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To: Clients and Friends

From: David F. Dulock

Subject: NCUA Removes Capitalized Interest Prohibition for Loan Workouts and Modifications by Federally Insured Credit Unions

In the June 30, 2021 issue of the Federal Register (86 FR 34611), the National Credit Union Administration (NCUA) published a final rule amending 12 CFR Appendix B to Part 741 to remove the prohibition on the capitalization of interest in connection with loan workouts and modifications. The final rule also establishes documentation requirements to help ensure that the addition of unpaid interest to the principal balance of a mortgage loan does not hinder the borrower's ability to become current on the loan. The final rule is effective July 30, 2021, and the hyperlink address for the above Federal Register is: <https://www.govinfo.gov/app/details/FR-2021-06-30/context>.

This summary of the final rule is taken from the final rule's preamble:

- Appendix B, as amended by the final rule, continues to apply to all federally insured credit unions (FICU).
- Appendix B, as amended by the final rule, will apply to workouts of all types of member loans, including commercial and business loans.
 - The amendments to Appendix B made by the final rule apply only to loan modifications involving the capitalization of interest. The final rule does not address the capitalization of interest that may occur in other contexts.
 - The final rule adds definitions of "Capitalization of Interest" and "Commercial Loan" to the Glossary of Appendix B.
 - Appendix B, as amended by the final rule, continues to provide that a FICU may not, under any event, authorize additional advances to finance credit union fees and commissions. FICUs will be permitted to continue to make advances to cover third party fees to protect loan collateral, such as force-placed insurance or property taxes.
 - The final rule keeps several requirements that apply to all loan workout policies in Appendix B:
 - Appendix B establishes the expectation that loan workouts will consider and balance the best interests of the FICU and the borrower, including consumer financial protection measures.
 - A FICU's policy must ensure that a FICU make loan workout decisions based on a borrower's renewed willingness and ability to repay the loan.
 - If a FICU restructures a loan more frequently than once a year or twice in five years, examiners will have higher expectations for the documentation of the borrower's renewed willingness and ability to repay the loan.
 - Appendix B also sets forth several supervisory expectations relating to multiple restructurings:
 - Examiners will request validation documentation regarding collectability if a FICU engages in multiple restructurings of a loan.
 - A FICU must maintain sufficient documentation to demonstrate that the FICU's personnel communicated the new terms with the borrower, that the borrower

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agreed to pay the loan in full under the new terms and the borrower has the ability to repay the loan under the new terms.

- The above requirements and expectations, which currently apply to FICUs' loan workout policies, will apply equally under the final rule if a FICU adopts a practice of capitalizing interest in connection with loan workouts.

- A FICU's policy must establish limits on the number of modifications allowed for an individual loan.

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

- Compliance with all applicable federal and state consumer protection laws and regulations.

- Documentation that reflects a borrower's ability to repay, source(s) of repayment, and when appropriate, compliance with the FICU's valuation policies on modification approval.

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

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

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

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

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

- Appropriate safety and soundness safeguards to prevent the following:

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

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

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

- iv. Circumventing internal controls.

The above summary is not a complete description of the final rule, and readers of this memorandum are advised to review the entirety of the final rule by clicking on the Federal Register hyperlink <https://www.govinfo.gov/app/details/FR-2021-06-30/context>.

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