7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 741

NCUA 2020—XX-XXXX

RIN: 3133-AF30

Capitalization of Interest in Connection with Loan Workouts and Modifications

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: The NCUA Board (Board) seeks public comment on a proposed rule to amend its regulations by removing the prohibition on the capitalization of interest in connection with loan workouts and modifications. The Board has determined that the current prohibition on authorizing additional advances to finance unpaid interest may be overly burdensome and, in some cases, hamper a federally insured credit union's (FICU's) good-faith efforts to engage in loan workouts with borrowers facing difficulty because of the economic disruption that the COVID-19 pandemic has caused. Advancing interest may avert the need for alternative actions that would be more harmful to borrowers. The proposed rule would establish documentation requirements to help ensure that the addition of unpaid interest to the principal balance of a mortgage loan does not hinder the borrower's ability to become current on the loan. The proposed change would apply to workouts of all types of member loans, including commercial and business loans. The Board has also taken this opportunity to make several technical changes to the Appendix to improve its clarity and update certain references. For the convenience of

readers, the Board is republishing the Appendix in its entirety so that the changes may be viewed in the context of the full document.

DATES: Comments must be received on or before [INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: You may submit written comments, identified by RIN 3133-AF30, by any of the following methods (**Please send comments by one method only**):

- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments for NCUA 2020—XX-XXXX.
- Fax: (703) 518-6319. Include "[Your Name]—Comments on "Proposed Rule: Capitalization of Interest in Connection with Loan Workouts and Modifications" in the transmittal.
- Mail: Address to Melane Conyers-Ausbrooks, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314-3428.

PUBLIC INSPECTION: You may view all public comments on the Federal eRulemaking Portal (http://www.regulations.gov) as submitted, except for those we cannot post for technical reasons. The NCUA will not edit or remove any identifying or contact information from the public comments submitted. Due to social distancing measures in effect, the usual opportunity to inspect paper copies of comments in the NCUA's law library is not currently available. After social distancing measures are relaxed, visitors may make an appointment to review paper copies by calling (703) 518-6540 or e-mailing OGCMail@ncua.gov.

FOR FURTHER INFORMATION CONTACT: Scott Neat, Associate Director of the Office of Examination and Insurance, at (703) 518-6360; and Ariel Pereira and Gira Bose, Staff Attorneys, Office of General Counsel, at (703) 518-6540.

SUPPLEMENTARY INFORMATION:

I. Background.

A. May 2012 Adoption of the Loan Workout and Accrual and TDR Requirements

In May 2012, the Board published a final rule on loan workout policies and monitoring requirements that applies to all FICUs. The rule also established requirements for nonaccrual policies, and for regulatory reporting of troubled debt restructurings (TDRs).[1] The Board noted that the May 2012 final rule was similar to guidance set forth in an interagency policy statement issued by the banking agencies of the Federal Financial Institutions Examination Council (FFIEC) on June 12, 2000,[2] though the NCUA did not join the agencies in issuing the statement.

The May 2012 final rule, codified in Appendix B to Part 741 of the NCUA's regulations, established four requirements.

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[1] 77 FR 31993 (May 31, 2012).

[2] FFIEC, Uniform Retail Credit Classification and Account Management Policy, 65 FR 36903 (June 12, 2000).

1. The final rule required that FICUs have written policies that address loan workouts and nonaccrual practices required under § 741.3, Criteria. In Appendix B, the Board also required that such policies prohibit a credit union from authorizing additional advances to a borrower to finance unpaid interest (capitalization of interest) and credit union fees. Credit unions are permitted to make such advances to cover third-party fees, excluding credit union commissions, such as force-placed insurance and property taxes. This requirement is similar to the expectation established in the June 2000 interagency statement of policy cited above, except that the interagency statement provided that a bank's policies should prohibit such advances but did not state that the policies must prohibit them.
2. The final rule standardized an industry-wide practice by requiring that FICUs cease to accrue interest on all loans at 90 days or more past due, subject to a few exceptions.
3. The final rule required that a FICU maintain member business workout loans in a nonaccrual status until it receives six consecutive payments under the modified terms.
4. The final rule required that FICUs calculate and report TDR loan delinquency based on restructured contract terms, rather than the original loan terms.

In adopting the May 2012 final rule, the Board stated its intention to provide regulatory relief to FICUs while instituting countervailing controls and clarifying regulatory expectations. In the 2012 rulemaking, the Board acknowledged the need to balance appropriate loan workout programs with safety and soundness considerations. The Board noted that such considerations include the ability to identify deterioration in the quality of the loan portfolio and delayed loss recognition in light of the high degree of relapse into past due status.

B. COVID-19 Pandemic and FFIEC Statement on Loan Accommodations

In light of the challenges and economic disruption caused by the COVID-19 pandemic, the Board is proposing an amendment to the requirement in the May 2012 final rule that relates to the capitalization of interest.[3] As the NCUA and other member agencies of the FFIEC noted in an August 2020 statement on loan accommodations, the COVID-19 pandemic has had a significant adverse impact on consumers, businesses, financial institutions, and the economy.[4]

To address such impacts, the Coronavirus Aid, Relief, and Economic Security (CARES) Act[5] provided several forms of relief to businesses and borrowers, and some states and localities have provided similar credit accommodations. Additionally, many financial institutions have voluntarily offered borrowers other credit accommodations.

The NCUA, along with the other FFIEC members, has encouraged financial institutions to work prudently with borrowers who are unable, or may become unable, to meet their contractual payment obligations as a result of the COVID-19 pandemic.[6] Specifically, the NCUA and the other FFIEC members have stated that they view loan accommodations as positive actions that can mitigate adverse effects on borrowers caused by the COVID-19

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[3] The coronavirus disease 2019 outbreak was declared a national emergency under Proclamation 9994, 85 FR 15337 (Mar. 18, 2020).

[4] *Joint Statement on Additional Loan Accommodations Related to COVID-19*, available at https://www.ncua.gov/files/press-releases-news/joint-statement-additional-loan-accommodations.pdf.

[5] Pub. L. 116-136, 134 Stat. 281 (Mar. 27, 2020).

[6] *See* Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Revised), (Apr. 7, 2020) and FFIEC's Joint Statement on Additional Loan Accommodations Related to COVID-19 (Aug. 3, 2020).

pandemic. For borrowers experiencing financial hardship, a prudently underwritten and appropriately managed loan modification, consistent with safe and sound lending practices, is generally in the long-term best interest of both the borrower and the credit union. Such modifications may allow a borrower to remain in their home or a commercial borrower to maintain operations due to external circumstances, and can help credit unions minimize the costs of default and foreclosures.

While some borrowers will be able to resume contractual payments at the end of an accommodation, others may be unable to meet their obligations due to continuing financial challenges. In light of these challenges, the NCUA and the other FFIEC members encouraged financial institutions to consider prudent accommodation options that are based on an understanding of a borrower's credit risk. Accommodations must also be consistent with applicable laws and regulations and ease cash flow pressures to improve the affected borrower's ability to service debt, which improves a financial institution's ability to collect on its loans. The agencies noted that such arrangements also may reduce financial stress on borrowers by decreasing delinquencies or other adverse consequences. Imprudent relief practices by a lender can adversely affect borrowers and expose financial institutions to increases in credit, compliance, reputational, operational, and other risks. Additionally, imprudent relief practices present risks to a financial institution's capital position.

C. Capitalization of Unpaid Interest

During development of the interagency guidance discussed above, the Board determined that the prohibition in the May 2012 final rule on the capitalization of interest might be overly burdensome and, in some cases, possibly hamper a FICU's good-faith efforts to engage in loan workouts with borrowers facing difficulty because of the economic disruption caused by the COVID-19 pandemic.

Banks are not subject to the same prohibition on capitalizing interest (the banking agencies have not adopted an absolute standard equivalent to the rule that the Board codified in 2012). The banking agencies have addressed capitalization of interest through guidance, letters, and Call Report instructions, none of which strictly prohibit the capitalization of interest when modifying loans. Instead, the banking agencies examine these practices for safety and soundness during the course of their supervision. As a result, FICUs have fewer options when working with their member borrowers, as compared to banks.

Further, the government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, have had a long-standing policy supporting the ability of servicers to capitalize interest and fees as part of a prudent modification program. When FICUs originate certain loans, they often do so with the intent of selling to the secondary market for liquidity or other strategic purposes, but many FICUs may retain servicing rights after the sale of the loan. The GSEs are frequent investors in FICU-originated loans. After such a sale, if a member with a loan sold by a FICU begins experiencing financial difficulty and needs assistance in the form of a modification, capitalization of interest is permitted within a loan workout by the GSE that now holds the loan. However, for loans retained by the FICU, the borrower would not get the benefit of interest capitalization upon a loan workout due to the prohibition currently in the Appendix. This contrast with the GSEs' policy results in inequitable treatment of members within the same FICU, which jeopardizes the integrity of the cooperative membership base.

For the reasons described in the preceding discussion, the Board believes the current rule's prohibition on the capitalization of interest limits a FICU's options to implement a mutually beneficial solution that addresses the potential financial challenge of their members when the forbearance period ends. As discussed in greater detail in the Summary of the Proposed Rule, the Board proposes to remove the prohibition on capitalization of interest from Appendix B. As noted, the Board's reconsideration was partially prompted by the economic impact of the COVID-19 pandemic and related developments. Other considerations described above, such as parity with the treatment of interest capitalization by banks, have also factored in the Board's determination. Accordingly, the Board believes it is appropriate to propose amending Appendix B to make capitalization of interest a permissible option indefinitely. Despite proposing this change, the Board underscores that Appendix B currently requires several safety and soundness and consumer protection-oriented measures that would also apply to this practice. Furthermore, capitalization of interest is not an appropriate solution in all cases and, as the Appendix currently provides, a FICU should consider and balance the best interests of the credit union and the borrower. In addition, the Board proposes to add several consumer protection and safety and soundness requirements to the Appendix for FICUs that capitalize interest in connection with loan workouts.

II. Legal Authority

The Board issues this proposed rule pursuant to its authority under the Federal Credit Union (FCU) Act.[7] Under the FCU Act, the NCUA is the chartering and supervisory authority

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[7] 12 U.S.C. 1751 *et al.*

for FCUs and the Federal supervisory authority for FICUs.[8] The FCU Act grants the NCUA a broad mandate to issue regulations that govern both FCUs and FICUs. Section 120 of the FCU Act is a general grant of regulatory authority and authorizes the Board to prescribe rules and regulations for the administration of the FCU Act.[9] Section 209 of the FCU Act is a plenary grant of regulatory authority to the NCUA to issue rules and regulations necessary or appropriate to carry out its role as share insurer for all FICUs.[10] Accordingly, the FCU Act grants the Board broad rulemaking authority to ensure that the credit union industry and the National Credit Union Share Insurance Fund remain safe and sound.

III. Summary of the Proposed Rule

A. Capitalization of Interest

The Board is proposing to amend a prescriptive requirement in its regulations by amending Appendix B of Part 741 to remove the prohibition on the capitalization of interest in connection with loan workouts and modifications. The proposed change would apply to workouts of all types of member loans, including commercial and business loans. The NCUA also notes that—consistent with the scope of Appendix B—the proposed change addresses the capitalization of interest in connection with loan modifications. The proposed rule, however, does not address the capitalization of interest that may occur in other contexts. The Board notes that banks frequently include interest capitalization as one of several components in a loan restructuring to mutually benefit the lender and the borrower. The Board expects that FICUs will

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[8] 12 U.S.C. 1752–1775.

[9] 12 U.S.C. 1766(a).

[10] 12 U.S.C. 1789(a)(11).

follow suit, and provide borrowers with the option to capitalize interest along with other loan modification options, such as the lowering of loan payments or the interest rate, extending the maturity date, partial principal or interest forgiveness and other modifications.

The proposed rule would add a definition of capitalized interest to the Glossary of Appendix B. For the purposes of this rulemaking, capitalization of interest constitutes the addition of accrued but unpaid interest to the principal balance of a loan. This differs from ceasing to accrue interest on past-due loans, generally when the loan reaches 90 days past due.

The rule will continue to provide that a credit union may, in no event, authorize additional advances to finance credit union fees and commissions. FICUs will be permitted to continue to make advances to cover third party fees to protect loan collateral, such as force-placed insurance or property taxes. The Board believes that maintaining the prohibition on the capitalization of credit union fees is an important consumer protection feature of the rule for member borrowers.

Prior to 2012, NCUA guidance contemplated capitalization of interest and fees as one of many options available to credit unions to modify a loan to accommodate a borrower's circumstances. In the 2012 final rule, the Board adopted a requirement that a FICU's loan workout policy prohibit additional advances to finance unpaid interest and fees. The final rule did allow such advances to finance third-party fees, which was in response to a request by a commenter on the proposed rule. The 2012 final rule did not explain the reasons this practice was prohibited. The Board has reconsidered the conclusion from the 2012 final rule and proposes to remove the prohibition on the capitalization of interest because, when used appropriately, capitalization of interest may be in the best interests of both a FICU and the borrower. Accordingly, the proposed rule would delete this prohibition from Appendix B.

The Board underscores that in proposing to remove this prohibition, it would maintain several requirements that apply to all loan workout policies in Appendix B. For example, the Appendix establishes the expectation that loan workouts will consider and balance the best interests of the FICU and the borrower, including consumer financial protection measures. Ensuring the best interest of the borrower prohibits predatory type lending practices such as including loan terms that result in negative amortization. In addition, a FICU's policy must establish limits on the number of modifications allowed for an individual loan. Further, the policy must ensure that a FICU make loan workout decisions based on a borrower's renewed willingness and ability to repay the loan.

If a FICU restructures a loan more frequently than once a year or twice in five years, examiners will have higher expectations for the documentation of the borrower's renewed willingness and ability to repay the loan. The current Appendix also sets forth several supervisory expectations relating to multiple restructurings, stating that examiners will request validation documentation regarding collectability if a FICU engages in multiple restructurings of a loan. The current Appendix also requires that a FICU maintain sufficient documentation to demonstrate that the FICU's personnel communicated the new terms with the borrower, that the borrower agreed to pay the loan in full under the new terms and, most importantly, the borrower has the ability to repay the loan under any new terms.

These requirements and expectations, which currently apply to FICUs' loan workout policies, would apply equally if a FICU adopts a practice of capitalizing interest in connection with loan workouts. In addition, in light of the potential for this practice to have a detrimental effect on borrowers if executed inappropriately, and to mask the true financial status of a loan and a credit union's financial statements, the Board proposes to add requirements to the Appendix to apply to FICUs that engage in this practice.

Modifications of loans that result in capitalization of unpaid interest are appropriate only when the borrower has the ability to repay the debt in accordance with the modification. At a minimum, if a FICU's loan modification policy permits capitalization of unpaid interest, the policy must require each of the following:

1. Compliance with all applicable consumer protection laws and regulations, including, but not limited to, the Equal Credit Opportunity Act, the Fair Housing Act, the Truth In Lending Act, the Real Estate Settlement Procedures Act, the Fair Credit Reporting Act, and the prohibitions against the use of unfair, deceptive or abusive acts or practices contained in the Consumer Financial Protection Act of 2010. (The Board notes that FICUs are also expected to comply with applicable State consumer protection laws that, in some instances, may be more stringent than Federal law, prohibiting, for example, the charging of interest on interest.)

2. Documentation that reflects a borrower's ability to repay, a borrower's source(s) of repayment, and when appropriate, compliance with the FICU's valuation policies at the time the modification is approved.

3. Providing borrowers with documentation that is accurate, clear, and conspicuous and consistent with Federal and state consumer protection laws.

4. Appropriate reporting of loan status for modified loans in accordance with applicable law and accounting practices. The FICU shall not report a modified loan as past due if the loan was current prior to modification and the borrower is complying with the terms of the modification.

5. Prudent policies and procedures to help borrowers resume affordable and sustainable repayments that are appropriately structured, while at the same time minimizing losses to the credit union. The prudent policies and procedures must consider:

i. Whether the loan modifications are well-designed, consistently applied, and provide a favorable outcome for borrowers.

ii. The available options for borrowers to repay any missed payments at the end of their modifications to avoid delinquencies or other adverse consequences.

6. Appropriate safety and soundness safeguards to prevent the following:

   i. Masking deteriorations in loan portfolio quality and understating charge-off levels;

   ii. Delaying loss recognition resulting in an understated allowance for loan and lease losses account or inaccurate loan valuations;

   iii. Overstating net income and net worth (regulatory capital) levels; and

   iv. Circumventing internal controls.

B. *Technical Updates to Appendix B*

The Board has also taken this opportunity to make several technical changes to the Appendix to improve its clarity and update certain references. For example, the Board is proposing several updates to references to the NCUA's or other guidance in the Appendix, such as guidance or standards issued by other federal banking agencies or the Financial Accounting Standards Board (FASB). These changes are intended to provide more current information, and are not intended to entail substantive policy changes within the Appendix.

In May 2014, FASB issued an accounting standards update for revenue recognition (ASU 2014-09) which replaced the cost recovery method of income recognition in ASC 605-10-25-4 with transition guidance found in ASC 606—Revenue from Contracts with Customers. The

(2012) Appendix made reference to the cost recovery method of income recognition with citation in the Glossary. As this has been superseded by ASC 606, the Board eliminated this reference in the Appendix and emphasizes that accrual of interest income ceases on a financial asset when full payment of principal and interest in cash is not expected.

In addition, to conform to the terminology that the Board adopted in 2016 in amending part 723,[11] the Board proposes to update references to member business loans to also refer to commercial loans. These changes are not intended to create new requirements or standards.

The Board also proposes to make terminology in the Appendix consistent with its purpose. The Appendix sets forth requirements for FICU policies relating to loan workouts, TDRs, and nonaccrual status. In several instances, the current Appendix uses the word "should" when referring to necessary elements of a FICU's policies or refers to the Appendix as "guidance" or an interpretive ruling and policy statement. To make the purpose and effect of the Appendix clearer, the Board proposes using mandatory language where appropriate and eliminating references to the Appendix as "guidance."

Finally, the Board proposes to clarify several statements of the Appendix to make it more consistent with plain language principles. The Board does not intend to make any substantive changes in these amendments. The *Federal Register*'s publication procedures require the Board to print the entire revised Appendix in the amendatory instructions of this proposed rule. To help commenters follow the proposed changes, the NCUA will post a document on its website that shows the specific proposed changes in redline or strikethrough form.

[11] 81 FR 13530 (Mar. 14, 2016)

C. NCUA Questions for Comment

The NCUA is interested in all aspects of the interest capitalization issue. In addition to offering your comments on any aspect of this proposed rule, please provide your input on the following questions:

1. What was your experience or level of use with interest capitalization before the agency prohibited the practice in 2012 pursuant to Appendix B?

2. How likely are you to incorporate interest capitalization as a mortgage modification tool if permitted by the agency?

3. What risks do you foresee, if any, to either the credit union or the borrower in a mortgage modification that includes capitalization of interest?

4. When credit unions originate certain loans, they often do so with the intent of selling to the secondary market. The GSEs are frequent investors in credit union originated loans. Subsequent to sale, if a member with a loan sold by a credit union begins experiencing financial difficulty and needs assistance in the form of a modification, capitalization of interest is permitted within a loan workout by the GSE who now holds the loan. However, Fannie Mae does not permit interest capitalization *prior* to sale and Freddie Mac does so only under certain conditions. How would this limitation on capitalizing interest prior to sale to a GSE impact your willingness or ability to offer interest capitalization on a loan?

5. In light of the fact that adding unpaid interest to the principal balance of a mortgage loan could potentially be detrimental to a member's ability to become current on the loan, the NCUA is proposing to add a number of consumer protection guardrails to Appendix B. We invite comments on these guardrails. In addition, what other documentation, disclosure, or other consumer protection features, if any, should the NCUA require before permitting capitalization of interest as a loan modification tool? Are the consumer protections that apply to other types of loan modification sufficient to protect borrowers who receive interest capitalization or should the agency consider any other protections to counter any risks caused specifically by interest capitalization?

6. The proposed rule continues to provide that a credit union may, in no event, authorize additional advances to finance credit union fees and commissions. Should the Board authorize the capitalization of such fees and commissions at the final rule stage? Why or why not? Depending on the information obtained through the rulemaking, the Board may consider making this change in the final rule.

IV. Regulatory Procedures

A. Regulatory Flexibility Act

The Regulatory Flexibility Act[12] generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial

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[12] 5 U.S.C. 603(a).

regulatory flexibility analysis that describes the impact of a proposed rule on small entities. A regulatory flexibility analysis is not required, however, if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the Regulatory Flexibility Act to include FICUs with assets less than $100 million) and publishes its certification and a short, explanatory statement in the Federal Register together with the rule. The proposed rule would allow FICUs to capitalize unpaid interest when working with borrowers. The proposed rule is not expected to increase the cost burden for FICUs. Accordingly, the NCUA certifies that the proposed rule will not have a significant economic impact on a substantial number of small credit unions.

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden.[13] For purposes of the PRA, a paperwork burden may take the form of a reporting, recordkeeping, or a third-party disclosure requirement, referred to as an information collection.

NCUA proposes to amend Appendix B of Part 741 to remove the prohibition on the capitalization of interest in connection with loan workouts and modifications and to allow FICUs to capitalize unpaid interest when working with borrowers. Currently, all FICUs are required to retain and maintain a written loan policy; of which 500 FICUs are estimated to take four hours annually to retain and maintain enhanced records related to loan workout activity. NCUA anticipates a 50 percent increase in the number of these respondents due to the amendments in this proposed rule. Information collection requirements prescribed by Appendix B to 741 are

[13] 44 U.S.C. 3507(d); 5 CFR part 1320.

currently approved under OMB control number 3133-0092. This revision of a currently approved collection would increase the information collection requirements by 2,000 burden hours.

OMB Control Number: 3133-0092.

Title of information collection: Loans to Members and Lines of Credit to Members, 12 CFR 701.21 and Appendix B to 741.

Estimated number of respondents: 5,236.

Estimated number of responses per respondent: 4.5.

Estimated total annual responses: 23,534.

Estimated burden per response: 1.0.

Estimated total annual burden: 23,584.

The NCUA invites comments on: (a) whether the proposed collection of information is necessary for the proper performance of the functions of the agency, including whether the information will have practical utility; (b) the accuracy of the agency's estimate of the burden of the proposed collection of information, including the validity of the methodology and assumptions used; (c) ways to enhance the quality, utility and clarity of the information to be collected; and (d) ways to minimize the burden of the collection of information on those who are to respond, including through the use of appropriate automated, electronic, mechanical, or other technological collection techniques or other forms of information technology; and (e) estimates of capital or start-up costs and cost of operation, maintenance, and purchase of services to provide information.

All comments are a matter of public record. Due to the limited in-house staff, email comments are preferred. Comments regarding the information collection requirements of this rule should be (1) mailed to: PRAcomments@ncua.gov with "OMB No. 3133-0133" in the subject line; faxed to (703) 837-2406; or mailed to Dawn Wolfgang, NCUA PRA Clearance Officer, National Credit Union Administration, 1775 Duke Street, Suite 6032, Alexandria, VA 22314, and to the (2) Office of Information and Regulatory Affairs, Office of Management and Budget, at www.reginfo.gov/public/do/PRAMain. Select "Currently under 30-day Review – Open for Public Comments" or use the search function.

C. Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, the NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order. This rulemaking will not have a substantial direct effect on the states, on the connection between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The NCUA has determined that this proposal does not constitute a policy that has federalism implications for purposes of the executive order.

D. Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this final rule will not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act, 1999.[14]

List of Subjects in 12 CFR Part 741

Credit, Credit unions, Share insurance.

By the National Credit Union Administration Board on November 19, 2020.

Melane Conyers-Ausbrooks

Secretary of the Board

[14] Pub. L. 105–277, 112 Stat. 2681 (1998).

For the reasons discussed in the preamble, the Board proposes to amend 12 CFR part 741 as follows:

PART 741—REQUIREMENTS FOR INSURANCE

1. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766(a), 1781-1790, and 1790d; 31 U.S.C. 3717.

2. Appendix B to Part 741 is revised to read as follows:

Appendix B to Part 741—Loan Workouts, Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans

This Appendix establishes requirements for the management of loan *workout*[1] arrangements, loan nonaccrual, and regulatory reporting of *troubled debt restructured loans* (herein after referred to as TDR or TDRs). This Appendix applies to all federally insured credit unions.

Under this Appendix, TDRs are as defined in *generally accepted accounting principles (GAAP)*, and the Board does not intend to change the Financial Accounting Standards Board's (FASB) definition of TDR in any way through this policy. In addition to existing agency policy,

[1] Terms defined in the Glossary will be italicized on their first use in the body of this =Appendix.

this Appendix sets the NCUA's supervisory expectations governing loan workout policies and practices and loan accruals.

WRITTEN LOAN WORKOUT POLICY AND MONITORING REQUIREMENTS[2]

For purposes of this Appendix, types of workout loans to borrowers in financial difficulties include *re-agings, extensions, deferrals, renewals, or rewrites*. See the Glossary entry on workouts for further descriptions of each term. Borrower retention programs or *new loans* are not encompassed within this policy nor considered by the Board to be workout loans.

A credit union can use loan workouts to help borrowers overcome temporary financial difficulties such as loss of job, medical emergency, or change in family circumstances such as the loss of a family member. Loan workout arrangements must consider and balance the best interests of both the borrower and the credit union.

The lack of a sound written policy on workouts can mask the true performance and *past due* status of the loan portfolio. Accordingly, the credit union board and management must adopt and adhere to an explicit written policy and standards that control the use of loan workouts, and establish controls to ensure the policy is consistently applied. The loan workout policy and practices should be commensurate with a credit union's size and complexity, and must conform with a credit union's broader risk mitigation strategies. The policy must define eligibility requirements (that is, under what conditions the credit union will consider a loan workout),

[2] For additional guidance on commercial and member business lending extension, deferral, renewal, and rewrite policies, see *Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts* (October 30, 2009) transmitted by Letter to Credit Unions No. 10-CU-07, and available at *http://www.ncua.gov*.

including establishing limits on the number of times an individual loan may be modified.[3] The policy must also ensure credit unions make loan workout decisions based on a borrower's renewed willingness and ability to repay the loan. If a credit union restructures a loan more frequently than once a year or twice in five years, examiners will have higher expectations for the documentation of the borrower's renewed willingness and ability to repay the loan. The NCUA is concerned about restructuring activity that pushes existing losses into future reporting periods without improving a loan's collectability. One way a credit union can provide convincing evidence that multiple restructurings improve collectability is to validate completed multiple restructurings that substantiate the claim. Examiners will ask for such validation documentation if a credit union engages in multiple restructurings of a loan.

In addition, the policy must establish sound controls to ensure loan workout actions are appropriately structured.[4] The policy must explicitly prohibit the authorization of additional advances to finance credit union fees and commissions. The credit union may, however, make advances to cover third-party fees, such as force-placed insurance or property taxes. For loan workouts granted, a credit union must document the determination that the borrower is willing and able to repay the loan.

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[3] Broad based credit union programs commonly used as a member benefit and implemented in a safe and sound manner limited to only accounts in good standing, such as Skip-a-Pay programs, are not intended to count toward these limits.

[4] In developing a written policy, the credit union board and management may wish to consider similar parameters as those established in the FFIEC's "Uniform Retail Credit Classification and Account Management Policy" (FFIEC Policy). 65 FR 36903 (June 12, 2000). The FFIEC Policy sets forth specific limitations on the number of times a loan can be re-aged (for open-end accounts) or extended, deferred, renewed or rewritten (for closed-end accounts). NCUA Letter to Credit Unions (LCU) 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Programs," also outlines policy best practices for real estate modifications. Those best practices remain applicable to real estate loan modifications (with the exception to the capitalization of credit union fees) but could be adapted in part by the credit union in their written loan workout policy for other loans.

Modifications of loans that result in capitalization of unpaid interest are appropriate only when a borrower has the ability to repay the debt. At a minimum, if a FICU's loan modification policy permits capitalization of unpaid interest, the policy must require:

1. Compliance with all applicable federal and state consumer protection laws and regulations, including, but not limited to, the Equal Credit Opportunity Act, the Fair Housing Act, the Truth In Lending Act, the Real Estate Settlement Procedures Act, the Fair Credit Reporting Act, and the prohibitions against the use of unfair, deceptive or abusive acts or practices in the Consumer Financial Protection Act of 2010.
2. Documentation that reflects a borrower's ability to repay, a borrower's source(s) of repayment, and when appropriate, compliance with the FICU's valuation policies at the time the modification is approved.
3. Providing borrowers with written disclosures that are accurate, clear and conspicuous and that are consistent with Federal and state consumer protection laws.
4. Appropriate reporting of loan status for modified loans in accordance with applicable law and accounting practices. The FICU shall not report a modified loan as past due if the loan was current prior to modification and the borrower is complying with the terms of the modification.
5. Prudent policies and procedures to help borrowers resume affordable and sustainable repayments that are appropriately structured, while at the same time minimizing losses to the credit union. The prudent policies and procedures must consider
    i. Whether the loan modifications are well-designed, consistently applied, and provide a favorable outcome for borrowers.

ii. The available options for borrowers to repay any missed payments at the end of their modifications to avoid delinquencies or other adverse consequences.

6. Appropriate safety and soundness safeguards to prevent the following:

   i. Masking deteriorations in loan portfolio quality and understating charge-off levels[5];

   ii. Delaying loss recognition resulting in an understated allowance for loan and lease losses account or inaccurate loan valuations;

   iii. Overstating net income and net worth (regulatory capital) levels; and

   iv. Circumventing internal controls.

The credit union's risk management framework must include thresholds, based on aggregate volume of loan workout activity, that trigger enhanced reporting to the board of directors. This reporting will enable the credit union's board of directors to evaluate the effectiveness of the credit union's loan workout program, understand any implications to the organization's financial condition, and make any compensating adjustments to the overall business strategy. This information will also be available to examiners upon request.

To be effective, management information systems need to track the principal reductions and *charge-off* history of loans in workout programs by type of program. Any decision to re-age, extend, defer, renew, or rewrite a loan, like any other revision to contractual terms, must be supported by the credit union's management information systems. Sound management

[5] Refer to NCUA guidance on charge-offs set forth in LCU 03-CU-01, "Loan Charge-off Guidance," dated January 2003. Examiners will require that a reasonable written charge-off policy is in place and that it is consistently applied. Additionally, credit unions need to adjust historical loss factors when calculating ALLL needs for pooled loans to account for any loans with protracted charge-off timeframes (for example, 12 months or more). See discussions on the latter point in the 2006 Interagency ALLL Policy Statement transmitted by Accounting Bulletin 06-1 (December 2006). Upon implementation of ASC 326—Financial Instruments—Credit Losses, credit unions will use the guidance in Interagency Policy Statement on Allowances for Credit Losses (May 2020).

information systems identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the frequency and extent of such action. Documentation normally shows that credit union personnel communicated with the borrower, the borrower agreed to pay the loan in full under any new terms, and the borrower has the ability to repay the loan under any new terms.

REGULATORY REPORTING OF WORKOUT LOANS INCLUDING TDR PAST DUE STATUS

Credit unions will calculate the past due status of all loans consistent with loan contract terms, including amendments made to loan terms through a formal restructure. Credit unions will report delinquency on the Call Report consistent with this policy.[6]

LOAN NONACCRUAL POLICY

Credit unions must recognize interest income appropriately. Credit unions must place loans in nonaccrual status when doubt exists as to full collection of principal and interest or the loan has been in default for a period of 90 days or more. Upon placing a loan in nonaccrual, a credit union must reverse or charge-off previously accrued but uncollected interest. A nonaccrual loan may be returned to accrual status when a credit union expects repayment of the remaining

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[6] Subsequent Call Reports and accompanying instructions will reflect this policy, including focusing data collection on loans meeting the definition of TDR under GAAP. In reporting TDRs on regulatory reports, the data collections will include all TDRs that meet the GAAP criteria for TDR reporting, without the application of materiality threshold exclusions based on scoping or reporting policy elections of credit union preparers or their auditors. Credit unions should also refer to ASC Subtopic 310-40 when determining if a restructuring of a debt constitutes a TDR.

contractual principal and interest or it is well secured and in process of collection.[7] This policy on loan accrual is consistent with longstanding credit union industry practice as implemented by the NCUA over the last several decades. The balance of the policy relates to *commercial* and *member business loan* workouts and is similar to the policies adopted by the federal banking agencies[8] as set forth in the FFIEC Call Report for banking institutions and its instructions.[9]

Nonaccrual Status

Credit unions may not accrue interest[10] on any loan where principal or interest has been in default for a period of 90 days or more unless the loan is both "*well secured*" and "in the *process of collection*."[11] For purposes of applying the "well secured" and "in process of collection" test for nonaccrual status listed above, the date on which a loan reaches nonaccrual status is determined by its contractual terms.

While a loan is in nonaccrual status, a credit union may treat some or all of the cash payments received as interest income on a cash basis provided no doubt exists about the collectability of the remaining *recorded investment in the loan.* A credit union must handle the

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[7] Placing a loan in nonaccrual status does not change the loan agreement or the obligations between the borrower and the credit union. Only the parties can effect a restructuring of the original loan terms or otherwise settle the debt.

[8] The federal banking agencies are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

[9] FFIEC Report of Condition and Income Forms, Instructions and Supplemental Instructions, *https://www.ffiec.gov/forms041.htm*.

[10] Nonaccrual of interest also includes the amortization of deferred net loan fees or costs, or the accretion of discount. Nonaccrual of interest on loans past due 90 days or more is a longstanding agency policy and credit union practice.

[11] A purchased credit impaired loan asset need not be placed in nonaccrual status as long as the criteria for accrual of income under the interest method in GAAP is met. Also, the accrual of interest on workout loans is covered in a later section of this Appendix.

reversal of previously accrued, but uncollected, interest applicable to any loan placed in nonaccrual status in accordance with GAAP.[12]

RESTORATION TO ACCRUAL STATUS FOR ALL LOANS EXCEPT COMMERCIAL AND MEMBER BUSINESS LOAN WORKOUTS

A nonaccrual loan may be restored to accrual status when:

- Its past due status is less than 90 days and the credit union expects repayment of the remaining contractual principal and interest within a reasonable period;
- It otherwise becomes both *well secured* and *in the process of collection;* or
- The asset is a purchased impaired loan and it meets the criteria under GAAP for accrual of interest income under the accretable yield method. See ASC 310-30.

In restoring all loans to accrual status, if the credit union applied any interest payments received while the loan was in nonaccrual status to reduce the recorded investment in the loan, the credit union must not reverse the application of these payments to the loan's recorded investment (and must not credit interest income). Likewise, a credit union cannot

[12] Acceptable accounting treatment includes a reversal of all previously accrued, but uncollected, interest applicable to loans placed in a nonaccrual status against appropriate income and balance sheet accounts. For example, one acceptable method of accounting for such uncollected interest on a loan placed in nonaccrual status is:

(1) To reverse all of the unpaid interest by crediting the “accrued interest receivable” account on the balance sheet,

(2) to reverse the uncollected interest that has been accrued during the calendar year-to-date by debiting the appropriate “interest and fee income on loans” account on the income statement, and

(3) to reverse any uncollected interest that had been accrued during previous calendar years by debiting the “allowance for loan and lease losses” account on the balance sheet.

The use of this method presumes that credit union management's additions to the allowance through charges to the “provision for loan and lease losses” on the income statement have been based on an evaluation of the collectability of the loan and lease portfolios and the “accrued interest receivable” account.

restore the accrued but uncollected interest reversed or charged-off at the point the loan was placed on nonaccrual status to accrual; it can only be recognized as income if collected in cash or cash equivalents from the member.

RESTORATION TO ACCRUAL STATUS ON COMMERCIAL AND MEMBER BUSINESS LOAN WORKOUTS[13]

A formally restructured commercial or member business loan workout need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the loan are supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must remain in nonaccrual status.

The credit union's evaluation must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance is a minimum of six consecutive payments, and includes timely payments under the restructured loan's terms of principal and interest in cash or cash equivalents. In returning the commercial or member business workout loan to accrual status, a credit union may consider sustained historical repayment performance for a reasonable time prior to the restructuring. Such a restructuring must improve the collectability of the loan in accordance with a reasonable repayment schedule

[13] This policy is derived from the "Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts" the NCUA and the other financial regulators issued on October 30, 2009.

and does not relieve the credit union from the responsibility to promptly charge off all identified losses.

The following graph provides an example of a schedule of repayment performance to demonstrate a determination of six consecutive payments. If the original loan terms required a monthly payment of $1,500, and the credit union lowered the borrower's payment to $1,000 through formal commercial or member business loan restructure, then based on the first row of the graph, the "*sustained historical repayment performance for a reasonable time prior to the restructuring*" would encompass five of the pre-workout consecutive payments that were at least $1,000 (months 1 through 5). In total, the six consecutive repayment burden would be met by the first month post workout (month 6).

In the second row, only one of the pre-workout payments would count toward the six consecutive repayment requirement (month 5), because it is the first month in which the borrower made a payment of at least $1,000 after failing to pay at least that amount. Therefore, the loan would remain on nonaccrual for at least five post-workout consecutive payments (months 6 through 10) provided the borrower continues to make payments consistent with the restructured terms.

Pre-workout					**Post-workout**				
Month 1	**Month 2**	**Month 3**	**Month 4**	**Month 5**	**Month 6**	**Month 7**	**Month 8**	**Month 9**	**Month 10**
$1,500	$1,200	$1,200	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000
1,500	1,200	900	875	1,000	1,000	1,000	1,000	1,000	1,000

After a formal restructure of a commercial or member business loan, if the restructured loan has been returned to accrual status, the loan otherwise remains subject to the nonaccrual standards of this policy. If any interest payments received while the commercial or member business loan was in nonaccrual status were applied to reduce the recorded investment in the loan the application of these payments to the loan's recorded investment must not be reversed (and interest income must not be credited). Likewise, accrued but uncollected interest reversed or charged-off at the point the commercial or member business workout loan was placed on nonaccrual status cannot be restored to accrual; it can only be recognized as income if collected in cash or cash equivalents from the member.

The following tables summarize nonaccrual and restoration to accrual requirements previously discussed:

TABLE 1—NONACCRUAL CRITERIA

Action	Condition identified	Additional consideration
Nonaccrual on All Loans	90 days or more past due unless loan is both well-secured and in the process of collection; or The loan is maintained on the Cash basis because there is a deterioration in the financial condition of the borrower, or for which payment in full of principal or interest is not expected	See Glossary definitions for “well secured” and “in the process of collection.”

Action	Condition identified	Additional consideration
Nonaccrual on Commercial or Member Business Loan Workouts	Continue on nonaccrual at workout point and until restore to accrual criteria are met	See Table 2—Restore to Accrual.

TABLE 2—RESTORE TO ACCRUAL

Action	Condition identified	Additional consideration
Restore to Accrual on All Loans except Commercial or Member Business Loan Workouts	When a loan is less than 90 days past due and the credit union expects repayment of the remaining contractual principal and interest within a reasonable period, or When it otherwise becomes both "well secured" and "in the process of collection"; or The asset is a purchased impaired loan and it meets the criteria under GAAP	See Glossary definitions for "well secured" and "in the process of collection." Interest payments received while the loan was in nonaccrual status and applied to reduce the recorded investment in the loan must not be reversed and income credited. Likewise, accrued but uncollected interest reversed or charged-off at the point the loan was placed on nonaccrual status cannot be restored to accrual.

Action	Condition identified	Additional consideration
	(see ASC 310-30) for accrual of interest income under the accretable yield method	
Restore to Accrual on Commercial or Member Business Loan Workouts	Formal restructure with a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms	The evaluation must include consideration of the borrower's sustained historical repayment performance for a minimum of six timely consecutive payments comprised of principal and interest. In returning a loan to accrual status, a credit union may take into account sustained historical repayment performance for a reasonable time prior to the restructured terms. Interest payments received while the commercial or member business loan was in nonaccrual status and applied to reduce the recorded investment in the loan must not be reversed and income credited. Accrued but uncollected interest reversed or charged-off at the point the commercial or member business loan was placed on nonaccrual status cannot be restored to accrual.

GLOSSARY[14]

"Capitalization of Interest" constitutes the addition of accrued but unpaid interest to the principal balance of a loan.

"Cash Basis" method of income recognition is set forth in GAAP and means while a loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis provided no doubt exists about the collectability of the remaining recorded investment in the loan.[15]

"*Charge-off*" means a direct reduction (credit) to the carrying amount of a loan carried at amortized cost resulting from uncollectability with a corresponding reduction (debit) of the ALLL. Recoveries of loans previously charged off must be recorded when received.

"*Commercial Loan*" is defined consistent with Section 723.2 of the NCUA's MEMBER BUSINESS LOANS; COMMERCIAL LENDING Rule, 12 CFR 723.2.

"*Generally accepted accounting principles (GAAP)*" means official pronouncements of the FASB as memorialized in the FASB Accounting Standards Codification® as the source of authoritative principles and standards recognized to be applied in the preparation of financial

[14] Terms defined in the Glossary will be italicized on their first use in the body of this guidance.

[15] Acceptable accounting practices include: (1) Allocating contractual interest payments among interest income, reduction of the recorded investment in the asset, and recovery of prior charge-offs. If this method is used, the amount of income that is recognized would be equal to that which would have been accrued on the loan's remaining recorded investment at the contractual rate; and, (2) accounting for the contractual interest in its entirety either as income, reduction of the recorded investment in the asset, or recovery of prior charge-offs, depending on the condition of the asset, consistent with its accounting policies for other financial reporting purposes.

statements by federally insured credit unions in the United States with assets of $10 million or more.

"*In the process of collection*" means collection of the loan is proceeding in due course either: (1) through legal action, including judgment enforcement procedures, or (2) in appropriate circumstances, through collection efforts not involving legal action which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future, i.e., generally within the next 90 days.

"*Member Business Loan*" is defined consistent with Section 723.8 of the NCUA's MEMBER BUSINESS LOANS; COMMERCIAL LENDING Rule, 12 CFR 723.8.

"*New Loan*" means the terms of the revised loan are at least as favorable to the credit union (*i.e.*, terms are market-based, and profit driven) as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the credit union, and the revisions to the original debt are more than minor.

"Past Due" means a loan is determined to be delinquent in relation to its contractual repayment terms including formal restructures, and must consider the time value of money. Credit unions may use the following method to recognize partial payments on "consumer credit," i.e., credit extended to individuals for household, family, and other personal expenditures, including credit cards, and loans to individuals secured by their personal residence, including home equity and home improvement loans. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past due status.

"Recorded Investment in a Loan" means the loan balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest.

"Troubled Debt Restructuring" is as defined in GAAP and means a restructuring in which a credit union, for economic or legal reasons related to a member borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider.[16] The restructuring of a loan may include, but is not necessarily limited to:

(1) The transfer from the borrower to the credit union of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan,

(2) a modification of the loan terms, such as a reduction of the stated interest rate, principal, or accrued interest or an extension of the maturity date at a stated interest rate lower than the current market rate for new debt with similar risk, or

(3) a combination of the above.

A loan extended or renewed at a stated interest rate equal to the current market interest rate for new debt with similar risk is not to be reported as a restructured troubled loan.

"Well secured" means the loan is collateralized by: (1) A perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to

[16] FASB ASC 310-40, "Troubled Debt Restructuring by Creditors."

sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount, or (2) by the guarantee of a financially responsible party.

"Workout Loan" means a loan to a borrower in financial difficulty that has been formally restructured so as to be reasonably assured of repayment (of principal and interest) and of performance according to its restructured terms. A workout loan typically involves a *re-aging, extension, deferral, renewal, or rewrite* of a loan.[17] For purposes of this policy statement, workouts do not include loans made to market rates and terms such as refinances, borrower retention actions, or new loans.[18]

"Extension" means extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they must be collected at the time of the extension and not added to the balance of the loan.

"Deferral" means deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity, of the loan. The account is shown current upon granting the deferral.

"Renewal" means underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms.

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[17] *"Re-Age"* means returning a past due account to current status without collecting the total amount of principal, interest, and fees that are contractually due.

[18] There may be instances where a workout loan is not a TDR even though the borrower is experiencing financial hardship. For example, a workout loan would not be a TDR if the fair value of cash or other assets accepted by a credit union from a borrower in full satisfaction of its receivable is at least equal to the credit union's recorded investment in the loan, e.g., due to charge-offs.

"*Rewrite*" means significantly changing the terms of an existing loan, including payment amounts, interest rates, amortization schedules, or its final maturity.