SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF EXAMINATION AND INSURANCE
1775 DUKE STREET, ALEXANDRIA, VA 22314

DATE: **March 2013** **Supervisory Letter No. 13-02**

TO: **All Field Staff**

SUBJECT: **Examiner Review of Loan Workouts, Nonaccruals and Regulatory Reporting of Troubled Debt Restructured Loans**

In May 2012, the NCUA Board revised part 741 of the NCUA Rules and Regulations including the addition of new Appendix C, *Interpretive Ruling and Policy Statement on Loan Workouts and Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans*.

This Supervisory Letter provides guidance for evaluating whether credit unions are following applicable regulatory requirements in administering a sound loan workout program. This guidance establishes a uniform examination approach to reviewing loan workouts, nonaccruals, and regulatory reporting of troubled debt restructured loans.

If examiners have any questions on this Supervisory Letter, they should direct them to their immediate supervisor or regional management.

Sincerely,

/s/

Larry Fazio, Director,
Office of Examination and Insurance

Supervisory Letter

Examiner Review of Loan Workouts, Nonaccruals, and Regulatory Reporting of Troubled Debt Restructured Loans

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1. What is the purpose of this Supervisory Letter (letter)?

This letter outlines changes the NCUA Board adopted to 12 C.F.R. § 741.3(b)(2) and the addition of new Appendix C to Part 741, at its May 2012 meeting regarding reporting and regulatory requirements for "workout loans",[1] loan nonaccrual, and troubled debt restructurings (TDR).[2] This guidance sets out a uniform examination approach for NCUA examiners and clarifies various provisions of the new reporting and regulatory requirements. NCUA examiners will use this guidance when reviewing loan workouts, loan accruals, and the reporting of TDRs during examination and insurance review contacts.

This letter also focuses on key related accounting issues but does not address all of the generally accepted accounting principles (GAAP) relevant to workout loan arrangements. Credit unions with $10 million or more in assets must follow GAAP in the reports they file with the NCUA Board.[3] This Supervisory Letter does not supersede or replace GAAP. When questions arise regarding proper GAAP accounting, examiners should encourage credit unions to consult with a licensed independent accountant.

2. Why did NCUA change the reporting and regulatory requirements for loan workouts, nonaccruals, and TDRs?

Credit unions work with members experiencing financial difficulties by offering sensible loan workout arrangements. These loan servicing and collection strategies provide credit unions with the ability to improve the collectability of loans while also helping members deal with financial difficulties, manage their debt, and retain their homes and businesses when possible.

The economic challenges of the last several years resulted in increased numbers of loan workouts for borrowers who have fallen behind on their payments. NCUA's prior reporting and supervisory requirements created practical challenges for credit unions, such as maintaining separate manual delinquency calculations. This constrained credit unions' prudently working with borrowers.

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[1] The glossary in Appendix C to 12 C.F.R. Part 741, Interpretative Ruling and Policy Statement (IRPS), defines a "workout loan" as a loan to a borrower in financial difficulty that has been formally restructured so as to be reasonably assured of repayment (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. Each of these terms, likewise, is defined in Appendix C to Part 741, the Glossary, footnote 19. Loan workouts do not include loans made at market rates and terms such as refinances, borrower retention actions, or new loans.

[2] The definition of "troubled debt restructuring" (TDR) provided in the glossary in Appendix C to 12 C.F.R. Part 741, adopts the GAAP definition of TDR, and is discussed in more depth in Question #9 of this Supervisory Letter.

[3] See section 202(a)(6)(C) of the Federal Credit Union Act, 12 U.S.C. § 1782(a)(6)(C), as amended by the Credit Union Membership Access Act, Pub. L. No. 105-219, § 201, 112 Stat. 913 (1998), providing that credit unions with less than $10 million in assets are still expected to comply with the requirements of 12 C.F.R. § 741.3(b)(2) and Appendix C to Part 741 to establish a loan workout policy, sound management information system framework and nonaccrual on loans over 90 days past due.

NCUA supports the prudent use of loan workouts as an effective tool to enhance collectability while assisting borrowers experiencing financial difficulty. The reporting and regulatory changes balance flexibility with appropriate safety and soundness safeguards. Specifically, potential safety and soundness concerns with this activity include:

- Masking deteriorations in loan portfolio quality and understating charge-off levels.
- Delaying loss recognition resulting in an understated allowance for loan and lease losses account and inaccurate loan valuations.
- Overstating net income and net worth (regulatory capital) levels.
- Circumventing internal controls.

The new reporting and regulatory requirements also improve consistency of reporting with other depository financial institutions.

3. What reporting and regulatory requirements for loan workouts, nonaccruals, and TDRs did NCUA change?

The NCUA Board revised 12 C.F.R. § 741.3(b)(2) and added new Appendix C to Part 741 of the NCUA's Rules and Regulations.[4] Section 741.3(b)(2) applies to all federally insured credit unions (FICUs), and specifies that the credit union's written lending policies include *"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."* The Interpretative Ruling and Policy Statement, which was published in Appendix C to Part 741 has the force and effect of regulation, and elaborates on the new elements added to § 741.3(b)(2).

Appendix C to Part 741 addresses the following requirements, which became effective on October 1, 2012 (with the exception of the modified regulatory reporting):

- Requires a written policy for loan workouts.
- Specifies management and internal controls for loan workouts.
- Modifies regulatory reporting of workout loans, including TDRs. This provision alters delinquent loan reporting on the Call Report, starting with the June 2012 cycle. It also focuses future data collection on loans meeting the definition of TDR under GAAP[5] starting with the Call Report cycle ending December 31, 2012.

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[4] Federal Register /Vol. 77, No. 105 /Thursday, May 31, 2012 /Rules and Regulations 31993, http://www.gpo.gov/fdsys/pkg/FR-2012-05-31/pdf/2012-13214.pdf.

[5] The data collection includes all loans meeting the GAAP criteria for TDR reporting without the application of materiality threshold exclusions based on scoping or reporting policy elections of preparers or auditors.

- Standardizes loan nonaccrual requirements, including the treatment of member business loan (MBL) workouts.

Sections 5 through 8 of this letter elaborate on each of the areas outlined in the bullets above, and what examiners will correspondingly focus on.

4. What are the examiner's primary responsibilities for the new loan workout requirements?

Examiners will ensure credit union compliance with 12 C.F.R. § 741.3(b)(2) and Appendix C to Part 741 of the NCUA's Rules and Regulations. The sections below outline specific aspects of loan workout programs for examiners to evaluate. The depth of the examiner's review will depend on the unique fact pattern for each credit union, as well as, the level of risk posed by the program. The examination process must be risk-focused and not a "one size fits all" review of the policy and program.

During the exam, examiners will check to see if the credit union has outstanding workout loans or is planning to begin this activity. If not, a written loan workout policy is not required. Otherwise, examiners will then determine the extent to which the credit union is engaged in this activity.

Examiners will scale the depth of review to the level of activity, complexity of the credit union and risk exposure. Examiners do not need to perform a comprehensive review in every credit union.

A. Under the risk focused examination process, examiners will focus resources on areas of greatest risk. When scoping the loan workout review, examiners will consider the following:

1. Does the credit union have appropriate system capability and internal controls to track and monitor all workout activity given the size and complexity of the organization?
2. What is the balance of workout activity including TDRs?
3. What is the balance of TDR compared to workout activity?
4. What is the percentage of workout or TDR activity in relation to capital, earnings and volume of loan activity?
5. Is the level of earnings sufficient to withstand proportionate incremental differences in ALLL valuations without causing a reader of the financial statements to reach incorrect conclusions about the health of the credit union?

6. How great would incorrect accounting/valuation need to be to result in a lower net worth category?[6]

7. How great would incorrect accounting/valuation need to be to cause positive earnings to become negative?

8. Are there external local economic variables that could result in a more material impact from misclassification (e.g. local real estate price trends, local unemployment rates, sponsor layoffs, etc.)?

If initial analytical testing reveals limited exposure, then examiners will limit the review to a high-level review of policy, controls and reporting. If the examiner believes the exposure is significant enough to influence conclusions about the financial performance, net worth classification or health of the credit union's loan portfolio,[7] then examiners will expand the review to include a more comprehensive analysis including transaction testing.

If the volume of activity exposes the credit union to significant risk, examiners will conduct a thorough review based on the guidance contained in the remainder of this letter.

As part of the examination process, examiners will determine the credit union complies with the loan nonaccrual standards specified in Appendix C to Part 741.

5. What are the specific requirements for the loan workout policy?

This section elaborates on the required elements of the loan workout and nonaccrual policy, and the Examiner's corresponding focus. Policy parameters should be reasonable based on the risk profile of the institution. An effective program improves loan collectability without delaying loss recognition or masking deteriorating loan quality. The effectiveness of the credit union's written loan workout policy should be determined through a sample review of workout loans. Examiners should consult additional NCUA and interagency guidance as appropriate.[8]

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[6] Examiners are reminded that credit unions must estimate loan losses in accordance with GAAP and existing supervisory guidance, i.e., the 2006 Interagency ALLL Policy Statement transmitted by Accounting Bulletin 06-1 (December 2006). The examination approach outlined above #5-8 aids examiner judgments about examination scope and appropriate depth of transaction testing but should not be construed in any way to permit preparer credit unions to manage income through loan loss provision adjustments.

[7] A key risk consideration in determining scope should be the evaluation of the overall ("big picture") health of the credit union. If the volume of workout activity is enough that impairment recognition (ALLL funding) may cause the credit union to report a loss instead of a profit for the period, or significant enough to move a credit union from a well-capitalized to a less than well capitalized net worth category, then the risks are elevated and the examiner should perform an in-depth review over and above policy, procedure and controls. Conversely, if a credit union has limited workout activity or moderate overall activity, with strong policy, controls and high levels of earnings and capital, the examiner should document the conclusions, limit the review and move on to another area of risk exposure. This requires good judgment. As a practical matter, workout activity measured at outstanding carrying amounts (net of respective ALLL) exceeding 10% of a credit union's net worth could affect earnings and net worth sufficiently to warrant a more in depth analysis.

[8] Refer to Letter to Credit Unions 10-CU-07, Commercial Real Estate Loan Workouts (June 2010), and Letter to Credit Unions 09-CU-19, Evaluating Residential Real Estate Mortgage Loan Modification Programs (September

A. The policy 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.

Credit union management must develop a sound, well thought out policy and framework for granting workout loans prior to engaging in this activity. Management must consider overall risk factors including attributes specific to their field of membership, economic conditions (both present and anticipated,) internally established impairment thresholds, borrower specific conditions, and risk limits to the loan workout activity.

Further, workout policies must be commensurate with the credit union's net worth (that is, the ability to absorb losses stemming from the program) and must be balanced with an effective risk management program. What may work in a large institution may not be effective or reasonable for a small institution. In smaller credit unions, in particular, officials may have to evaluate other business strategies (loan and dividend rates, fees, etc.) to compensate for the risks embedded in the loan workout program.

B. The policy must define borrower eligibility requirements (i.e. under what conditions the credit union will consider a loan workout), including establishing limits on the number of times it will modify an individual loan.

When establishing borrower eligibility requirements, consider the following items:

1. What types of loans will the workout program include? Are there limits on collateral types or other specific loan types?

2. How will the credit union value the underlying collateral for collateralized loans?

3. Will there be provisions for requesting additional collateral?

4. How will the credit union handle balloon payments or principal amortization?

5. Does the borrower need to be delinquent on their loan for the credit union to consider a workout arrangement? If so, how delinquent? Alternatively, is demonstration of a financial hardship sufficient for considering a loan workout? If so, what documentation will suffice to demonstrate the hardship?

6. What type of income verification will the credit union require?

7. Will the credit union set debt to income ratio limits for workout loans?

8. Must the borrower demonstrate renewed ability and willingness to repay the revised note amount?

2009), when evaluating the credit union's member business loan and real estate mortgage loan workout provisions and practices respectively. Also refer to the FFIEC's "Uniform Retail Credit Classification and Account Management Policy." *See* 65 Fed. Reg. 36903 (June 12, 2000).

9. Must the borrower demonstrate the renewed ability and willingness to repay the revised note amount for a series of months before the loan is re-written? How many months?

10. Does the policy address permanent reductions in income vs. temporary hardships? The workout terms should align with the circumstances.

11. Does the credit union test for financial impact prior to the restructure, i.e., does the credit union compare the cost of the concessions to the borrower with the estimated loss given foreclosure (See LTCUs 09-CU-19, page 3-4)?

12. When will loans be considered for multiple restructure? What must the borrower document?

13. Does the policy address reporting requirements? Does the policy identify the staff responsible for the reporting function and reporting frequency?

Both credit unions and examiners should use the amount and trending of non-accruing TDRs as a risk indicator to gauge if workout strategies are improving loan collectability, and modify workout policies and practices accordingly.

In general, loan workout arrangements should consider and balance the best interests of both the borrower and the credit union. The credit union should evaluate the changed circumstances of the borrower and balance that with the need to improve the collectability of the loan. Further, the credit union should establish strong servicing and collection strategies for workout loans. These strategies, typically, should be more stringent for loan workouts and should include quicker escalation of collection efforts when these loans become delinquent.

In relation to multiple restructure strategies, credit unions must perform a validation or "look back" to past multiple restructures and track in aggregate and by loan type, the relative re-default rates, the number of times the loan has been restructured, dates of restructuring, and any other pertinent information related to the restructurings. Some level of re-default is unavoidable. Examiners need to review a representative sample of loan workouts that have re-defaulted and loans subject to multiple workouts to assess the credit union's compliance with part 741, the soundness of the credit union's workout program, and the accuracy of financial and statistical reports.

Credit unions should have higher expectations for renewed willingness and ability to repay for multiple restructures occurring more than once per year or twice in five years (since any previous workout). For loans that have had multiple restructurings, credit unions must maintain documentation of the valid reasons for multiple restructures such as various life changes.[9]

Reasonable approaches to conducting the validation include tracking each loan workout to its original loan source. Evidence of a successful restructure includes principal amortization and improved collectability. A reasonable period to see results may vary but would typically be approximately twelve months.

C. The policy must also ensure the credit union makes loan workout decisions based on the borrower's renewed willingness and ability to repay the loan.[10]

The credit union must document each loan workout determination as part of the formal record. This includes documented communication with the borrower demonstrating the borrower has a renewed willingness and ability to repay the debt. Further, sufficient documentation of the ability to repay the debt is "demonstrated performance" as outlined in the workout policy (see Section 5B above for items to be considered when evaluating a borrower's ability to repay).

D. The policy must establish sound controls to ensure responsible staff appropriately structure loan workout actions.[11]

This provision includes establishing comprehensive management and internal controls over loan workout activity (see Section 6 of this letter for detail on the role of management information systems). This includes establishing authority levels and segregation of duties over the various types of workouts (modifications, refinances, adjusting due dates, etc.). In addition, the policy needs to specify volume thresholds tied to financial performance elements such as net worth, delinquency and/or net charge off rates, etc. that trigger enhanced reporting to the credit union's board of directors. The policy must also provide provisions to ensure compliance with the regulatory restriction on no additional advances or financing of interest and fees other than advances to cover third-party fees, such as forced placed insurance or property taxes.[12] Examiners will obtain an understanding of controls based on a sample review (file maintenance reports, etc.) during the examination. Examiners will also evaluate the adequacy of enhanced reporting during the examination.

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[9] For example, a member borrower may re-marry and the new spouse may be willing to act as a cosigner on the existing note in return for a lower market interest rate on the continuing loan. To the extent the addition of the cosigner on the loan serves as adequate compensation for the lower interest rate, the credit union will have improved the collectibility of the loan while limiting additional risk.

[10] See Appendix C to Part 741, section entitled, *Written Loan Workout Policy and Monitoring Requirements*.

[11] Ibid., footnote 10.

[12] This prohibition does not preclude the credit union from maintaining the legal obligation for the member to repay in cash the arrearages in interest or penalties. It simply means for financial reporting purposes, these amounts cannot be capitalized in the loan balance through additional advances or credits to income.

6. What constitutes a sound management information system framework for loan workouts?

This section elaborates on how management information systems should support the control and monitoring of workout loans. Examiners must ensure adequate control and monitoring exists, including support for the decision to revise contractual terms, through the credit union's management information systems.

A. 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.[13]

(i) While credit unions are only required to report TDRs on the quarterly Call Report, management must at all times be able to appropriately identify and segregate TDR and non-TDR workouts and maintain monthly reports of this activity. Procedures should address identifying loans for review considering the factors to assess TDR status and designating responsibility for the TDR decision. The lending functions (underwriting, loan grading & monitoring, collections) should have ongoing communications with the financial reporting function (accounting policy elections, TDR identification, proper nonaccrual & impairment measurement, timely charge-offs).

(ii) Sound management information systems also maintain adequate documentation for the loan workout decision. Appropriate documentation should show communication with the borrower, borrower agreement to pay the loan in full, and borrower ability to repay the loan under the new terms. This is an important element in evaluating the collectability of a loan workout arrangement. Credit unions must perform renewed underwriting and repayment verification at the restructure point to support their workout decision. Documentation may vary depending on whether the loan is a member business loan or a consumer loan.[14] For example, MBL analysis will focus more on the cash flows generated by the operation of the business entity, collateral value and guarantees, while consumer loans will focus more on income verification and credit scoring.

(iii) The strength and soundness of the credit union's monitoring systems demonstrate the effectiveness of the loan workout program. Examiners review the management information systems to ensure the credit union has the ability to appropriately identify and document loan workouts. Further, these monitoring systems allow credit union management to report information related to the workout program to senior management and/or officials. Officials should receive sufficient information regarding the program to make informed decisions about whether or not the program works as expected or if they need to make adjustments to program parameters. The frequency of this type of reporting should be commensurate with

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[13] Ibid., footnote 1.

[14] For member business loans, see pages 4-7 of the guidance in Letter to Credit Unions 10-CU-07, *Commercial Real Estate Loan Workouts* (June 2010). For consumer loans, particularly residential mortgage loans, see pages 5-6 of Letter to Credit Unions 09-CU-19, *Evaluating Residential Real Estate Mortgage Loan Modification Programs* (September 2009).

the volume of workout loans granted as well as the risk exposure the workout program presents to the credit union's net worth.

B. Management information systems must be able to track the principal reductions and charge-off history of loans in workout programs by type of program.

In addition, it is important monitoring and tracking systems capture historical data elements related to principal reductions and charge-offs for financial reporting purposes, collection, and ongoing evaluation. The credit union's financial reporting policy elections should be documented and consistent with GAAP, supervisory guidance, and credit union policy in:

(i) TDR identification,
(ii) Nonaccrual triggers,
(iii) Restoration to accrual triggers,
(iv) Cash or Cost Recovery basis policy implementation,
(v) Application of payments when collection of principal and/or interest is in doubt, and
(vi) Impairment methodology.

Systems should also capture the required data elements to support regulatory reporting on the 5300 Call Report as discussed below.

7. What are the specifics for the new regulatory reporting requirements, and the Examiner's associated responsibilities?

A. Regulatory Reporting

Appendix C to Part 741 requires credit unions to calculate the past due status of all loans consistent with loan contract terms, including amendments through a formal restructure.[15] Thus, credit unions are no longer required to report delinquency for six months after amending a loan based on the prior contract terms. This provision therefore changes how delinquent loans are reported on the Call Report (5300), starting with the June 2012 cycle.

The NCUA Board also stated in Appendix C to Part 741 that NCUA's future Call Report data collection will focus on loans meeting the definition of TDR under GAAP. The data collection will include all loans meeting the GAAP criteria for TDR reporting without the application of materiality threshold exclusions based on scoping or reporting policy elections of preparers or auditors. This change went into effect starting with the December 31, 2012, Call Report cycle.

B. Verifying Accuracy of Call Report Data

The revisions to the Call Report allowed NCUA to:

[15] See Appendix C to Part 741, section entitled, *Regulatory Reporting of Workout Loans Including TDR Past Due Status.*

(i) Focus on the subset of loan workouts that are most important to safety and soundness, specifically those considered TDRs under GAAP.

(ii) Provide data to aid in determining that nonaccruals align with reported past due status.

(iii) Evaluate the effectiveness of credit union strategies by reviewing TDR trends.

Consistent with existing policies and procedures, examiners will continue to verify the accuracy of the credit union's Call Reports. During examinations, examiners will review the credit union's process for reporting TDR activity consistent with revised Call Report instructions.

8. What are the specifics for the new loan nonaccrual requirements, and the Examiner's associated responsibilities?[16]

Credit unions must ensure appropriate income recognition by placing loans in nonaccrual status consistent with the requirements in Appendix C to Part 741.[17] Accrued loan interest must be both earned and realizable. As loan performance deteriorates, the uncertainty of realizing or collecting interest rises. GAAP addresses the various acceptable methods of income recognition in cases of deteriorating credit quality.

Examiners will focus on appropriate nonaccrual treatment in line with Appendix C to Part 741 and GAAP. Examiners will assess whether the credit union has the capability, safeguards and internal controls to implement GAAP and NCUA's nonaccrual requirements. Examiners must ensure the credit union reports nonaccruals on the Call Report consistent with this policy.

A. Nonaccrual Requirements

(i) Section 741.3(b)(2) and Appendix C to Part 741specify that credit unions may not accrue interest on any loan upon which principal or interest has been in default for a period of 90 days or more.[18] An exception to the discontinuance of interest accrual occurs when the loan is both "well secured" and "in process of collection."[19] For purposes of this exception, the date

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[16] Examiners may wish to refer to Table 1 *Nonaccrual*, & Table 2 *Restoration to Accrual*, in Appendix C to Part 741 as he/she reviews this portion of the Supervisory Letter related to nonaccrual policy.

[17] See Appendix C to Part 74, section entitled, *Loan Nonaccrual Policy.*

[18] 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.

[19] The Glossary in Appendix C to Part 741 defines the terms "well secured" and "in process of collection." "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. "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.

on which a loan reaches nonaccrual status is determined by its contractual terms (that is, the credit union should use contractual due dates to determine the 90 day default timeline).

(ii) Credit unions 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 and interest is not expected. GAAP specifies the conditions for use of the Cash (or Cost Recovery) basis. Examiners should ensure credit unions have a documented accounting policy election and sound process for making this determination, and the credit union's report of nonaccrual loans includes loans past due 90 or more days as well as any loans maintained on a Cash (or Cost Recovery) basis.

(iii) When a loan reaches 90 days past due, previously accrued but uncollected interest must be reversed or charged off. For financial reporting purposes, the previously accrued but uncollected interest cannot be restored (reestablished as a receivable or capitalized in the loan balance) once the loan returns to accrual status. These amounts can only be credited to income if received from the borrower in cash or cash equivalents.[20]

B. Restoration to Accrual Status

Appendix C to Part 741 requires that before returning a nonaccrual loan to accrual status, the credit union must obtain an affirmation of the member's renewed willingness and ability to make timely payments of principal and interest under the revised contract terms. Below are the regulatory provisions for restoring a nonaccrual loan to accrual status.

(i) For all loans other than member business workout loans -- credit unions can return the loan to accrual when:

- the loan becomes both well secured and in the process of collection; or,
- The past due status is less than 90 days, GAAP does not require it 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.[21]

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[20] By way of further explanation, one could look at it in similar terms to a loan charge-off. The only way to get an ALLL "recovery" on a charged-off loan is to collect the charge-off in cash. So, in a similar way, if a loan reaches 90 days or more past due, a credit union should stop accruing interest and place it on the Cash basis. At the same time, the credit union must reverse or charge-off accrued but uncollected interest. These amounts cannot be restored (reestablished as a receivable or capitalized in the loan balance) once the loan returns to accrual. They can only be credited to income **if** received in cash.

Some within the credit union industry have asserted that certain GSE's require or allow the capitalization of interest upon loan workout (e.g., HAMP). These programs generally allow the lender to increase the monthly payment under the revised terms to also collect contractual interest in arrears or uncollected at the workout point. This practice is not the capitalization of interest (addition of interest to the principal balance) but the increase in the effective rate of interest to be recognized over the remaining life of the loan.

[21] Also, a purchased impaired loan may be returned to accrual status if it meets the criteria under GAAP for accrual of income under the interest method - see FASB ASC 310-30, available at http://www.fasb.org.

(ii) For member business workout loans -- a workout for a member business loan may be returned to accrual status if the borrower has demonstrated the ability to make at least six consecutive timely contractual payments of principal and interest under the restructured terms. In making this determination, the credit union may consider the borrower's recent repayment performance just prior to the formal restructuring action.

Key Principle for Return to Accrual
"Some period of payment performance generally is necessary in order to make an assessment of collectability that would permit returning the loans to accrual status."
FASB ASC 942-310

Example: A credit union originated a 36-month $10 million loan for the purchase of an office building. The loan had an interest reserve to cover interest payments over the three-year term. At the end of the third year, there is $10 million outstanding on the loan. At the time of origination, the appraisal reported a market value of $13.5 million for the property.

Current financial statements indicate the borrower has minimal other resources available to support this credit. The credit union decided not to restructure the $10 million loan into a new single amortizing note of $10 million at a market rate of interest because the projected cash flow would only provide a 0.88x debt service coverage ratio as the borrower has been unable to lease space. A recent appraisal on the office building reported a market value of $9 million, which results in a LTV of 111 percent.

Therefore, at the original loan's maturity, the credit union restructured the $10 million debt into two notes. The credit union placed the first note of $7.2 million on monthly payments that amortize the debt over 20 years at a market rate of interest that provides for the incremental credit risk. The debt service coverage ratio equals 1.20x for the $7.2 million loan based on the office building's projected net operating income.

The credit union placed the second note of the remaining principal balance of $2.8 million into a 2 percent interest-only loan scheduled to reset in five years to an amortizing payment. The credit union then charged-off the $2.8 million note due to the lack of repayment capacity and to provide reasonable collateral protection for the remaining on-book loan of $7.2 million. Since the restructuring, the borrower has made payments on both loans for more than six consecutive months.

Nonaccrual Treatment: The credit union restored the on-book loan of $7.2 million to accrual status as the borrower has the ability to repay the loan, has a record of performing at the revised terms for more than six months, and full repayment of principal and interest is expected. The examiner concurred with the credit union's accrual treatment. Interest payments received on the charged-off note were recorded as recoveries because, in this case, full recovery of principal and interest on this loan was not reasonably assured.[22]

[22] Example adapted from the guidance in Letter to Credit Unions 10-CU-07, *Commercial Real Estate Loan Workouts* (June 2010), *available at* http://www.ncua.gov.

C. Application of Payments when Loans are in Nonaccrual

GAAP provides some key principles that govern credit union accounting policy elections related to the application of cash payments during periods of loan nonaccrual.

For amounts received on a loan in nonaccrual, the credit union must make a determination about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

(i) Recognizing income on the Cash Basis. The credit union may treat some or all of the cash interest payments received as interest income on a Cash Basis as long as the remaining recorded investment in the loan is deemed fully collectable.

(ii) Applying cash payment to principal. If the ultimate collectability of principal, wholly or partially, is in doubt, any payment received shall be applied to reduce principal to the extent necessary to eliminate such doubt.

(iii) Recognizing income on the Cost Recovery Basis. Where assets are collectable over an extended period of time and, because of the terms of the transaction 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.[23] Under this method, 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.[24]

Key Principle for Application of Payments

If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income. If the ultimate collectability of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended shall be applied to reduce principal to the extent necessary to eliminate such doubt.

FASB ASC 942-310

While in nonaccrual status, interest payments applied to reduce the investment in the loan may not be reversed (and interest income must not be credited). Accrued but uncollected interest reversed or charged-off at the initial point of nonaccrual cannot be restored even if the loan returns to accrual status; it can only be recognized as income if collected from the member in cash or cash equivalents.

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[23] 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.

[24] FASB ASC 605-10-25-4, *available at* http://www.fasb.org.

9. What are other important considerations for Examiners?

While not explicitly discussed in Appendix C to Part 741, examiners must consider the guidance below when evaluating whether a credit union has implemented a loan workout program commensurate with its risk profile.

A. Determining which loan workouts are, or are not, TDRs

It is the credit union's responsibility to analyze and document each loan's fact pattern in light of the Financial Accounting Standards Board's (FASB) accounting guidance to determine if the workout is, or is not, a TDR. NCUA does not intend through Appendix C to Part 741or this letter to change the FASB's definition of TDR in any way. Examiners will evaluate credit risk related to all credit union restructure activity that meets the GAAP criteria for TDR reporting, regardless of whether the credit union itself or its auditor elects materiality threshold exclusions. Examiners should review a sample of workout loans for adequacy of documentation and the credit union's decision regarding TDR classification.

Keep in mind that a workout loan is not always a TDR. There might be instances where a workout loan is not a TDR even though the borrower is experiencing financial hardship. GAAP defines TDR. Two criteria are required for a loan to be a TDR: the borrower must be experiencing financial difficulty and the credit union must have granted a concession it would not have otherwise considered but for the borrower's financial difficulty.

Key Principle on Loan Workouts

"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 borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. 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.

FASB ASC 310-40

The credit union must provide the examiner an analysis to support its determination the extension, renewal, deferral or rewrite is, or is not, a TDR. The credit union must provide a well-documented analysis that illustrates (1) whether the borrower is experiencing financial difficulty and (2) whether the credit union granted a concession it would not otherwise consider except for the borrower's financial difficulty.[25] The credit union's conclusion and rationale must be clearly stated in supporting documents.

More specifically, the credit union must:

[25] See summary flowchart in appendix 2 to this letter.

- Designate who is responsible for the TDR determination;
- Make and document its conclusion regarding the borrower's financial difficulty;
- Make and document its conclusion regarding whether a concession is involved;
- Taking the two evaluations together, conclude and document if the workout arrangement is, or is not, a TDR; and
- Have a process for the loan to be flagged and tracked as a TDR and/or workout going forward including placing or retaining the TDR on nonaccrual.

On a workout arrangement, if the credit union fails to document its analysis of its TDR conclusion consistent with the above elements and GAAP, examiners should note in the exam report and discuss with management the concerns regarding the identification, documentation and reporting of TDRs.

Analyzing the two elements for a TDR determination -- financial difficulty and granting a concession -- requires a high degree of judgment. In reviewing the credit union's decisions, examiners will consider the following:[26]

- Credit union documentation and conclusions related to financial difficulty and concession determinations should draw from GAAP guidance. This letter includes summary information from GAAP literature but is not a substitute for a credit union's full understanding of GAAP.
- Assuming the member meets the "experiencing financial difficulty" criteria, then additional analysis is required to determine whether there is a concession. A restructured loan at a below-market rate would be indicative of a concession. But, a restructuring that results in only a delay in payment that is insignificant is not a concession.[27] On the latter point, GAAP provides that the following factors, when considered together, may indicate that a delay in payment is insignificant:
    a. <u>Amount</u>. The amount of the restructured payments subject to the delay is insignificant relative to the unpaid principal or collateral value of the debt and will result in an insignificant shortfall in the contractual amount due.
    b. <u>Timing</u>. The delay in timing of the restructured payment period is insignificant relative to any one of the following: (1) the frequency of payments due under the debt; (2) the debt's original contractual maturity; or (3) the debt's original expected duration.

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[26] Examination guidance in Letter to Credit Unions 10-CU-07, *Commercial Real Estate Loan Workouts* includes several examples of MBL TDR identification scenarios. The FASB also has several examples set forth in their Accounting Standards Codification, *available at* http://www.fasb.gov.

[27] To correlate the term "delay" as used in GAAP and the related terms used in the recent Board revisions in Appendix C to Part 741, a "delay" could encompass a "deferral", an "extension" or a combination of the two.

FASB has provided several examples in the Accounting Standards Codification (ASC) demonstrating delays in payments that are insignificant and therefore, not concessions. One FASB example is duplicated below:

> *"Residential Mortgage Debt—Temporary Payment Deferral*
>
> A debtor obtains a 30-year mortgage loan that requires monthly principal and interest payments. In year 4, the debtor experiences financial difficulties and misses two payments. On the basis of the debtor's financial hardship, the debtor and the creditor agree on a forbearance arrangement and repayment plan. Under the terms of the forbearance arrangement and repayment plan, the creditor agrees not to take any foreclosure action if the debtor increases its next four monthly payments such that each payment includes one fourth of the delinquent amount plus interest. The agreement does not result in the creditor charging the debtor interest on past due interest. At the end of the forbearance arrangement, the debtor will:
>
> a. Have repaid all past due amounts
> b. Be considered current in relation to the debt's original terms
> c. Have resumed making monthly payments set out under the debt's original terms.
>
> The restructuring results in a delay in payment that is insignificant. At the time of the forbearance arrangement, the creditor expects to collect all amounts due for the periods of delay. Furthermore, the length of delay resulting from the forbearance arrangement is considered insignificant in relation to the frequency of payments due, the debt's original contractual maturity, and the debt's original expected duration."
>
> *FASB ASC 310 Receivables -40 Troubled Debt Restructurings by Creditors-55 Implementation Guidance and Illustrations - 20-22 General*

Ultimately, the credit union is responsible for understanding the nuances of TDR identification and documentation of the financial difficulty and concession elements, as well as the overall TDR conclusion. Examiners may recommend the credit union consult with a qualified independent accountant to properly identify, document and report TDRs.

B. Charge-Offs

Appendix C to Part 741 indicates credit union's need to provide for timely recognition of losses. Therefore, examiners need to ensure credit unions have a reasonable written charge-off policy that is consistently applied.[28] Examiners should ensure the credit union has adjusted the historical loss factors when calculating ALLL needs for pooled loans to account for any loans with protracted charge-off timeframes (loans greater than 12 months past due), i.e., adjusting the pool loss rate upward for an internal qualitative and environment factor when the credit union inappropriately delays charge-offs.

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[28] See NCUA Letter to Credit Unions 03-CU-01, *Loan Charge-off Guidance* (January 2003), *available at* http://www.ncua.gov. Refer also to best practices outlined in the FFIEC's "Uniform Retail Credit Classification and Account Management Policy." *See* 65 Fed. Reg. 36903 (June 12, 2000).

10. Conclusion

Credit unions fulfill their mission by working with members experiencing financial difficulties. Granting concessions through formal loan restructuring enables members to better manage their debt and retain their homes and businesses. Oftentimes these arrangements qualify under GAAP for financial reporting as TDRs. TDR arrangements that improve the collectability of the loan are those that allow the borrower to make timely consecutive payments of contractual principal and interest under modified terms without relapse into past due status. The collectability of a loan improves if it results in the borrower's sustained repayment of the restructured credit over a reasonable term. Examination and supervisory actions guided by this letter are aimed at promoting safe and sound loan workout strategies.

Appendix 1 – References

1. Appendix C to 12 C.F.R. Part 741, Interpretative Ruling and Policy Statement on *Loan Workouts and Nonaccrual, and Regulatory Reporting of Troubled Debt Restructuring,* 77 Fed. Reg. 31993 (May 31, 2012), *available at* http://www.gpo.gov or http://www.ncua.gov.

2. FASB Accounting Standards Codification. Copyright FASB, *available at* http://www.fasb.org. Some relevant GAAP citations, although not an all-inclusive list, include:

TDR	ASC 310 Receivables- 40 Troubled Debt Restructuring by Creditors.
Impairment	ASC 310 Receivables-10 Overall - 35 Subsequent Measurement
Nonaccrual	ASC 605 Revenue Recognition -10 Overall-25 Recognition

3. Letter to Credit Unions 10-CU-07, *Commercial Real Estate Loan Workouts*, transmitting *Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts,* (June 2010), and Enclosure , *available at* http://www.ncua.gov.

4. Letter to Credit Unions 09-CU-19, *Evaluating Residential Real Estate Mortgage Loan Modification Programs*, (September 2009), *available at* http://www.ncua.gov.

5. FFIEC Call Report, Glossary, *available at* http://www.ffiec.gov.

6. FFIEC's "*Uniform Retail Credit Classification and Account Management Policy*". *See* 65 Fed. Reg. 36903 (June 12, 2000), *available at* http://www.gpo.gov or http://www.ffiec.gov.

7. IRPS 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions (May 2002), available a*t http://www.ncua.gov.

8. *2006 Interagency ALLL Policy Statement and FAQ transmitted by Accounting Bulletin 06-1 (December 2006), available a*t http://www.ncua.gov .

9. Charge-off Policy. Letter to Credit Unions No. 03-CU-01, *Loan Charge-off Guidance* (January 2003), and its Enclosure, *available a*t http://www.ncua.gov.

Appendix 2 – TDR Decision Flowchart