I. PURPOSE

Examiners will evaluate the credit union's risk management practices regarding loan workouts and/or Troubled Debt Restructurings (TDRs). The adequacy of policies, procedures, and controls will be reviewed to determine if proper risk assessment and due diligence was performed in implementing any loan workout program. Management infrastructure to identify, control, and manage any loan workout activity as well as the experience and training for individuals involved in this program will be evaluated. Documentation must be in place to verify the borrower's financial condition, collateral values for security pledged and proper lien perfection for that collateral. The effectiveness of loan collection procedures as well as proper accounting and reporting of workout loans and TDRs will be evaluated. All reporting guidelines, supervisory guidance and adherence to statutory, regulatory and internal rules, regulations and internal lending limits will be evaluated.

II. PRIMARY REFERENCES / REGULATIONS

1. Michigan Credit Union Act:
   a. Section 342(3)(i): Adopting policies
   b. Section 342(4)(g): Establishing internal controls
   c. Section 382: Fiscal year; accounting principles
   d. Section 386: Establishment and maintenance of reserves
   e. Section 421: Credit Committee
   f. Section 423: Loan conditions
2. Accounting Standards Codification (ASC):
   a. ASC 450-20: Loss Contingencies
   b. ASC 310-10: Receivables
   c. ASC 310-40: Troubled Debt Restructurings by Creditors
3. FASB Accounting Standards Update (ASU) 2011-02: Receivables: A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring
4. FFIEC Uniform Retail Credit Classification and Account Management Policy
5. Truth in Lending Act (Regulation Z)
6. 12 CFR 741 Appendix C: Interpretive Ruling and Policy Statement on Loan Workouts, Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans

7. NCUA Letter to Credit Unions 10-CU-07: Prudent Commercial Real Estate Loan Workouts

III. LOAN WORKOUT ARRANGEMENTS

Loan workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions. A renewal or restructuring should improve the lender's prospects for repayment of principal and interest and be consistent with sound lending, supervisory, and accounting practices. The key elements of a workout plan include:

1. Updated and comprehensive financial information on the borrower, business, and any guarantor.
2. Current valuations of the collateral supporting the loan and the workout plan.
3. Analysis and determination of appropriate loan structure (e.g., term and amortization schedule), curtailment, or covenant requirements.
4. Appropriate legal documentation for any changes to loan terms.

IV. CRITERIA OF TROUBLED DEBT RESTRUCTURING

1. A Troubled Debt Restructuring (TDR) is, as defined in GAAP, 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. The restructuring of a loan may include, but is not necessarily limited to:
   a. 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;
   b. 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
   c. A combination of the above.

2. 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.

V. IMPAIRMENT EVALUATION FOR TROUBLED DEBT RESTRUCTURINGS

All loans whose terms are modified in a TDR are subject to the provisions of ASC 310-40, including those exempt prior to restructuring. A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. For a loan that has been restructured in a troubled debt restructuring, the contractual terms of the loan agreement refer to the contractual terms specified by the **original** loan agreement, not the contractual terms specified by the restructuring agreement.

1. Measuring Impairments for TDRs

- **a.** When a loan is impaired, impairment is based on the difference between the present value of the future expected cash flows discounted at the original loan's effective interest rate and the recorded investment in the loan.
- **b.** As a practical expedient, ASC 310-40 allows the impairment to be measured by the loan's observable market price of the fair value of collateral, if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided <u>solely</u> by the underlying collateral.
- **c.** A loan may be considered collateral dependent because it is not performing under the provisions of the TDR agreement.
- **d.** A loan is not impaired during an insignificant period of delay in payment if the creditor expects to collect all amounts due including the accrued interest at the contractual interest rate for the period of delay (i.e., usual 3 month extension agreement).

2. Recognizing Impairment Losses

When the present value (or alternative measurement) of the loan is less than the recorded value, the credit union must:

- **a.** Create a valuation allowance with a corresponding charge to bad debt expense, or

b. Adjust an existing valuation allowance for the impaired loan with a corresponding charge or credit to bad-debt expense.
c. Reduce the ALLL as payments are made.
d. Increase or decrease the valuation account for subsequent changes to the impairment, but never below zero.

VI. MINIMUM PROCEDURES

1. **Review policy guidelines and restrictions for granting workout loans and TDRs.** The Board of Directors 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 the credit union's size and complexity, and must be in line with the broader risk mitigation strategies. The policy must:
   - **a.** 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.
   - **b.** Ensure loan workout decisions are 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 must have higher expectations for the documentation of the borrower's renewed willingness and ability to repay the loan.
   - **c.** Establish sound controls to ensure loan workouts are appropriately structured.
   - **d.** Provide that in no event may the credit union authorize additional advances to finance unpaid interest and credit union fees. The credit union may make advances to cover third-party fees, excluding credit union commissions, such as force-placed insurance or property taxes.
   - **e.** Establish requirements for placing loans in nonaccrual status. Interest may not be accrued on any loan upon which principal or interest has been in default for 90 days or more, unless the loan is both well secured and in the process of collection.
   - **f.** Establish standards for determining adequacy of collateral value (e.g., standard appraisal, automated valuation model, broker price opinion, etc.) and condition and acceptable LTV limits.

g. Establish procedures for identifying, tracking, and monitoring workout loans and TDRs. The policy should address the individual(s) or position(s) responsible for identifying, tracking, and monitoring these types of loans.

h. Establish guidelines and timelines for aggressive collections for workout loans and TDRs.

2. **Review processes and procedures for identifying, tracking and monitoring workout loans and TDRs.**

   a. Management must ensure 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 management, to provide for timely recognition of losses, and to permit review by examiners. The 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 Board of Directors to evaluate the effectiveness of the loan workout program, any implications to the institution's financial condition, and to make any compensating adjustments to the overall business strategy.

   b. 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 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.

3. **Ensure accurate regulatory reporting of workout loans, including TDR past due status**.

   a. 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.

b. Ensure TDRs are accurately reported on the Call Report as required by the Call Report instructions.

4. **Review policies and procedures for placing loans in nonaccrual status.** Management 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.
   a. Interest may not be accrued 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, 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 the process of collection* test for nonaccrual status listed above, the date on which a loan reaches nonaccrual status is determined by its contractual terms.
   b. Placing a loan in nonaccrual status does not change the loan agreement or the obligations between the borrower and the credit union.
   c. 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 to any loan placed in nonaccrual status must be handled in accordance with GAAP.
   d. 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.
   e. A nonaccrual loan (except for a member business loan) may be restored to accrual status when:
      i. 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

management is assured of repayment of the remaining contractual principal and interest within a reasonable period;

- **ii.** When it otherwise becomes both *well secured* and *in the process of collection;* or
- **iii.** The asset is a purchased impaired loan and it meets the criteria under GAAP for accrual of income under the interest method specified therein.
- **iv.** 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.

f. 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.

- **i.** 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.
- **ii.** A sustained period of repayment performance would be a minimum of six consecutive payments and would involve timely payments under the restructured loan's terms of principal and interest in cash or cash equivalents.
- **iii.** In returning the member business workout loan to accrual status, sustained historical repayment performance for a reasonable time prior to the restructuring may be considered. 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.

5. **Review workout loans (sample, if appropriate).**
   a. Determine whether the workout loans comply with the policy guidelines and regulatory requirements.
   b. Assess the level of credit risk apparent in the workout loans.
   c. Determine whether any of the workout loans meet the criteria of TDRs.
   d. Determine whether the credit union has properly reserved for probable losses for workout loans.
   e. If appropriate, classify workout loans as substandard, doubtful, or loss on the Asset Risk Classification page of the examination report.

6. **Review TDRs (sample, if appropriate).**
   a. Determine whether the TDRs comply with the policy guidelines and regulatory requirements.
   b. Assess the level of credit risk apparent in the TDRs.
   c. Assess the accuracy of TDR impairments.
   d. If appropriate, classify TDRs as substandard, doubtful, or loss on the Asset Risk Classification page of the examination report.