CUNA COMMENT CALL

Proposed Rule:
Capitalization of Interest in Connection with Loan Workouts and Modifications

NCUA is proposing to remove the prohibition on the capitalization of interest in connection with loan workouts and modifications. The agency has determined that the current prohibition on authorizing additional advances to finance unpaid interest (capitalization of interest) may be overly burdensome and, in some cases, hamper a credit union’s good-faith efforts to engage in loan workouts with borrowers facing difficulty because of the economic disruption caused by the pandemic. Advancing interest may avert the need for alternative actions that would be more harmful to borrowers.

The proposed rule would establish documentation requirements to help ensure that the addition of unpaid interest to the principal balance of a mortgage loan does not hinder the borrower’s ability to become current on the loan. The proposed change would apply to workouts of all types of member loans, including commercial and business loans. The proposal would also make several technical changes to Appendix B of Part 741 to improve clarity and update certain references.

Comments on the proposal are due to NCUA by 2/2/2021.

Background

In May 2012, NCUA adopted a rule requiring credit unions to have written policies that address loan workouts and nonaccrual practices. The rule specified in Appendix B to Part 741 that such policies must prohibit a credit union from capitalizing interest. Banks are not subject to the same prohibition on capitalizing interest (the banking agencies have not adopted an absolute standard equivalent to the rule adopted in May 2012). The banking agencies examine these practices for safety and soundness during the course of their supervision. As a result, credit unions have fewer options when working with their member borrowers, as compared to banks.

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

NCUA believes the current rule’s prohibition on the capitalization of interest limits a credit union’s options to implement a mutually beneficial solution that addresses the potential financial challenge of their members when the forbearance period ends. Thus, NCUA proposes to remove the prohibition on capitalization of interest from Appendix B, making it a permissible option indefinitely. The agency’s reconsideration was partially prompted by the economic impact of COVID-19 and related developments. Other considerations, such as parity with the treatment of interest capitalization by banks, have also factored in NCUA’s determination. Despite proposing this change, the agency underscores that Appendix B currently requires several safety and soundness and consumer protection-oriented measures that would also apply to this practice. Furthermore, capitalization of interest is not an appropriate solution in all cases and, as the Appendix currently provides, a credit union should consider and balance the best interests of the credit union and the borrower. In addition, NCUA proposes to add several consumer
protection and safety and soundness requirements to the Appendix for credit unions that capitalize interest in connection with loan workouts.

Summary of Proposed Rule

NCUA is proposing to amend a prescriptive requirement in its regulations by amending Appendix B of Part 741 to remove the prohibition on the capitalization of interest in connection with loan workouts and modifications. The proposed change would apply to workouts of all types of member loans, including commercial and business loans. The NCUA also notes that—consistent with the scope of Appendix B—the proposed change addresses the capitalization of interest in connection with loan modifications. The proposed rule, however, does not address the capitalization of interest that may occur in other contexts. NCUA notes that banks frequently include interest capitalization as one of several components in a loan restructuring to mutually benefit the lender and the borrower. NCUA expects that credit unions will follow suit, and provide borrowers with the option to capitalize interest along with other loan modification options, such as the lowering of loan payments or the interest rate, extending the maturity date, partial principal or interest forgiveness and other modifications.

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

The rule will continue to provide that a credit union may, in no event, authorize additional advances to finance credit union fees and commissions. Credit unions 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. NCUA believes that maintaining the prohibition on the capitalization of credit union fees is an important consumer protection feature of the rule for member borrowers.

NCUA is proposing to remove the prohibition on the capitalization of interest because, when used appropriately, capitalization of interest may be in the best interests of both a credit union and the borrower. The agency underscores that in proposing to remove this prohibition, it would maintain several requirements that apply to all loan workout policies in Appendix B. For example, the Appendix establishes the expectation that loan workouts will consider and balance the best interests of the credit union and the borrower, including consumer financial protection measures. Ensuring the best interest of the borrower prohibits predatory type lending practices such as including loan terms that result in negative amortization. In addition, a credit union’s policy must establish limits on the number of modifications allowed for an individual loan. Further, the policy must ensure that a credit union make loan workout decisions based on a borrower’s renewed willingness and ability to repay the 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 credit union’s loan modification policy permits capitalization of unpaid interest, the policy must require each of the following:

1) Compliance with all applicable consumer protection laws and regulations, such as the Equal Credit Opportunity Act, the Fair Housing Act, and the Truth In Lending Act.
2) Documentation that reflects a borrower’s ability to repay, a borrower’s source(s) of repayment, and when appropriate, compliance with the credit union’s valuation policies at the time the modification is approved.
3) Providing borrowers with documentation that is accurate, clear, and conspicuous and consistent with federal and state consumer protection laws.
4) Appropriate reporting of loan status for modified loans in accordance with applicable law and accounting practices. The credit union shall not report a modified loan as past due if the loan was current prior to modification and the borrower is complying with the terms of the modification.
5) Prudent policies and procedures to help borrowers resume affordable and sustainable repayments that are appropriately structured, while at the same time minimizing losses to the credit union. The prudent policies and procedures must consider:
i) Whether the loan modifications are well-designed, consistently applied, and provide a favorable outcome for borrowers.

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

6) Appropriate safety and soundness safeguards to prevent the following:
   i) Masking deteriorations in loan portfolio quality and understating charge-off levels;
   ii) Delaying loss recognition resulting in an understated allowance for loan and lease losses account or inaccurate loan valuations;
   iii) Overstating net income and net worth (regulatory capital) levels; and
   iv) Circumventing internal controls.

Request for Comment

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

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

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

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

5) In light of the fact that adding unpaid interest to the principal balance of a mortgage loan could potentially be detrimental to a member’s ability to become current on the loan, the NCUA is proposing to add a number of consumer protection guardrails to Appendix B (numbered 1-6 in section Summary of Proposed Rule above). Please share input on these guardrails. In addition, what other documentation, disclosure, or other consumer protection features, if any, should the NCUA require before permitting capitalization of interest as a loan modification tool? Are the consumer protections that apply to other types of loan modification sufficient to protect borrowers who receive interest capitalization or should the agency consider any other protections to counter any risks caused specifically by interest capitalization?

6) The proposed rule continues to provide that a credit union may, in no event, authorize additional advances to finance credit union fees and commissions. Should the agency authorize the capitalization of such fees and commissions at the final rule stage? Why or why not?