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NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 741

RIN 3133-AE01

**Loan Workouts and Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans**

**AGENCY:** National Credit Union Administration (NCUA).

**ACTION:** Final rule; limited extension of compliance date for certain requirements.

**SUMMARY:** NCUA is amending its regulations to require federally insured credit unions (FICUs) to maintain written policies that address the management of loan workout arrangements and nonaccrual policies for loans, consistent with industry practice or Federal Financial Institutions Examination Council (FFIEC) requirements. The final rule includes guidelines, set forth as an interpretive ruling and policy statement (IRPS) and incorporated as an appendix to the rule, that will assist FICUs in complying with the rule, including the regulatory reporting of troubled debt restructured loans (TDR loans or TDRs) in FICU Call Reports.

**DATES:** The effective date for this rule is [Insert date 30 days after date of publication in the FEDERAL REGISTER]. The compliance date is extended to October 1, 2012 for the rule's requirements to adopt written policies addressing loan workouts and nonaccrual practices and to December 31, 2012 to collect nonaccrual status data.

**FOR FURTHER INFORMATION CONTACT:** Director of Supervision Matthew J. Biliouris and Chief Accountant Karen Kelbly, Office of Examination and Insurance at the above address or telephone: (703) 518-6360.

**SUPPLEMENTARY INFORMATION:**

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I. Background

- a. Why is NCUA issuing this rule?

In order to better serve members experiencing financial difficulties over the last several years and improve collectability, FICUs worked with members and offered sensible workout loans, including programs offered through the Obama Administration's "Making

Home Affordable Program”.<sup>1</sup> NCUA’s existing reporting requirements creates practical challenges for the industry as the volume of workouts increased. To follow the NCUA 5300 Call Report (Call Report) instructions for reporting past due status on TDRs, many FICUs maintain separate, manual delinquency computations. To respond to feedback from the industry and in the spirit of reduced regulatory burden, the NCUA Board (Board) issued a Notice of Proposed Rulemaking (NPRM) in February. 77 FR 4927 (Feb. 1, 2012).

In the NPRM, the Board acknowledged the need to effectively balance appropriate loan workout programs with safety and soundness considerations. Such considerations can include the inability 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. The Board issued the NPRM with the goal of granting certain regulatory relief, instituting some countervailing controls, and clarifying regulatory expectations.

In the NPRM, the Board proposed four regulatory changes through an amendment to §741.3 and the addition of proposed Appendix C to part 741. First, the NPRM proposed a requirement that FICUs have written policies addressing loan workouts and nonaccrual practices under §741.3. Second, the NPRM proposed to standardize an industry-wide practice by requiring that FICUs cease to accrue interest on all loans at 90

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<sup>1</sup> The Making Home Affordable Program (MHA) was developed to help homeowners avoid foreclosure, stabilize the country’s housing market, and improve the nation’s economy. MHA includes such programs as the “Home Affordable Refinance Program” (HARP) and “Home Affordable Modification Program” (HAMP). Programs such as these further enable FICUs to provide workout loans to their members. For additional information regarding programs available through MHA see <http://www.makinghomeaffordable.gov/pages/default.aspx>.

days or more past due, subject to a few exceptions. Third, the NPRM proposed that FICUs maintain member business workout loans in a nonaccrual status until the FICU receives 6 consecutive payments under the modified terms. Finally, the NPRM proposed that FICUs calculate and report TDR loan delinquency based on restructured contract terms rather than the original loan terms. To that end, the Board noted that NCUA would modify the Call Report to reduce data collection to TDRs as defined by GAAP.

b. When will FICUs have to comply with the proposed rule?

The Board proposed that the final rule would go into effect 120 days after it was published in the Federal Register and require that FICUs adopt the required written lending policies by such date. The NPRM also stated that NCUA would closely time its adjustments to the Call Report requirements for reporting TDRs with the rule and stated a goal for the Call Report requirements to go into effect no later than the quarter ending December 31, 2012. The NPRM specifically sought comments on the proposed implementation dates.

In response to the NPRM, the Board received many varied comments on how it should approach implementation of the rule, appendix and NCUA's modification of the Call Report. One trade group urged NCUA to move forward with Call Report changes as soon as it adopted the rule, while a FICU supported the Call Report reporting requirements to become effective no later than December 31, 2012. One FICU commenter stated that the quick adoption of the proposed changes would have a profound effect on FICU personnel hours needed to perform the TDR reporting

requirement and, therefore, requested implementation of the final rule by the end of the 2<sup>nd</sup> quarter of 2012. Likewise, another FICU stated that the December 31, 2012 report date would not give FICUs enough time to purchase software and perform a six-month due diligence review. The FICU noted that, while a new system can effectively capture new loan history, it will have serious challenges with systematically capturing existing loan history retrospectively for data previously tracked manually. The commenter requested a two-year timeframe to allow appropriate time for due diligence and full compliance.

One FICU and one league expressed concern that the proposed 120 days compliance timeframe would not be enough time if a FICU has to modify systems. The FICU stated there may be disparities in how various computer systems handle the 90-day nonaccrual policy, as well as the handling of accrued interest, reprogramming, and testing. The commenter suggested that NCUA set a firm, but reasonable, date for compliance. Several commenters raised concerns about the ability of small credit unions to revise or implement changes to their lending policies and systems. Four leagues requested that small credit unions be given extra time or transition period beyond the proposed 120 days. One league suggested that NCUA permit compliance within 120 days, but not require compliance for at least 180 days to accommodate small credit unions. Similarly, one trade group, on behalf of FICUs that are able to comply with the changes, urged NCUA to adopt the rule and make it effective as soon as possible. Yet the trade group also asked for additional time for smaller institutions to comply with the final rule. One FICU asked NCUA to adopt the rule as soon as possible

with a 180-day transition period for implementation. One league requested a twelve-month implementation period.

After reviewing the various approaches suggested by the commenters, the Board has decided to make one provision of the final rule effective within 30 days of publication in the Federal Register, while delaying the compliance date of the other provisions. Under the final rule, FICUs will be required to calculate the past due status of workout loans consistent with loan contract terms, including amendments made through formal restructures as soon as the rule goes into effect on [Insert date 30 days after date of publication in the FEDERAL REGISTER]. Data collections on the Call Report for the quarter ending June 30, 2012 will reflect revised TDR past due reporting. NCUA will begin collecting IRPS compliant data in the Call Report filing for quarter ending December 31, 2012. In order for FICUs to file the data related to loans placed in nonaccrual status in accordance with the final rule and IRPS for quarter ending December 31, 2012, FICUs must have their written nonaccrual and loan workout policies in place at the beginning of the quarter. The compliance date for adopting written loan policies and collecting nonaccrual information as discussed in Section III is October 1, 2012. FICUs, however, may adopt their policies and adjust their financial reporting systems as soon as is practicable after the rule's effective date, rather than waiting for the mandatory compliance date if they so choose.

## II. Summary of Comments on the Proposed Rulemaking

The NPRM's comment period ended on March 2, 2012. NCUA received forty-five comment letters on the NPRM: thirty from FICUs, two from trade associations representing credit unions, ten from state credit union leagues, one from an accounting firm, one from an organization representing state credit union regulators, and one from a non-profit policy organization. Of the forty-five comments received, thirteen commenters supported the rulemaking generally, while thirty-one commenters offered some support for the rulemaking but objected to certain provisions or requested substantive revisions. One commenter questioned the purpose of the proposed rule. For the reasons discussed below, the Board adopts the amendments almost exactly as it proposed but, as requested by many commenters, provides some clarifications and excludes the proposed requirement that FICUs adopt aggregate limits in their loan workout and nonaccrual policies tied to net worth.

a. Written Loan Workout Policy and Monitoring Requirements

Thirteen FICUs, three leagues and the accounting firm supported the proposed rule's requirement that FICUs have a written loan workout policy combined with associated monitoring and controls. Most of these commenters stressed, however, that regulators must not review these policies from a standardized approach under the supervisory process. They urged regulators to afford a FICU an appropriate degree of flexibility based on the individuality of that FICU and the composition of its field of membership. They argued that each loan modification should stand on its own merits, and that a FICU should be able to modify a loan if it is in the long term best interests of the

member and the FICU without a “one size fits all” approach in the guidelines. One trade group and one league stated that, while FICUs should maintain loan workout policies, examiners should not expect a separate policy on TDRs. These commenters also stated that examiners should recognize that loan workout policies and practices must be commensurate with a FICU’s size and complexity. One league requested that NCUA provide, at a minimum, an outline with suggestions of specific areas that examiners will expect to see addressed in policies. It also suggested that any requirements for a policy allow room for an individual’s particular circumstance. In contrast, one industry trade group opposed a requirement that FICUs adopt loan workout or nonaccrual policies and advocated that NCUA issue guidance rather than a rule. It noted that many FICUs already engage in such a practice and already have invested in implementing software.

The Board continues to believe it is necessary to require a written loan workout policy. Because NCUA is relaxing its previous directives on past due calculations for TDRs and modifying the related Call Report data collections to reduce regulatory burden, the Board believes countervailing controls are necessary. It finds the final rule’s requirement that FICUs adopt written loan workout and nonaccrual policies adequately addresses NCUA’s supervisory interests. Furthermore, the Board notes the proposed IRPS clearly stated that a FICU’s loan workout policy and practices should be “commensurate with each credit union’s size and complexity,” in line with its broader risk mitigation strategies. 77 FR at 4934. By taking the approach in the NPRM that FICU management must design policies appropriate for their institutions, rather than

setting forth “bright line” regulatory requirements or otherwise placing defined parameters on FICU policies, the Board acknowledges it is not appropriate to take a one-size fits all approach. As such, the final rule and IRPS continue to give a FICU’s management the ability to establish institution-appropriate policies. In addition, the Board commits to providing NCUA’s examiners with appropriate guidance for evaluating whether loan modifications made under a FICU’s policy improves collectability.

Most commenters objected to the requirement that loan workout policies establish particular limits or benchmarks. Four commenters stated that the imposition of aggregate limits is unnecessary and could result in greater risk to FICUs by preventing them from making sound decisions that could result in future collectability. One commenter stated that setting aggregate limits could create the unintended consequence of a FICU treating members differently if the FICU approaches any such regulatory limit. Other commenters echoed similar concerns, stating that loan modifications should always be considered when they are in the best interests of the lender and the borrower, but that FICUs need flexibility in the current economic cycle. Failure to approve sound modifications simply because of a policy limit could increase risk of default and expose a FICU to reputation risk. Fourteen FICU commenters and three leagues specifically objected to tying loan modification program limits to a percentage of a FICU’s net worth. One commenter stated that, while a limit might be appropriate for some FICUs, that same limit might not be the appropriate measure for others. Another FICU noted that its net worth declined during the recent severe economic conditions in its state. The FICU argued that, had the proposed limitation

been in place, it would have reduced the FICU's ability to help members at a time when assistance was most needed. Another FICU noted that modifications are a risk mitigation strategy for loans already on a FICU's balance sheet, not a business strategy to incur additional risk.

The Board carefully considered the substantial comments on the NPRM's requirement that a FICU's loan workout policy include aggregate program limits set to a percentage of its net worth and agrees with the commenters that the proposed requirement could prevent a FICU from appropriately mitigating risk and assisting its members. 77 FR at 4930, 4934. The final IRPS does not include a requirement to place aggregate limits on a loan workout program as the Board proposed in the NPRM. As discussed in greater detail in Section III, NCUA will focus on a FICU's restructuring practices and whether its efforts have demonstrated an improvement in collectability of TDRs.

Two commenters suggested that, instead of a specified aggregate limit, the rule require FICU management to provide enhanced reporting on TDR activity to the FICU's board of directors. Another commenter suggested mandatory reporting to the FICU board on a regular basis. The Board agrees with these suggestions and has incorporated enhanced reporting requirements in the final rule. One commenter suggested continued reporting in Call Reports, including the number of times a loan has been modified in a 12-month period. The Board will consider this suggestion as it moves forward with its modifications to the Call Report. One commenter stated that ensuring proper documentation supporting a TDR and the borrower's ability to comply with the

new terms best addresses concerns that a FICU is masking true performance and the past due status of its portfolio. The Board agrees with the commenter. As discussed in Section III, the final IRPS addresses the need for proper documentation and effective restructuring practices, preventing delayed loss recognition.

One FICU specifically commented on the proposal's requirement to limit the number of times a loan workout may be provided to a member over a period of time. The FICU stated that, while such a limit may eliminate the issue of masking problem loans, it also creates obstacles when there are legitimate reasons for multiple workouts. For example, as state and local governments and school districts have restricted spending, members endured layoffs and rounds of wage and hours cuts. As they have had to adjust their own budgets, many have asked their lender FICUs to revise terms of their workout loans. If a FICU's policy limits the number of times a workout loan can be modified or changed, these members will be adversely affected for no reason other than policy. Therefore, the commenter recommended that the rule be changed to allow workout loans to be modified any time a FICU can legitimately identify a reasonable change in the member's economic circumstances (i.e., income and other documentation should be required prior to making a change to a workout loan). The proposed IRPS in the NPRM includes a requirement that FICUs define eligibility requirements, including limits on the number of times an individual loan may be restructured, but these decisions as to limits are left to the discretion of the FICU when establishing its written policy. "Loan workout arrangements should consider and balance the best interests of both the borrower and the credit union." 77 FR at 4934. The Board expects a FICU to

evaluate the changed circumstances of an individual borrower with the need to improve collectability for the profitable operation of the institution. It is the FICU's responsibility to craft loan workout policies that strike that balance. NCUA will then measure the success of the policy based on the FICU's ability to collect TDRs. The final IRPS, therefore, retains the requirement to establish eligibility requirements as proposed in the NPRM.

b. Loan Nonaccrual Policy for All Loans and Restoration to Accrual for Loans Other than Member Business Loan (MBL) Workout Loans

Four FICUs and two leagues supported the proposed requirement that FICUs maintain nonaccrual policies that address the discontinuance of interest accrual for loans past due by 90 days or more and the requirements for returning such loans, including MBLs, to accrual status. The commenters noted that the proposed nonaccrual policy has long been the practice of FICUs and is supported by current institution interest management systems, so it would not present additional unwarranted work for FICUs. In addition, an accounting firm and two FICUs found the proposal consistent with industry practice and FFIEC requirements. They supported the proposed rule's effort to formalize the practice of placing loans on nonaccrual status when they are 90 days past due. One league argued that compliance with the proposal would require FICUs to change loan tracking systems, thereby incurring significant programming costs. The final rule and IRPS retain the requirement for a written policy addressing nonaccrual practices as proposed in the NPRM, with a few clarifications as discussed below.

One FICU objected to a blanket requirement that interest may not accrue on loans that are 90 days or more past due. The commenter stated that if a loan is performing at a level agreed to by the FICU and debtor, and it can be reasonably demonstrated that full recovery of the balance owed is likely, continuing to accrue interest due is appropriate and should be allowed. The commenter incorrectly characterized the requirement as a blanket prohibition. The proposed IRPS states that a FICU may not accrue interest on a loan in default for a period of 90 days or more “unless the loan is both *well secured* and in the *process of collection*.” *Id.* The final IRPS retains this provision.

One FICU expressed concern that the proposal places an undue burden on individual small accounts and requested that the final rule exclude accounts under \$25,000 from the nonaccrual policy. The commenter also suggested that NCUA consider using a more individualized index to determine a nonaccrual amount based on the total TDR classified loan balance. The commenter contended this approach would take far less time to calculate, and be more accurate, than under the current process. The Board does not agree with the commenter’s rationale. The Board believes that a standard policy applicable to all loans in nonaccrual status, other than typically riskier and higher-dollar business loans, ensures consistency as the policy is employed by FICUs and reviewed by examiners.

One industry trade group did not support a requirement that FICUs must adopt nonaccrual procedures because they are not required by GAAP or the Federal Credit

Union Act. This commenter agreed, however, that the proposed IRPS' restoration to accrual status for loans, excluding MBL workouts, is consistent with GAAP. Two FICUs and two leagues also questioned the necessity of a formal regulation for this requirement because, for years, it has been the industry standard to terminate the accrual of interest when a loan is 90 days delinquent. The commenters argued that the proposal is redundant and it is therefore unnecessary to include this standard practice in a regulation. They contend that NCUA could better handle exceptions to this nonaccrual approach through the examination and supervision process. While recognizing the practice has been longstanding in the industry, the Board believes that memorializing the practice as a rule, ensures ongoing, consistent and appropriate income recognition for loans that are past due by 90 days or more. In addition, the rule enables the agency to enforce noncompliance if necessary.

One FICU and one league stated there is great disparity in FICUs' computer systems in dealing with the 90-day policy, specifically that some FICUs time the policy to 90 days while others time the policy to 91 or more days. The FICU commenter noted a difference in practice as to whether accrued interest is reversed when it goes into nonaccrual status or if there actually is no additional interest accrued to the general ledger prospectively. The final IRPS clarifies that the nonaccrual policy applies when the loan is 90 days or more past due. In response to the FICU commenter, the final IRPS also clarifies that when accrued interest is reversed, the reversed interest cannot be subsequently restored but can only be recognized as income if it is collected in cash or cash equivalents, and that there is no additional accrual until restoral to accrual

conditions are met. This approach is consistent both with GAAP principles governing interest recognition on loans and longstanding banking industry practice.

One league requested that the final rule clarify that placing a loan on nonaccrual status does not change the loan agreement or the obligations between the borrower and the FICU, unless and until the parties reach express agreement on modifying the original loan terms. The commenter expressed concern that the final rule will be perceived as forgiveness of interest or principal or any type of right to a modification conferred to the borrower. To address this concern, the final IRPS includes a footnote to make clear that the accounting procedure to place a loan on nonaccrual status has no impact on the borrower's contractual obligation to the FICU.

c. Restoration of Member Business Workout Loans to Accrual

Thirteen FICUs and eight leagues stated they saw no justification for treating MBLs differently than consumer/residential loans. They objected to the proposal's continuation of the current requirement that MBLs remain in nonaccrual status until a FICU receives six consecutive payments under modified loan terms. One commenter questioned the application of the proposal to all MBLs given that not all MBLs are commercial real estate loans. Two FICUs stated that this provision contradicts GAAP. Two commenters misunderstood the Board's remedy to past due reporting of all loans, including MBLs, and argued that the proposal's treatment of MBLs will artificially inflate delinquency. The differentiation the rule makes between MBLs and other loans regards

provisions for restoration to accrual status, not delinquency reporting. Past due reporting will now be consistent with loan contract terms for all loans including MBLs. One commenter stated that, in general, MBL portfolios are comprised of a pool of individually unique loans with different collateral terms and repayment capabilities based on the financial situation and creditworthiness of the borrower/guarantor. As such, the commenter felt it was inappropriate to establish a six-month standard that would uniformly apply to a pool of individually unique loans. The commenter argued that the determination to place an MBL back into accrual status should be based on the individual financial circumstances of the borrower rather than an arbitrary period of time. One industry trade group also strongly urged NCUA to provide consistent relief for consumer loan and MBL workouts. It stated that the proposal perpetuates an unnecessary obstacle for FICUs to accommodate business members. Another trade group opposed the proposed treatment of MBLs because it is not required by the Federal Credit Union Act or GAAP. One FICU, six leagues, and one trade group stated that the tracking of MBLs as proposed would continue the burden of manually tracking these loans, thus imposing an additional barrier to making MBLs.

The Board considered the commenters' concerns but retained the proposed provisions for the restoration of MBL workout loans to accrual status in the final rule. In drafting the NPRM, NCUA weighed requiring identical treatment of both consumer and MBL workouts, i.e., the FICU would need to demonstrate a period of member repayment performance of six consecutive payments before the return to accrual status. In the interest of providing FICUs reduced burden without undue increased supervisory risk,

the Board limited the more stringent requirement to only MBL workout loans. The Board's decision to retain the NPRM's proposed requirements for restoring MBL workout loans to accrual status is threefold: 1) the principle forming the basis for the provision is found in GAAP; 2) NCUA has previously joined the other federal regulators in advancing this provision in multiple interagency policy issuances, and 3) the requirement is a longstanding accepted banking practice.

One commenter encouraged NCUA to specifically define "consecutive payment" or give FICUs the authority to define the term in loan workout policies. Similarly, another FICU suggested that a payment made within a 30-day window of the due date (i.e., no late payments) be considered consecutive. This commenter also asked for clarification on what constitutes a payment for this purpose (e.g., principal and interest, principal only, or interest only) to ensure consistent reporting among FICUs. To clarify, a FICU is required to use the Cash Basis method of income recognition in GAAP until the borrower makes six consecutive timely payments of *principal and interest* consistent with the loan contract terms. The Board has clarified in the final IRPS that repayment performance involves timely payments of principal and interest under the restructured loan's terms.

One FICU, while agreeing with the proposal's requirement for maintaining certain MBLs in nonaccrual status for safety and soundness reasons, objected to extending the policy to multi-family residential mortgages. The commenter suggested that loans secured by

1-4 family residential properties, which fall into NCUA's MBL definition for other purposes, follow the proposal's non-MBL requirements for restoration to accrual status.

One FICU offered a slight modification to the proposed rule by expanding it to "greater than 90 days and/or 3 months past due." It argued that many FICUs currently label internal reports as "90 day," but upon a closer analysis of the actual technical format of FICUs' core processors, some FICUs would change the label to "3 months." The final rule and IRPS maintain the uniform standard of 90 days or more.

One FICU requested clarification that MBL workout loans on nonaccrual status would not be considered delinquent for reporting purposes if the borrowers have made payments conforming to a loan workout but have not completed the 6-month period to resume accruals. The Board notes that past due status and nonaccrual are separate elements. The final IRPS, as proposed, is clear that past due status is remedied at the time of restructure regardless of the nonaccrual requirement.

One FICU requested that NCUA clarify its "broad" statement in the guidance that "in no event should the credit union authorize additional advances to finance unpaid interest and fees," or eliminate the language altogether. The commenter stated that a FICU could interpret this language to suggest that the payment of a third-party fee could not be added to the collectible loan balance when attempting to recover losses. The commenter stated that its ability to capitalize interest at the point of restructure is an important tool in providing solutions to troubled borrowers. By mandating the

acceptance of greater losses, NCUA would be inadvertently increasing risk in the area of safety and soundness, and possibly eliminating a viable member solution by ultimately creating too great a loss. The Board agrees such third-party fees should not hinder sound restructure decisions. Accordingly, the final IRPS includes new language to clarify that, while a FICU cannot make additional advances to the borrower to finance unpaid interest and credit union fees, it may make advances to cover third-party fees exclusive of credit union commissions, such as forced place insurance or property taxes.

d. Regulatory Reporting of Workout Loans, Including TDRs

Thirteen FICUs, an accounting firm, a non-profit consumer advocate, the state supervisory organization, eight leagues, and two industry trade groups supported the elimination of the current requirement to track and report TDRs as delinquent until six consecutive payments. Several commenters noted the change is a needed improvement, as the current reporting requirement has been problematic for many FICUs and an obstacle to helping members. The consumer advocate stated that by moving to more commonsense reporting, the proposal eliminates a disincentive for a FICU to consider TDRs, which in turn will result in fewer foreclosures. One FICU commenter also stated that the current requirements have been quite cumbersome and contrary in purpose to the FICU's efforts to keep members in their homes and avoid unnecessary foreclosure actions.

Several commenters believed that NCUA should enable FICUs to perform appropriate loan restructurings without a reporting treatment that has a chilling effect on this essential business decision during a period of economic downturn, particularly in hard hit states. Two commenters stated that FICUs overstate their true delinquencies under the current reporting process. One commenter stated that if institutions follow sound workout loan policies in which the borrower has a better capability and willingness to repay, then the TDR should be treated as performing under the new terms of the loan agreement. To pretend a loan is delinquent for six months based on the original past due date distorts the true delinquency of loans in the portfolio. One commenter noted that the overstatement of delinquencies causes unnecessary concern with counterparties and creates an “apples to oranges” comparison with other financial institutions because banks do not report TDRs as delinquent.

In support of the proposal, one FICU and one league noted that FICUs have developed elaborate tracking systems. They stated, however, that dual reporting systems have resulted in different financial reporting for internal and audited financial statements from that used in Call Reports. These differences have resulted in confusion. One of these commenters suggested that the new guidance caution FICUs that, when modifying loans and removing them from delinquency status, documentation of the borrower’s ability to pay under the modified terms should include a thorough analysis of recent past payment performance with strong consideration of the immediately preceding three months. This commenter suggested that the guidance should limit to two the number of times during a 12-month period that a loan may be formally modified with a reset of the

delinquency counters. This limitation would allow for tracking (without dual reporting) and prevent FICUs from masking true delinquency through continuous modifications. The commenter stated that data tracking should focus on: 1) current levels of delinquency under restructured loan terms; 2) number and dollar amount of new TDRs modified during the quarter/year; 3) number and amount of current TDRs in the portfolio and reserves in the ALLL for TDRs; and 4) number and dollar amount of TDRs currently in the portfolio that have been formally restructured where the delinquency counters have re-set more than once during the last 12-month period to identify loans that have been rolled. The Board will consider these suggestions when it modifies the Call Report.

One FICU recommended that the final rule impose stricter monitoring and reporting of TDRs. It offered one example, which is a requirement for FICUs to track and report TDRs that are 30 days delinquent under the restructured terms.

Many commenters noted confusion in the industry and among examination staff about what makes a modified loan a TDR. Commenters suggested that NCUA refrain from using “workout loan” and “TDR” interchangeably, stating that all workout loans are not TDRs. They recommended that the proposal be restricted to TDRs to avoid confusion. Another commenter requested that, if the term “workouts” has any applicability in the final rule, a definition should clarify the materiality or significance of the loan term changes before the loan is deemed a “workout.” Two commenters stated that NCUA’s definition of “TDR” is not consistent with FASB and suggested that NCUA review FASB

Accounting Standards Update No. 2011-02, “A Creditor’s Determination of Whether a Restructuring Is a Troubled Debt Restructuring” for clarification. One FICU and a league asked NCUA to consider detailed standards for FICUs and examiners to determine which loan modifications qualify as TDRs. Similarly, one FICU noted that the proposal shifts documentation requirements from TDRs to workout loans. It further noted that GAAP allows for some workout loans to be immaterial and non-reportable as TDRs if they satisfy “insignificant” criteria. The commenter, therefore, suggested that the rule apply only to TDRs and not to workout loans that do not meet the materiality component of GAAP. The Board plans to direct staff to develop supervisory guidance to examiners that will incorporate current agency regulatory and examination approaches and address many of these areas that have caused confusion in implementation. Staff will consider commenters concerns in drafting the supervisory guidance. The supervisory guidance will be provided to the credit union industry as well. However, the Board has determined the final rule language will continue to incorporate both the term “TDR” and the broader term “workout” in the final rule, both of which are defined in the IRPS glossary.

Three leagues, one trade group, and two FICUs objected to the proposal’s statement “that in an economic downturn absent contrary supportable information workout loans are TDRs.” The commenters stated that this language only perpetuates confusion about what constitutes a TDR and is inconsistent with the definition of TDR in GAAP. One commenter stated that economic climate should not be the barometer of how a TDR is defined. Another commenter asked NCUA to address the definition of

“economic downturn” and “contrary supportable information,” as well as what happens to modified loans in an environment that is not an economic downturn. One league urged NCUA to ensure that its glossary definitions are consistent with GAAP and to eliminate the “economic downturn” language and simply adopt the GAAP definition of TDR. The Board notes that in the NPRM, the proposed IRPS explicitly stated that “[u]nder this IRPS, TDR loans are as defined in generally accepted accounting principles (GAAP) and the Board does not intend through this policy to change the Financial Accounting Standards Board’s (FASB) definition of TDR in any way.” 77 FR at 4933. Furthermore, it tracked GAAP in defining TDR in the glossary. The NPRM also urged FICUs to consider FASB clarifications in their recently revised, Accounting Standards Update No. 2011-02 (April 2011) to the FASB Accounting Standards Codification entitled, Receivables (Topic 310), “A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring.” The Board believes it is clear that the rule’s focus is on restructures that meet the GAAP definition of TDR. When a FICU works with members in financial difficulty and grants term concessions as described in GAAP, the FICU will have TDRs to report in its regulatory reports. Working with members is consistent with its mission. Particularly in downward economic cycles, the need to work with members increases, thus the increase in restructuring strategies to serve members. As such, the Board acknowledges the value of TDRs. If a FICU enters into TDR arrangements that improve the collectability of loans, properly recognizes loan losses, and restores the loans to accrual status, the FICU has met its mission and its regulatory reporting burden. Risk is mitigated, achieving a goal desired by both NCUA and the FICU.

Two leagues and one trade group requested that the final rule include additional guidance, consistent with GAAP, on impairment testing and recognition requirements. Impairment testing is beyond the scope of this rulemaking, the Board refers to IRPS 02-1, “Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions,” and NCUA’s Accounting Bulletin No. 06-01 (December 2006) that transmits the 2006 Interagency ALLL Policy Statement for further information.

### III. Final Rule and IRPS

#### a. Section 741.3, Lending Policies

The final rule amends §741.3(b)(2) to require FICUs to adopt policies that govern loan workout arrangements and nonaccrual practices. The rule specifically requires that a FICU’s written nonaccrual standards include the discontinuance of interest accrual on loans that are past due by 90 days or more and requirements for returning such loans, including MBLs workouts, to accrual status.

To set NCUA’s supervisory expectations and assist FICUs in complying with the amendments to §741.3(b)(2), the final rule includes an appendix to Part 741. The appendix thoroughly addresses the loan workout account management and reporting standards FICUs must implement in order to comply with the rule. It also explains how

FICUs report their data collections related to TDRs on Call Reports. The contents of the appendix are described in detail below.

b. Appendix C to Part 741, Interpretive Ruling and Policy Statement on Loan Workouts, Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans

#### 1. Written Loan Workout Policy and Monitoring Requirements

The Board recognizes loan workouts can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. The Board further acknowledges that the lack of a sound workout policy can mask the true performance and past due status of the loan portfolio. Accordingly, the final rule requires the FICU board and management to 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 each credit union's size and complexity, and must be in line with the credit union's broader risk mitigation strategies.

The policy must define eligibility requirements (i.e. under what conditions the FICU will consider a loan workout), including establishing limits on the number of times an

individual loan may be modified.<sup>2</sup> The policy must ensure the FICU makes loan workout decisions based on the borrower's renewed willingness and ability to repay the loan. In addition, the policy must establish sound controls to ensure loan workout actions are appropriately structured, including a prohibition against any authorizations of additional advances to finance unpaid interest and credit union fees. The final IRPS does provide that the policy may allow a FICU to make advances to cover third-party fees, such as force-placed insurance or property taxes. The FICU, however, cannot finance any related commissions it may receive from the third party.

Furthermore, the Board believes loan workouts should be adequately controlled and monitored by the board of directors and management, and therefore requires the decision to re-age, extend, defer, renew, or rewrite a loan, like any other revision to contractual terms, be supported by the FICU's management information systems. Sound management information systems are able to identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the frequency and extent such action has been taken. Appropriate documentation typically shows that the FICU's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan under the new terms.

NCUA is concerned, however, about restructuring activity that pushes existing losses into future reporting periods without improving the loan's collectability. The final IRPS

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<sup>2</sup> 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.

includes a provision notifying FICUs that if they engage in restructuring activity on a loan that results in restructuring a loan more often 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. Examiners will ask FICUs to provide evidence that their policy of permitting multiple restructurings improve collectability.

In developing a written policy, the FICU 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). Additionally, LCU 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Programs," outlines policy requirements for real estate modifications. Those requirements remain applicable to real estate loan modifications but could be adapted in part by the FICU in its written loan workout policy for other loans.

The Board does not intend for these minimum requirements to be an all inclusive list, rather they provide a basic framework within which to establish a sound loan workout program.

## 2. Regulatory Reporting of Workout Loans Including TDR Past Due Status

The Board recognizes that loan workouts that qualify under GAAP as TDRs require special financial reporting considerations. The final IRPS mandates that the past due status of all loans should be calculated consistent with loan contract terms, including amendments made to loan terms through a formal restructure. The IRPS eliminates the current, dual, and often manual delinquency tracking burden on FICUs managing and reporting TDR loans, while instituting a nonaccrual policy on TDR loans apart from past due status. The Board will modify the Call Report instructions accordingly.

Additionally, the final IRPS institutes revised Call Report data collections related to loan workouts eliminating much of the current data collections on the broad category “loan modifications,” focusing data collection on TDR loans. The Board will add additional data elements as necessary to effectively monitor and measure TDR activity and corresponding risk to the NCUSIF. This will assist national and field examination and supervision staff both to detect the level of activity and possible overuse of reworking a nonperforming loan multiple times without improving overall collectability, and will ensure income recognition is appropriate.

### 3. Loan Nonaccrual Policy

Generally, NCUA has required,<sup>3</sup> and it has become accepted credit union practice, to cease accruing interest on a loan when it becomes 90 days or more past due. The existing approach is referenced in various letters and publications but currently is not memorialized or enforceable through any statute or regulation. The final rule and IRPS require a FICU to adopt written nonaccrual policies that specifically address the discontinuance of interest accrual on loans past due by 90 days or more, as well as the requirements for returning such loans (including member business loan workouts) to accrual status.

### *Nonaccrual Status*

The final IRPS specifies when FICUs must place loans in nonaccrual status, including the reversal of previously accrued but uncollected interest, sets the conditions for restoration of a nonaccrual loan to accrual status, and discusses the criteria under GAAP for Cash or Cost Recovery basis of income recognition. FICUs may not accrue interest on any loan upon which 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.” Additionally, FICUs must place loans in nonaccrual status if maintained on a Cash (or Cost Recovery) basis because of deterioration in the financial condition of the borrower, or for which payment in full of principal or interest is not expected. The IRPS also addresses the treatment of cash interest payments received during periods of loan

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<sup>3</sup> The policy was discussed in an obsolete version of the NCUA Accounting Manual for FCUs, last published in June 1995.

nonaccrual and prohibits the restoration of previously reversed or charged-off accrued, but uncollected, interest applicable to any loan placed in nonaccrual status.

*Restoration to Accrual Status (not including Member Business Loan Workouts)*

The final IRPS sets forth specific parameters for returning a nonaccrual loan to accrual.

A nonaccrual loan may be returned to accrual status when:

- Its past due status is less than 90 days, GAAP does not require it to be maintained on the Cash or Cost Recovery basis, and the credit union is plausibly assured of repayment of the remaining contractual principal and interest within a reasonable period;
- When it otherwise becomes 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 income under the interest method specified therein.

In restoring all loans to accrual status, if any interest payments received while the 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 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.

### *Restoration to Accrual Status on Member Business Loan Workouts*

The Board recognizes there are unique circumstances governing the restoration of accrual for member business loan workouts and has set forth a separate policy in the proposal. This policy is largely derived from the “Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts” that NCUA and the other financial regulators issued on October 30, 2009.<sup>4</sup> The final IRPS requires a formally restructured member business loan workout to remain in nonaccrual status until the FICU can document a current 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 reasonable period prior to the date on which the loan is returned to accrual status.

A sustained period of repayment performance would be a minimum of six consecutive timely payments under the restructured loan’s terms of principal and interest in cash or cash equivalents. In returning the member business workout loan to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account. Such a restructuring must improve the collectability of the loan in accordance with a reasonable repayment schedule and does not relieve the FICU from the responsibility to promptly charge off all identified losses.

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<sup>4</sup> 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>.

#### 4. Glossary

The final section of the IRPS is a glossary of terms used throughout.

To assist commenters in understanding existing agency guidance, the following illustration is provided:

#### Summary of Source Guidance Related to Lending and Loan Modifications

Source of Supervisory Guidance	Consumer Lending	Member Business Lending
<p><b>Existing Recent Supervisory Guidance on Lending and/or Loan Modifications</b></p>	<p>Letter to Credit Union 11-CU-01, <i>Residential Mortgage Foreclosure Concerns</i>, (January 2011) <a href="http://www.ncua.gov">http://www.ncua.gov</a></p> <p>Letter to Credit Unions 09-CU-19, <i>Evaluating Residential Real Estate Mortgage Loan Modification Programs</i>, (September 2009) <a href="http://www.ncua.gov">http://www.ncua.gov</a></p> <p>Federal Financial Regulatory Agencies Issue Statement In Support of the “<i>Making Home Affordable</i>” Loan Modification Program,” (March 2009) <a href="http://www.ncua.gov">http://www.ncua.gov</a></p> <p><i>Statement on Loss Mitigation Strategies for Servicers of Residential Mortgages</i>, (September 2007) <a href="http://www.ncua.gov">http://www.ncua.gov</a></p>	<p>Letter to Credit Unions 10-CU-07, <i>Commercial Real Estate Loan Workouts</i>, transmitting <i>Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts</i>, (June 2010), and Enclosure <a href="http://www.ncua.gov">http://www.ncua.gov</a></p> <p>Letter to Credit Unions 10-CU-02, <i>Current Risks in Business Lending and Sound Risk Management Practices</i>, (February 2010) <a href="http://www.ncua.gov">http://www.ncua.gov</a></p>
<p><b>Written Policy Requirement on Frequency of Modifications</b></p>	<p>Final IRPS, Appendix C of Part 741.</p>	<p>Final IRPS, Appendix C of Part 741 and</p> <p>Letter to Credit Unions 10-CU-07, <i>Commercial Real Estate Loan Workouts</i>, transmitting <i>Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts</i>, (June 2010) and Enclosure <a href="http://www.ncua.gov">http://www.ncua.gov</a></p>

<b>Nonaccrual</b>	Final IRPS, Appendix C of Part 741.
<b>Delinquency</b>	Final IRPS, Appendix C of Part 741.
<b>Allowance for Loan and Lease Losses</b>	IRPS 02-3, <i>Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions (May 2002)</i> , <a href="http://www.ncua.gov">http://www.ncua.gov</a> .  2006 Interagency ALLL Policy Statement transmitted by Accounting Bulletin 06-1 (December 2006), <a href="http://www.ncua.gov">http://www.ncua.gov</a> .
<b>Charge-offs</b>	Letter to Credit Unions No. 03-CU-01, <i>Loan Charge-off Guidance</i> (January 2003), and its Enclosure, <a href="http://www.ncua.gov">http://www.ncua.gov</a> .

IV. Regulatory Procedures

a. Regulatory Flexibility Act

The Regulatory Flexibility Act requires NCUA to prepare an analysis to describe any significant economic impact agency rulemaking may have on a substantial number of small credit unions, defined as those under ten million dollars in assets. This rule tightens loan account management processes that should already be in place in FICUs. While FICUs are required to have policies that address loan management protocols, the final rule and IRPS set additional parameters that are consistent with existing best practices and federal banking regulators’ policies. NCUA has determined this final rule will not have a significant impact on a substantial number of small credit unions so NCUA is not required to conduct a Regulatory Flexibility Analysis.

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. 44 USC 3507(d); 5 CFR part 1320. For purposes of the PRA, a paperwork burden may take the form of either a reporting or a recordkeeping requirement, both referred to as information collections. As required, NCUA has applied to the Office of Management and Budget (OMB) for approval of the information collection requirement described below.

The final rule contains an information collection in the form of a written policy requirement. Any FICU making loan workout arrangements that assist borrowers must have a written policy to govern this activity. FICUs will only need to modify current policies to include any additional parameters established in the rule. It is therefore NCUA's view that implementing this type of policy will create minimum burden to credit unions. The parameters established within the rule and IRPS are usual and customary operating practices of a prudent financial institution. In the proposed rule, NCUA estimated it should take a FICU an average of 8 hours to modify current policies to comply with the parameters set forth in the proposed IRPS. Therefore, the total initial burden imposed to 7,250 FICUs for modifying the policies is approximately 58,000 hours. NCUA further estimated a FICU spends on average 15 minutes per month manually calculating and reporting past due status on each TDR loan. This policy eliminates this requirement. Per the September 30, 2011, Call Report, FICUs have 150,453 TDR loans outstanding. Eliminating this reporting requirement therefore results

in an annual savings of 451,359 hours. Thus, on net, this policy results in a substantial hours (393,359 annually) reduction of regulatory burden.

OMB assigned No. 3133-~~XXXX~~ to this rulemaking.

c. Small Business Regulatory Enforcement Fairness Act

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104-121) provides generally for congressional review of agency rules. A reporting requirement is triggered in instances where NCUA issues a final rule as defined by Section 551 of the Administrative Procedure Act. 5 U.S.C. 551. The Office of Management and Budget has determined that this rule is not a major rule for purposes of the Small Business Regulatory Enforcement Fairness Act of 1996.

d. Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. This final rule applies to all FICUs but will not have a substantial direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that

this rule does not constitute a policy that has federalism implications for purposes of the executive order.

e. Assessment of Federal Regulations and Policies on Families

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, Pub. L. 105-277, 112 Stat. 2681 (1998).

List of Subjects

12 CFR part 741

Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on May 24, 2012.

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Mary F. Rupp

Secretary of the Board

For the reasons discussed above, NCUA amends 12 CFR part 741 as follows:

## PART 741 - REQUIREMENTS FOR INSURANCE

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

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

2. In §741.3, revise paragraph (b)(2) to read as follows:

### §741.3 Criteria

- (b) Financial condition and policies. \* \* \*

(2) The existence of written lending policies, including adequate documentation of secured loans and the protection of security interests by recording, bond, insurance or other adequate means, adequate determination of the financial capacity of borrowers and co-makers for repayment of the loan, adequate determination of value of security on loans to ascertain that said security is adequate to repay the loan in the event of default, loan workout arrangements, and nonaccrual standards that include the discontinuance of interest accrual on loans past due by 90 days or more and requirements for returning such loans, including member business loans, to accrual status.

3. Amend Part 741 by adding Appendix C to read as follows:

## Appendix C to Part 741 - Interpretive Ruling and Policy Statement on Loan Workouts, Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans

This Interpretive Ruling and Policy Statement (IRPS) establishes requirements for the management of loan *workout*<sup>1</sup> arrangements, loan *nonaccrual*, and regulatory reporting of *troubled debt restructured loans* (herein after referred to as TDR or TDRs).

This IRPS applies to all federally insured credit unions.

Under this IRPS, TDR loans are as defined in *generally accepted accounting principles* (GAAP) and the Board does not intend through this policy to change the Financial Accounting Standards Board's (FASB) definition of TDR in any way. In addition to existing agency policy, this IRPS sets NCUA's supervisory expectations governing loan workout policies and practices and loan accruals.

### Written Loan Workout Policy and Monitoring Requirements<sup>2</sup>

For purposes of this policy statement, 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

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<sup>1</sup> Terms defined in the Glossary will be *italicized* on their first use in the body of this guidance.

<sup>2</sup> For additional guidance on 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>.

programs or *new loans* are not encompassed within this policy nor considered by the Board to be workout loans.

Loan workouts can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. Loan workout arrangements should 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 each credit union's size and complexity, and must be in line with the credit union's broader risk mitigation strategies. The policy must define eligibility requirements (i.e. under what conditions the credit union will consider a loan workout), including establishing limits on the number of times an individual loan may be modified.<sup>3</sup> The policy must also ensure credit unions make loan workout decisions based on the borrower's renewed willingness and ability to repay the loan. If a credit union engages in restructuring activity on a loan that results in restructuring the loan more often than once a year or twice in five years, examiners will have higher expectations for the documentation of the borrower's renewed willingness

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<sup>3</sup> 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.

and ability to repay the loan. NCUA is concerned about restructuring activity that pushes existing losses into future reporting periods without improving the loan's collectability. One way a credit union can provide convincing evidence that multiple restructurings improve collectability is to perform validation of completed multiple restructurings that substantiate the claim. Examiners will ask for such validation documentation if the 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.<sup>4</sup> The policy must provide that in no event may the credit union authorize additional advances to finance unpaid interest and credit union fees. The credit union may, however, make advances to cover third-party fees, excluding credit union commissions, such as force-placed insurance or property taxes. For loan workouts granted, the credit union must document the determination that the borrower is willing and able to repay the loan.

Management must ensure that comprehensive and effective risk management and internal controls are established and maintained so that loan workouts can be adequately controlled and monitored by the credit union's board of directors and

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<sup>4</sup> 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). Additionally, NCUA Letter to Credit Unions (LCU) 09-CU-19, "Evaluating Residential Real Estate Mortgage Loan Modification Programs," outlines policy requirements for real estate modifications. Those requirements remain applicable to real estate loan modifications but could be adapted in part by the credit union in their written loan workout policy for other loans.

management, to provide for timely recognition of losses,<sup>5</sup> and to permit review by examiners. 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, any implications to the organization's financial condition, and to make any compensating adjustments to the overall business strategy. This information will also then 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, needs to be supported by the credit union's management information systems. Sound management information systems are able to identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the frequency and extent such action has been taken. Documentation normally shows that the credit union's 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.

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<sup>5</sup> 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 (e.g., 12 months or greater). See discussions on the latter point in the 2006 Interagency ALLL Policy Statement transmitted by Accounting Bulletin 06-1 (December 2006).

## Regulatory Reporting of Workout Loans Including TDR Past Due Status

The past due status of all loans will be calculated 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.<sup>6</sup>

### Loan Nonaccrual Policy

Credit unions must ensure appropriate income recognition by placing loans in nonaccrual status when conditions as specified below exist, reversing or charging-off previously accrued but uncollected interest, complying with the criteria under GAAP for *Cash* or *Cost Recovery* basis of income recognition, and following the specifications below regarding restoration of a nonaccrual loan to accrual status.<sup>7</sup> 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 *member business loan* workouts and is similar to the FFIEC policies adopted by the federal

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<sup>6</sup> 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 the recently revised standard from the FASB, Accounting Standards Update No. 2011-02 (April 2011) to the FASB Accounting Standards Codification entitled, Receivables (Topic 310), "A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring." This clarified the definition of a TDR, which has the practical effect in the current economic environment to broaden loan workouts that constitute a TDR. This standard is effective for annual periods ending on or after December 15, 2012.

<sup>7</sup> 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.

banking agencies<sup>8</sup> as set forth in the FFIEC Call Report for banking institutions and its instructions.<sup>9</sup>

### Nonaccrual Status

Credit unions may not accrue interest<sup>10</sup> on any loan upon which 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.*”<sup>11</sup> Additionally, loans will be placed in nonaccrual status if maintained on a Cash (or Cost Recovery) basis because of deterioration in the financial condition of the borrower, or for which payment in full of principal or interest is not expected. 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, some or all of the cash interest payments received may be treated as interest income on a cash basis as long as the remaining *recorded investment in the loan* (i.e., after charge-off of identified losses, if any) is deemed to be fully collectable. The reversal of previously accrued, but uncollected, interest applicable

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<sup>8</sup> 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.

<sup>9</sup> FFIEC Report of Condition and Income Forms and User Guides, Updated September 2011, <http://www.fdic.gov>.

<sup>10</sup> 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.

<sup>11</sup> 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 separate section of this IRPS later in the policy statement.

to any loan placed in nonaccrual status must be handled in accordance with GAAP.<sup>12</sup>

Where assets are collectable over an extended period of time and, because of the terms of the transactions or other conditions, there is no reasonable basis for estimating the degree of collectability - when such circumstances exist, and as long as they exist – consistent with GAAP the *Cost Recovery Method* of accounting must be used.<sup>13</sup>

Use of the Cash or Cost Recovery basis for these loans and the statement on reversing previous accrued interest is the practical implementation of relevant accounting principles.

#### Restoration to Accrual Status for all Loans except Member Business Loan Workouts

A nonaccrual loan may be restored to accrual status when:

- Its past due status is less than 90 days, GAAP does not require it to be maintained on the Cash or Cost Recovery basis, and the credit union is plausibly assured of repayment of the remaining contractual principal and interest within a reasonable period;

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<sup>12</sup> 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.

<sup>13</sup> When a purchased impaired loan or debt security that is accounted for in accordance with ASC Subtopic 310-30, "Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality," has been placed on nonaccrual status, the cost recovery method should be used, when appropriate.

- 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 for accrual of income under the interest method specified therein.

In restoring all loans to accrual status, if any interest payments received while the 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 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.

#### Restoration to Accrual Status on Member Business Loan Workouts<sup>14</sup>

A formally restructured 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 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 would be a minimum of six consecutive

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<sup>14</sup> This policy is derived from the "Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts" NCUA and the other financial regulators issued on October 30, 2009.

payments and would involve timely payments under the restructured loan's terms of principal and interest in cash or cash equivalents. In returning the member business workout loan to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account. Such a restructuring must improve the collectability of the loan in accordance with a reasonable repayment schedule and does not relieve the credit union from the responsibility to promptly charge off all identified losses.

The graph below 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 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); so, 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. The loan, therefore, 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	Month6	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 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 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 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 If the loan must be maintained on the Cash or Cost Recovery basis because there is a deterioration in the financial condition of the borrower, or for which payment in full of	See Glossary descriptors for “well secured” and “in the process of collection.”  Consult GAAP for Cash or Cost Recovery basis income recognition guidance. See also Glossary Descriptors.

	principal or interest is not expected	
Nonaccrual on 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 Member Business Loan Workouts	<p>When the loan is past due less than 90 days, GAAP does not require it to be maintained on the Cash or Cost Recovery basis, and the credit union is plausibly assured of repayment of the remaining contractual principal and interest within a reasonable period.</p> <p>When it otherwise becomes both “well secured” and “in the process of collection”; or</p> <p>The asset is a purchased impaired loan and it meets the criteria under GAAP for accrual of income under the interest method.</p>	<p>See Glossary descriptors for “well secured” and “in the process of collection.”</p> <p>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.</p>
Restore to Accrual on Member Business Loan Workouts	<p>Formal restructure with a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms</p>	<p>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 the loan to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be taken into account.</p> <p>Interest payments received while the member business 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 member business loan was placed on nonaccrual status cannot be restored to accrual.</p>

Glossary<sup>15</sup>

“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

<sup>15</sup> Terms defined in the Glossary will be *italicized* on their first use in the body of this guidance.

treated as interest income on a cash basis as long as the remaining recorded investment in the loan (i.e., after charge-off of identified losses, if any) is deemed to be fully collectible.<sup>16</sup>

*“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 should be recorded when received.

*“Cost Recovery”* method of income recognition means equal amounts of revenue and expense are recognized as collections are made until all costs have been recovered, postponing any recognition of profit until that time.<sup>17</sup>

*“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 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

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<sup>16</sup> 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.

<sup>17</sup> FASB Accounting Standards Codification (ASC) 605-10-25-4, “Revenue Recognition, Cost Recovery.”

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 723.1 of NCUA’s Member Business Loan Rule, 12 CFR §723.1.

*“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.<sup>18</sup> 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 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.<sup>19</sup> For purposes of this policy

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<sup>18</sup> FASB ASC 310-40, “Troubled Debt Restructuring by Creditors.”

<sup>19</sup> *“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.

*“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 should 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.

statement, workouts do not include loans made to market rates and terms such as refinances, borrower retention actions, or new loans.<sup>20</sup>

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

<sup>20</sup> 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.