Bank Notes

May/June 2011

A timely information and idea statement

Clarifications to Accounting for Troubled Debt Restructurings by Creditors

According to the FDIC Quarterly Banking Profile, Troubled Debt Restructurings (TDRs) for all insured institutions have grown from $6.9 billion at year end 2007 to $87.5 billion at year end 2010. Federal banking regulators have noted that TDRs are an area of focus for examiners and the larger volume of modifications have resulted in significant concerns about the level of allowance for loan losses associated with these loans. In addition, the Federal Financial Institutions Examination Council (FFIEC) recently made Call Report revisions, effective March 31, 2011, that require additional TDR information by loan type on Schedules RC-C and RC-N.

Because of the magnitude of restructuring activities, regulators, investors, auditors and lending institutions have raised concerns about the diversity in practice in identifying loan modifications that constitute TDRs for a creditor. To achieve more consistent application of generally accepted accounting principles for debt restructurings, the Financial Accounting Standards Board (FASB) recently issued Accounting Standards Update (ASU) 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. The ASU sets forth guidance to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a TDR, both for purposes of recording an impairment and for disclosure of TDRs.

In evaluating whether a restructuring constitutes a TDR, a creditor must separately conclude that both of the following exist: a) the restructuring constitutes a concession; and b) the debtor is experiencing financial difficulties. The accounting guidance has been amended to clarify:

- If a debtor does not otherwise have access to funds at a market rate for debt with similar risk characteristics as the restructured debt, the restructuring would be considered to be at a below-market rate, which may indicate that the creditor has granted a concession. In that circumstance, a creditor should consider all aspects of the restructuring in determining whether it has granted a concession. If a creditor determines that it has granted a concession, the creditor must make a separate assessment about whether the debtor is experiencing financial difficulties to determine whether the restructuring constitutes a TDR.
- A temporary or permanent increase in the contractual interest rate as a result of a restructuring does not preclude the restructuring from being considered a concession. This is the case because the new contractual interest rate on the restructured debt could still be below the market interest rate for new debt with similar risk characteristics. **Note:** This guidance will be more challenging for lending institutions to document in practice, especially in an increasing interest rate environment.
- A restructuring that results in a delay in payment that is insignificant is not a concession. However, an entity should consider various factors in assessing whether a restructuring resulting in a delay in payment is insignificant. The amended guidance includes examples illustrating the assessment of whether a restructuring results in a delay in payment that is insignificant.
- A creditor may conclude that a debtor is experiencing financial difficulties, even though the debtor is not currently in payment default. A creditor should evaluate whether it is probable that the debtor would be in payment default on any of its debt in the foreseeable future without the modification.
- A creditor is precluded from using the effective interest rate test in the debtor's guidance on restructuring of payables (paragraph 470-60-55-10) when evaluating whether a restructuring constitutes a TDR.
- A creditor has granted a concession when, as a result of the restructuring, it does not expect to collect all amounts due, including interest at the original contract rate. In that situation, and if the payment of principal is primarily dependent on the value of collateral, an entity shall consider the *current* value of that collateral in determining whether the principal will be paid.
- A creditor may restructure a debt in exchange for additional collateral or guarantees from the debtor. In that situation, a creditor has granted a concession when the nature and amount of the additional collateral or guarantees received as part of a restructuring does not serve as adequate compensation for other terms of the restructuring.

For public entities, the amendments are effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to restructurings occurring on or after the beginning of the annual period of adoption. For purposes of measuring impairment of those receivables, an entity should apply the amendments prospectively for the first interim or annual period beginning on or after June 15, 2011. The disclosures required by paragraphs

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Emerging Technologies and When to Implement From a Risk Perspective

What are "emerging technologies"?

Emerging technologies are technologies that are new and innovative, or in some cases using relatively recent existing technology in a new or converged manner. For purposes of this article, we will limit the discussion of emerging technologies to the convergence of existing technologies as they tend to have the largest impact on business due to their process disruptions.

Examples of the convergence of technologies include cellphones and personal digital assistants (PDAs), which were previously separate technologies and now are generally packaged as one in the form of a smartphone (iPhone, Android, etc.). Prior to the convergence of these technologies, each singular device (cellphone and PDA) ran separate proprietary operating systems and hardware. For example, as little as seven to eight years ago, it was common to carry a Palm Pilot PDA, as well as a Motorola Star TAC cellphone. Each was separate, did not interface with each other and required a docking station or cable and software to interface with corporate applications.

In our example, we can take it one step further; as convergence has continued as corporate applications and other device-specific applications (GPS for example) continue to be merged/converged into smartphones. We could continue down this path as several smartphones have music player capabilities and other uses. We can even remotely start cars with them via OnStar.

The implementation question

There are various business factors that go into the decision of when to implement emerging technologies. One of the most important considerations is the benefits sought from the implementation; some of the most commonly desired are:

- Cost savings
- Customer service
- Market leadership
- Power savings

A technologist will quickly identify that there are many more benefits that can be listed, but when working with clients in the field the above benefits are the most commonly mentioned.

Of course, the actual benefits derived from the implementation of a particular emerging technology depend on the technology being deployed. For example, in recent years many customer service oriented businesses, such as banks and online retailers, have implemented some form of "live chat" so that their Internet savvy customers can converse online with one of their customer support representatives or sales staff. A primary benefit of implementing this technology is customer service, while secondary benefits may exist as well such as accuracy of orders in the case of online retail.

While these benefits are important, another critical factor that often gets overlooked when considering the implementation of an emerging technology is that of risk. When risk is not accounted for, the true cost of implementation is under estimated and can also lead to poor implementation.

Generally speaking, new or emerging technology implementations should always be treated as riskier than the technology they replace. This should be an important factor in deciding when (or if) to implement the technology.

There are many examples of new technology not being managed properly and the subsequent costs exceeding the benefits of the technology, such as when Nike had a 28 percent restatement of earnings in 2001 from a poorly managed enterprise software implementation. What is unusual regarding this example is the size of business in which the technology was being deployed and the complexity of the solution, but it does point to the enormity of the potential risks of implementation.

When we consider contemporary emerging technologies, such as smartphones and smartphone applications, there are several examples of security issues being discovered. A short list of some of the more recent security issues documented includes the following:

1. Citigroup disclosed that its free mobile banking application accidentally saved account numbers and other sensitive information on devices. (2010)
2. Google recently began remote wiping Android devices infected with malware after discovering more than 50 malicious applications in the official Android market. (2011)
3. Apple released iOS 4.3 for the iPhone 3 and other devices to address critical security issues with their product, according to US-Cert and other information sources. (2011)
4. According to US-Cert, Research In Motion (RIM), the maker of the BlackBerry issued a security alert warning users that during browsing, the BlackBerry is susceptible to a data mining exploit. (2011)

As can be seen from this short list, serious security risks have been discovered in what many would consider to be the smartphone market leaders, and we can conservatively assume that all smartphones are likely to have security issues that are or will be discovered. This does not mean that an organization should NOT implement emerging technology, but that the decision to implement should consider the potential risks associated with the implementation.

Consideration of risk

There are many risk models that attempt to factor the risk of the implementation of emerging technology into the organization; some complicated and others straightforward. To illustrate one approach, we will use mobile banking as an example of a business process (e-banking) utilizing an emerging technology (smartphones). A simple approach or framework includes, at a minimum, the following steps (in an actual implementation, there will likely be more):

The technology:
Identify the technology (smartphones) and the business process (mobile banking), as well as an inventory of the components that enable the solution and features.

Our example will include:

1. The smartphones supported (the goal could be all of them, but iPhones, for example, have not been able to support Adobe Flash, although a recent announcement addresses this)

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Tax Concerns Related to Bank Mergers

Under the Internal Revenue Code, there are no fewer than nine different types of reorganizations that permit one corporation to acquire a second corporation in a tax-free (really tax deferred) manner. Other than FDIC-assisted acquisitions, the predominant method of acquisition in the banking industry is the statutory merger. Three types of these mergers exist under the Code, and each has potential taxation issues that could lead to trouble.

Mergers are prevalent in the banking industry due to the tax and business benefits they provide. However, any agreement involving the transfer of large amounts of assets and liabilities should not be considered lightly as trouble spots can arise. With proper planning, potential missteps can be anticipated and frequently eliminated to help the transaction achieve the desired results.

For a comprehensive analysis of specific areas that could lead to taxation issues during a merger, download the white paper *The Trouble With Mergers: Tax Concerns Within the Banking Industry* at www.mcgladrey.com.

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2. The mobile banking solution vendor
3. One could argue that the core system belongs here or at least the interface
4. The mobile banking features that the user will have access to

The risks associated with the technology:
Essentially, an attempt is made to identify the risks of using the technology. The list should be as exhaustive as possible and a subject matter expert might need to be consulted.

If we continue with our example, a short list of some of the risks could be:

1. User loses their smartphone
2. User browses to unsafe sites, and smartphone becomes infected with Trojan code
3. Smartphone user information is not updated
4. User purchases a new phone and has their information moved from the old phone to the new phone, but does not securely erase their old phone before selling or discarding it

Control measure to mitigate the risks
This is where an organization identifies control measures that remove or reduce the risks identified above. In some cases, it may take multiple control measures to mitigate a risk; often there is not one "silver bullet" for each of the risks identified.

Continuing with our example in order of risks listed:

1. Multifactor authentication, red flagging unusual activity, out-of-band authentication of transfers
2. Application cookie verification to mitigate cookie replay attempts, red flagging unusual activity
3. Application performs a system health check and notifies the user of out-of-date smartphone, application cookie verification to mitigate cookie replay attempts, red flagging unusual activity
4. Utilization of the registration of devices to the application, which would red flag the legitimate users attempts and when the organization is notified, the old version would be unregistered, red flagging unusual activity

Summary

Emerging technologies have and will continue to be introduced into banks at an ever increasing pace. While emerging technologies generally bring many improvements to the institution and their customers, the technologies also bring risks to the organization. An important step in the implementation planning phase is to identify the risks associated with the technology and control measures that need to be introduced to minimize the risks. Only when the risks have been accounted for and their implementation costs included in the overall plan will an institution have a good understanding of the total costs and the impact of the technology on their risk posture.

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310-10-50-33 through 50-34, which were deferred by ASU 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*, are effective for interim and annual periods beginning on or after June 15, 2011. These disclosures include the financial effects of loan modifications and default information on restructured loans. As such, public entities will need appropriate policies, procedures and controls to look back at loan renewals and modifications affected since Jan. 1, 2011 that were not classified as TDRs and determine if they should be classified as TDRs pursuant to this amended guidance.

For nonpublic entities, the amendments are effective for annual periods ending on or after Dec. 15, 2012, including interim periods within those annual periods. Early adoption is permitted.

In conclusion, this guidance is expected to increase the level of loan modifications that will be reported and accounted for as TDRs. While it is understandable that many may not like the short term accounting implications of reporting TDRs, there clearly remains the business decision for TDRs in an attempt to protect as much of the value in the loan receivable as possible. The objective is to make the best of a difficult situation and to prudently structure terms whereby the creditor expects to obtain more cash or other value from the debtor, or increase the probability of receipt, by granting the concession than by not granting it.

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