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National Association of Federally-Insured Credit Unions

September 1, 2020

The Honorable Rodney E. Hood, Chairman
The Honorable Todd M. Harper, Board Member
The Honorable J. Mark McWatters, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: Capitalization of Interest

Dear Chairman Hood and Board Members Harper and McWatters:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), we are writing to request the National Credit Union Administration (NCUA) act quickly to issue an interim final rule permitting credit unions to capitalize interest under Appendix B to Part 741. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve nearly 121 million consumers with personal and small business financial service products. Credit unions and their members continue to face the impacts of the COVID-19 pandemic and are anticipating many borrowers will need more relief in the coming months. The NCUA should act now to revise its current interpretation of Appendix B to Part 741 and issue an interim final rule to alleviate as many operational challenges for credit unions and potential confusion and hardship for borrowers.

Appendix B to Part 741 contains NCUA's Interpretive Rule and Policy Statement (IRPS) on Loan Workouts, Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans.[1] The flexibilities provided by the recent interagency guidance (issued by the NCUA, Federal Deposit Insurance Fund (FDIC), Office of the Comptroller of the Currency (OCC), and the Federal Reserve Board (collectively, "other banking agencies")) on loan modifications[2] combined with the authority granted to the NCUA to suspend Generally Accepted Accounting Principles (GAAP) with respect to loan modifications that would otherwise be categorized as troubled debt restructurings (TDRs)[3] has offered some relief for credit unions. Unfortunately, as credit union

[1] The IRPS describes the requirement to establish sound controls to ensure loan workout actions are appropriately structured. In relevant part, the text reads "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" (emphasis added). This "additional advances" language has been relied upon to prohibit the capitalization of interest.
[2] Interagency Statement on Loan Modifications and Reporting for Financial Institutions Working with Customers Affected by the Coronavirus (Mar. 22, 2020), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200322a1.pdf. This guidance was revised on April 7, 2020, available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200407a1.pdf.
[3] Coronavirus Aid, Relief, and Economic Security Act (CARES Act), S. 3548, 116th Cong. § 4013 (2020).

members continue to struggle with economic difficulties and are unable to resume normal payments on their loans, credit unions will likely see an increase in the number of loan modifications and TDRs.

The NCUA's current interpretation of Appendix B to Part 741 poses challenges for both borrowers and credit unions and makes it harder for credit unions to work prudently with their members who may not be able to meet their loan payment obligations due to the effects of COVID-19. Permitting credit unions to capitalize interest in a loan modification allows them to work with borrowers in a safe and sound manner and provide an option that will mitigate adverse effects on the borrower. The NCUA should reinterpret Appendix B to Part 741 to permit the capitalization of interest to align with GAAP, the practices of Fannie Mae and Freddie Mac, the government-sponsored enterprises (GSEs), and the other banking regulators. NAFCU urges the NCUA to issue this reinterpretation in an interim final rule to provide credit unions with immediate access to this option, eliminating unnecessary hardship and confusion for borrowers and additional challenges for credit unions.

The NCUA's Current Loan Modification Options are Unworkable

Currently, once the forbearance period ends, the credit union's options create scenarios that are not beneficial for the borrower or the institution. For example, a borrower may have already been many months delinquent or even in foreclosure when they submitted a completed CARES Act or similar hardship package requesting modification. That could amount to tens of thousands of dollars of past due payments and delinquent interest owed to the credit union. Under one option, the credit union may try to capture the deferred interest first as the borrower resumes making payments, which would create a similar effect as capitalizing interest by lowering the amount of principal balance reduction from these early payments, thereby creating a balloon payment at the end or extended maturity. This option would also likely result in negative loan amortization.

A second option is requiring the borrower to pay deferred interest up front or on a shortened term (such as over the course of 12, 24, or 36 months), which places additional payment burden on the borrower who is still recovering from a hardship, and adds operational burden on the credit union. Another option is to create a balloon payment at maturity, which the member may not be able to pay off without an additional modification, creating an unfavorable member experience and a similar dilemma. Because borrowers will not see the additional deferred interest amount on their regular monthly statements, they may be surprised to see it when they seek to pay off the loan, possibly creating additional difficulties in selling their home or clearing the title.

Yet another option is to extend the loan by roughly the number of payments deferred, which still produces additional interest paid by the member, while simultaneously creating additional operational burden and a long-term opportunity cost for the credit union on the outstanding interest. In addition, assuming the deferred interest is tracked and added to the payoff amount if the member pays off early, it will increase the total required payoff, resulting in the same type of unfavorable member experience and operational challenges as the balloon payment option. Alternatively, the credit union may forgive the interest, which not only creates a taxable event for the borrower but also impairs the credit union's capital levels.

The final option, which NCUA examiners often recommend, is to bifurcate the loan and create a separate non-interest-bearing loan for the deferred interest with the same term as the original or modified loan. This option creates a significant negative impact on the borrower and poses many operational complications for the credit union, ultimately making it unworkable. First, under this option, members and the credit union would now be required to keep track of two loans on the same property, for what was initially one loan, and members would need to make two separate payments. Additionally, members may not remember this process or the second loan balance when they seek to pay off their primary mortgage loan, creating an unfavorable experience and potential difficulties in selling a home or clearing the title.

As for additional impacts on the credit union, bifurcating the loan in this manner requires not only tracking two separate loans that were originally the same loan, but also (1) requires additional modification, TDR and reserve calculations and tracking; (2) poses credit reporting challenges; (3) creates payment posting challenges, for example, uncertainty as to how to post the payment if the borrower does not make a full payment or overpays; (4) requires payment tracking for both amounts; (5) requires additional Board reporting; (6) requires complex explanations to likely confused borrowers and (7) adds further complexities to the calculations of TDR impacts and metrics. A simpler solution would be to permit credit unions to capitalize the interest accrued during the forbearance period, adding it to the principal loan amount, and re-amortizing the loan once the borrower exits forbearance and resumes regular payments. The payment differential is generally going to be fairly small when amortized over the remaining life of the average mortgage loan.

Reinterpreting Appendix B to Part 741 Would Align with GAAP and the Requirements of Other Financial Regulators

The complicated outcomes described earlier in this letter are avoidable if the NCUA correctly interprets Appendix B. The NCUA has the authority to permit credit unions to capitalize interest on loan modifications by reinterpreting Appendix B of Part 741 to be consistent with GAAP as well as the GSEs and the other banking regulators. Many credit unions' loan systems are generally modeled to work based on GSE practices, which means they assume a re-amortization with capitalized interest. Re-amortizing a loan without capitalizing the interest, as NCUA examiners currently require, is operationally challenging on existing loan systems and generally requires the credit union to either use the loan bifurcation option described above or suspend the entire deferred interest until the ultimate pay off of the loan, both of which create many complications for the credit union and confusion for the borrower.

NAFCU proposes that Appendix B provide for the capitalization of interest and fees upon objective and persuasive evidence supporting the timing and collectability of future payments of the capitalized amounts. To ensure adequate consumer protections, credit unions would provide members with disclosures detailing the amount of capitalized interest and any associated fees. To ensure safety and soundness, credit unions would establish procedures for monitoring and controlling these loans. These consumer protections and safety and soundness considerations are in line with those required by the other banking regulators.[4] NAFCU urges the NCUA to establish parity with the other banking regulators as well as the practices of the GSEs by reconsidering its current approach and instead permit the capitalization of interest based on its reading of Appendix B to Part 741.

Conclusion

Thank you for your attention to this urgent matter and we look forward to discussing this with you in more detail. Credit unions and their members need a simpler solution to loan modifications that does not create confusion and additional hardship for the borrower and operational challenges for the credit union. NAFCU requests that the NCUA promptly issue an interim final rule to address this concern. If you have any questions, please do not hesitate to contact Ann Kossachev, NAFCU's Director of Regulatory Affairs, at akossachev@nafcu.org or (703) 842-2212.

Sincerely,

DM Schwartz

Debra Schwartz
NAFCU Board of Directors, Chair/Director-at-Large
President/CEO, Mission FCU

NAFCU's Regulatory Committee:

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Yvonne De La Rosa, Credit Human FCU
Tony Diaz, SchoolsFirst FCU
Dawn Donovan, Sunmark FCU
Gail Enda, American Airlines FCU
John Farmakides, Lafayette FCU

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[4] *See* Bank Accounting Advisory Series, Office of the Comptroller of the Currency, at 27 (Aug. 2020), available at https://www.occ.treas.gov/publications-and-resources/publications/banker-education/files/pub-bank-accounting-advisory-series.pdf. *See also* Guidelines for Capitalization of Interest on Loans, Comptroller of the Currency Administrator of National Banks, EC-229 (May 1, 1985), available at https://www.occ.gov/static/news-issuances/bulletins/pre-1994/examining-circulars/ec-1985-229.pdf

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