards may be industry averages, the performance of "best-in-class" banks, or even your own bank's past performance. Benchmarking can be an effective tool for identifying areas for improvement, spotting dangerous trends while there's still time to address them and enhancing your bank's profitability.

SELECT BANK-SPECIFIC BENCHMARKS

In general, KPIs are financial and nonfinancial metrics that help evaluate an organization's progress toward its objectives. You'll need to determine a relevant set of metrics for your bank based on such factors as its size, geographical location and product mix.

The types of metrics available to evaluate performance are virtually unlimited. Six examples of *financial* metrics that may be particularly helpful for banks include:

1. Efficiency ratio (noninterest expense/revenue) to measure how efficiently the bank generates revenue,
2. Net interest margin (interest income – interest expense/total assets) to gauge how effectively the bank is lending its capital,
3. Operating leverage (revenue growth rate – noninterest expense growth rate) to assess operational efficiency,
4. Leverage ratio (Tier 1 capital/total assets) to measure capital adequacy, since Tier 1 capital represents assets that can be liquidated readily in a crisis,
5. Liquidity coverage ratio (high-quality liquid asset amount/total net cash flow) to evaluate the bank's ability to meet short-term obligations without raising outside cash, and
6. Uninvested funds (total uninvested funds – reserve requirements) to show whether the bank keeps its funds invested and generates income.

Also, compare loan and deposit activity during each period to measure growth. When evaluating deposits, be sure to review the total value and number of new deposit accounts, as well as closed deposit accounts.

Nonfinancial metrics should be specific and measurable. For example, if your goal is to improve customer service, a relevant KPI might be to provide an initial response to customer inquiries or complaints within 24 hours.

FIND BENCHMARKING DATA

There are various sources of benchmarking data, including banking trade associations and publications. One valuable resource is the Uniform Bank Performance Report (UBPR), which is published quarterly by the Federal Financial Institutions Examination Council (FFIEC) based on data collected from banks' call reports.

The UBPR includes extensive financial and operational data for each bank, including income statements,

balance sheets, and various financial ratios and metrics related to capital and asset quality. It allows you to benchmark your bank's KPIs against industry or regional averages or against comparable banks in your area or nationwide. If your bank's metrics differ significantly from these benchmarks, uncover the cause and take appropriate action.

> KPIS ARE FINANCIAL AND NONFINANCIAL METRICS THAT HELP EVALUATE AN ORGANIZATION'S PROGRESS TOWARD ITS OBJECTIVES.

TAILOR THE ANALYSIS TO YOUR BANK

For benchmarking to be effective, tailor the analysis to your bank's characteristics. That means measuring your bank's performance against comparable peers in terms of balance sheet, revenue sources, loan mix and so forth.

It's also important to recognize the limitations of specific financial metrics. For example, various financial ratios are available to quantify liquidity, but they don't necessarily tell the whole story. Your bank's liquidity risk may be influenced by qualitative factors, such as borrowing capacity and deposit structure. Two banks may have identical liquidity ratios, but if one is more likely to experience early withdrawals, for instance, its liquidity risk is much higher.

MONITOR YOUR VITAL SIGNS

When you go to the doctor, the first thing they do is measure your pulse, blood pressure, temperature and other vital signs. If any of these measurements are out of line with what's considered "normal," it may signal an underlying issue. Similarly, banks should monitor their financial health by benchmarking their financial performance. But just as with your personal health, these financial vital signs aren't meaningful by themselves. It's important to diagnose the underlying causes to determine whether there's a problem that needs to be addressed. ■

HOW TO MONITOR AND MANAGE INTEREST RATE RISK

Interest rates have been at top of mind for many financial professionals in recent years. Interest rate fluctuations can significantly affect a bank's deposit stability, earnings and asset values, for better or worse. Banks need to control their interest rate risk to ensure their capital and liquidity remain stable through the ups and downs.

WHAT'S INTEREST RATE RISK?

Interest rate risk means risk to a bank's financial condition or resilience (that is, its ability to withstand periods of stress) caused by movements in interest rates. Examples of this risk include:

Repricing risk. Banks experience this risk when their assets and liabilities reprice or mature at different times. Suppose a bank makes a five-year, fixed-rate loan at 7% that's funded by a six-month certificate of deposit (CD) at 3%. Every six months, when the CD renews, the bank is exposed to repricing risk. If the CD rate increases to 4% after six months, the bank's net interest income drops from 4% to 3%. Conversely, if the CD rate declines, the bank's net interest income increases.

To gauge repricing risk, compare the volume of assets and liabilities that mature or reprice over a given time period. The potential impact of fluctuating interest rates depends in part on whether your bank is asset- or liability-sensitive. If it's asset-sensitive — meaning assets reprice more quickly than liabilities — then its earnings generally increase when interest rates rise and decrease when they fall. If it's liability-sensitive — meaning liabilities reprice more quickly than assets — then its earnings generally increase when interest rates fall and decrease when they rise. Some banks are neutral — that is, their assets and liabilities reprice at the same time.

Basis risk. This risk arises when there's a shift in the relationship between rates in different markets or on different financial instruments. Suppose, for example, that an asset and a related liability are tied to the prime rate and the one-year U.S. Treasury rate, respectively. If the spread between those two rates widens or narrows, it will affect the bank's net interest margins.

Yield curve risk. This risk arises from changes in the relationships among yields from similar instruments with different maturities. For instance, a bank funds long-term loans with short-term deposits. A typical yield curve reflects rates that rise as maturities increase. However, if market conditions cause the yield curve to flatten or even slope downward, the bank's net interest margins can shrink or even turn negative.

Options risk. Bank assets and liabilities often contain embedded options, such as the right to pay off a loan or withdraw deposits early with little or no penalty. The bank is compensated for offering customers this flexibility (typically in the form of higher interest rates on loans or lower interest rates on deposits). But these options create interest rate risk. For example, if interest rates go up, deposit holders will have an incentive to move their funds into investments that enjoy higher returns. If rates go down, many borrowers will refinance at a lower rate.

Another risk associated with rising interest rates is an increased risk of default by borrowers with variable rate loans.

WHAT STEPS SHOULD YOUR BANK TAKE?

Banks can apply financial modeling techniques to measure and monitor their interest rate risk. If your risk is unacceptably high, consider strategies for mitigating it, such as:

- Adjusting your bank's mix of assets and liabilities,
- Increasing capital to help the bank absorb the impact of fluctuating interest rates,
- Reducing options risk by controlling the terms of loans and deposits, and
- Using interest rate swaps or other techniques to hedge against interest rate risk.

Keep in mind that a key component of interest rate risk management is stress testing.

ONE PIECE OF THE RISK-MANAGEMENT PUZZLE

It's important not only to address interest rate risk, but also to understand how it relates to other risks your bank is facing. This provides context for improving your entire risk-management system going forward. ■

BANK WIRE

CFPB FINALIZES RULE TO REMOVE MEDICAL BILLS FROM CREDIT REPORTS

In January, the Consumer Financial Protection Bureau (CFPB) finalized a rule that bans the inclusion of medical bills on credit reports. It also prohibits lenders from using medical information in their lending decisions. According to the CFPB's research, the existence of a medical bill on a person's credit report is a poor predictor of his or her ability to repay a loan.

The rule aims to "increase privacy protections and prevent debt collectors from using the credit reporting system to coerce people to pay bills they don't owe." Lenders will still be permitted to consider medical information for certain legitimate purposes, such as verifying medical expenses that will be paid with a loan. ■

WATCH OUT FOR FinCEN-RELATED FRAUD SCHEMES

In a recent alert, the Financial Crimes Enforcement Network (FinCEN) warned of fraud schemes "abusing FinCEN's name, insignia and authorities for financial gain." FinCEN asks financial institutions to report suspicious activities and urges customers to be vigilant.

For example, one scheme targets companies trying to report beneficial ownership information (BOI) to FinCEN. A scammer may attempt to convince a company to pay a filing fee to submit the company's BOI report to FinCEN. The scammer then pockets the money but doesn't file the report. Sensitive information about the company, including details about its owners and officers, also may be stolen from the report and exploited for fraud or other malicious purposes.

Scammers may contact targeted companies via text message, email or U.S. mail. In some cases, they use names similar to FinCEN or pose as government agencies, such as "United States Business Regulations Department" or "Annual Records Service." ■

BANKS URGED TO COMBAT ELDER FRAUD

The federal banking agencies recently published an interagency statement to "raise awareness and provide strategies to supervised institutions for combating elder financial exploitation, consistent with applicable legal requirements."

Potential strategies include:

- Implementing policies and practices — such as risk-based policies, internal controls, employee codes of conduct, ongoing transaction monitoring practices and complaint processes — to better protect account holders and institutions from the elder financial exploitation,
- Providing clear, comprehensive and recurring training to help employees recognize and respond to elder financial exploitation,
- Using transaction holds and disbursement delays, in compliance with applicable laws, to prevent consumer losses and respond to situations that may involve elder financial exploitation, and
- Establishing policies and procedures that enable account holders to designate one or more trusted contacts that employees can contact about elder financial exploitation suspicions.

In addition, institutions may be required to file suspicious activity reports when elder fraud is suspected, and should consider reporting suspected fraud to the authorities. (In some states, this is required.) ■

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We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

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