Loan Workouts, Loan Nonaccrual and Regulatory Reporting of Troubled Debt Restructuring

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Lisa Dolin: Good afternoon. Welcome to today's NCUA's webcast for credit unions on Loan Workouts, Loan Nonaccrual Policy and Regulatory Reporting of Troubled Debt Restructuring. My name is Lisa Dolin and I am a program officer with the National Credit Union Administration's Office of Examination and Insurance.

Today we plan to review the NCUA Board's finalized revisions to Part 741 of NCUA Rules and Regulations, including the addition of Appendix C to Part 741, which is an interpretive ruling and policy statement or an IRPS on loan workout and nonaccrual policy and regulatory reporting of troubled debt restructurings.

Through the rulemaking, the Board sought to enhance its oversight over loan workout arrangements. Shortly E&I will be issuing a Supervisory Letter to examiner staff advancing a uniform and consistent national examination approach to review loan workouts and nonaccrual, and reporting of TDR loans. That letter is the subject of today's webcast.

This afternoon we're pleased to have with us representatives of the auditing firm Crowe Horwath as well as NCUA staff to share in a panel discussion of the examination implementation of the new IRPS policy. With me today are representatives of Crowe Horwath, Sydney Garmong and Mark Taylor, both of whom are partners with Crowe. Good afternoon, Sydney and Mark.

Mark Taylor: Good afternoon.

Sydney Garmong: Good afternoon.

Lisa Dolin: We have both Sydney and Mark's bios posted for you to download so you can learn a little bit more about them. We also have Jeff Marshall, a specialized lending subject matter expert from NCUA's Region III.

Jeff Marshall: Hello.

Lisa Dolin: And Karen Kelbly, NCUA's Chief Accountant.

Karen Kelbly: Welcome to today's webinar.

Lisa Dolin: I do have a few administrative announcements related to the functionality of the webcast that I'd like to cover. First, please ensure that the volume on your computer is turned up so that you can clearly hear the webcast. Second, please allow pop-ups from the website. You may need to turn off your pop-up blocker. Third, set your screen resolution to 1024 x 768 or higher so that you can see the slides appropriately. Fourth, if you have a question you can actually submit it at any time in the Submit Question box which you should see on the lower left-

hand area of the console window. We will address questions throughout the webcast and also at the end, time permitting. Finally, when you click the Download Slides button on the webinar console, you should see a list of items available for download. You can download today's presentation slides, the federal register version of the IRPS, as well as several other resources from Crowe including Sydney and Mark's bios.

As we've done in the past, the webcast will be archived for on-demand viewing within about a week, two weeks from the live event. A media advisory will be issued when the archive is available for you to view and the archive will have the same URL as the live event. Welcome to everyone and thank you for participating. And with that, let's begin today's subject matter.

Again, the format will be a panel discussion. I will moderate the panel and coordinate the discussion. I will provide each panel member with the opportunity to address relevant topics, whether regulatory policy, exam implementation, GAAP requirements, and/or audit practices. So let's begin, Karen, with you. Why is NCUA offering this webcast today and why is NCUA issuing a Supervisory Letter on the subject?

Karen Kelbly: Thank you, Lisa. As Lisa said, in the near term the NCUA will be publishing a Supervisory Letter on loan workouts, nonaccrual policy and regulatory reporting of troubled debt restructured loans, which we'll call TDRs. Although the Supervisory Letter -- through the letter we outline changes that the NCUA Board adopted at its May 2012 meeting regarding reporting and regulatory requirements for loan workouts, loan nonaccruals and TDRs. The letter will set out a uniform examination approach for NCUA examiners and it will clarify various provisions of the new reporting and regulatory requirements. We will expect NCUA examiners to use this guidance when reviewing loan workouts, loan nonaccruals and reporting of TDRs during examine and insurance review contacts.

The letter will focus also on some key related accounting issues but it doesn't address all of general accepted accounting principles, or GAAP, relevant to loan workout arrangements. Credit unions are reminded that if they are $10 million or more in assets they must follow GAAP in the reports they file with the NCUA Board according to the Federal Credit Union Act. But through this letter we do not intend to supersede or replace GAAP in any way. Examiners are always encouraged when they have questions about the proper GAAP accounting -- that they should be encouraging credit unions to consult with independent licensed accountants.

Lisa Dolin: So, Karen, why did NCUA change the reporting and regulatory requirements for loan workouts, nonaccruals and TDRs?

Karen Kelbly: 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 it also helps 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 decreased numbers of loan workouts for distressed borrowers. NCUA's prior reporting and supervisory requirements created practical challenges for credit unions and this inhibited them from working prudently with their borrowers.

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 balanced flexibility with appropriate safety and soundness safeguards. Specifically, some potential safety and soundness concerns with this activity include masking of deteriorations in loan portfolio quality, delays in lost recognition, overstatements of net worth or circumventions of sound internal control. The new reporting and regulatory requirements also improve consistency of reporting with other depository financial institutions.

Lisa Dolin: So can you give us an overview? What did the Board's recent amendment to Part 741 of the Rules and Regulations with that addition Appendix C the IRPS change for credit unions in relation to loan workouts?

Karen Kelbly: The NCUA Board revised Section 741.3(b)(2) of the NCUA Rules and Regulations and added an Appendix C to Part 741. Section 741.3(b)(2) applies to all federally insured credit unions and was revised to specify that the credit unions 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 IRPS incorporated into Appendix C of Part 741 has the force and affect of regulation and elaborates on the new elements added to Section 741.3(b)(2).

Appendix C addresses the following requirements which become effective on October 1, 2012, with the exception of the modified regulatory reporting.

- It requires a written policy for loan workouts.
- It specifies management and internal control for loan workouts.
- It modifies the regulatory reporting of workout loans including TDRs. This provision alters how delinquent loans are reported on the call report starting with the June 2012 cycle. It also focuses future data collection on loans that meet the definition of TDR under GAAP starting again with the call report cycle ending December 31, 2012.
- The IRPS standardizes loan nonaccrual requirements and return to accrual requirements including the treatment of MBL workout loans.

Lisa Dolin: Given that background, what will the examiners be focusing on in their examinations in relation to credit union loan workout arrangements? Jeff, do you want to take that one?

Jeff Marshall: Sure, Lisa. The examiners' responsibility is to assess the effectiveness of the loan workout program. An effective program improves loan collectability without delaying loss recognition or masking deteriorating loan quality. Examiners are responsible for ensuring credit unions comply with Section 741.3(b)(2) and Appendix C of Part 741 of NCUA Rules and Regulations. The depth of the examiners review will depend on the unique fact pattern of each credit union and level of risk posed by the program. The examination process is risk-focused and therefore not a one-size-fits-all review.

If initial analytical testing reveals limited exposure then the examiner should limit their scope 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 the examiner will expand the review to include a more comprehensive analysis, including transactional testing.

Additionally, as part of the examination process examiners will determine the credit unions compliance with the loan nonaccrual standards specified in Appendix C. Mark and Sydney will address this area later.

Lisa Dolin: Given that background, we want to talk about the examiners review of a credit union's loan workout program in greater detail, but let's drill down a little bit more into the IRPS requirements. The Board and senior management in NCUA decided to focus the examination approach and call report data collections more narrowly on the population of loan workouts that meet the definition of a troubled debt restructuring or TDR. Even so, the IRPS and Supervisory Letter use two terms throughout, workout and TDR. So, Karen, what is encompassed in the term loan workout?

Karen Kelbly: So if you go to your resources tab I think the second resource that you could download is the Federal Register posting of the Board's final rule, and that's a good resource that you might want to refer to as we're talking through the IRPS. If you go to the very last page of the IRPS there is a glossary and we very specifically defined the terms that we used in the IRPS, and so we wanted to focus here on loan workout and TDR.

So by loan workout we mean that it's a loan to a borrower in financial difficulty that has been formerly restructured so it could be reasonably assured of repayment and of performance according to its restructured term. And then we list some activities that would be loan workout activities, re-aging, extension, deferral, renewal or rewrite and each of those terms is also defined in a footnote to the glossary on loan workouts. So I won't walk through each of the definitions for those terms, but throughout the IRPS and the Supervisory Letter when we use these terms we are using them as defined in the glossary of the IRPS.

Lisa Dolin: So the next logical question is what is encompassed in the term TDR? Since Crowe Horwath previously presented a TDR webinar for NCUA to the credit union industry in January of 2011, we've invited them back and we're going to ask them to give us a brief high level summary of some of the key points they shared with us previously regarding TDRs as a reference point to anchor today's discussions. So, Sydney, can you review for us what is a TDR, how do we know a TDR when we see it, and can you explain some of the GAAP concepts around TDRs?

Sydney Garmong: Sure, Lisa. I'm happy to do that. First of all, I think the first question we need to ask ourselves is why is it important to identify when a workout is indeed a TDR? Well, it's important to make that determination because in these cases what's happened is the credit union has given up something and that is an accounting event which needs to be recognized. Now, as such a TDR is deemed to be an impaired loan and as we know there is an accounting result as -- the result is in accounting and accounting entry needs to be made. The TDR

accounting is covered in the FASB's Accounting Standards Codification for which I'm still not used to using codification terms, but in the codification it's at 310-40.

So how do you know when a workout is a TDR? Well, two conditions have to be met. First of all, the borrower or the member in this case is experiencing financial difficulty, and then secondly the credit union grants a concession that it otherwise would not consider except for the member's financial difficulties. Now, that seems pretty easy on the surface, right, just two simple criteria. But as we're going to cover later on, making that determination is actually a little tricky and what the FASB was trying to do is provide additional guidance on those two points.

Now, Lisa had referred to the webcast that was done in January of 2011 and at the time FASB was in process of issuing these clarifications. In February 2011 the FASB did issue clarifications in the form of accounting standards update or ASU 2011-2. The concept of TDRs has been in GAAP for decades but with the downturn that was occurring there were many questions that arose because people frankly had not dealt with it for a number of years. When the FASB did issue these clarifications they made the effective date effective for most credit unions January 1 of this year, so 2012. We're going to circle back and cover those clarifications a bit later, but at a very high level that's why making a determination on what a TDR is that's why it's important.

Lisa Dolin: Thank you, Sydney. So with that TDR review fresh in our minds, we're going to move forward discussing several topics discussed both in the IRPS and the Supervisory Letter describing the examination approach examiners will follow in reviewing that requirement. So let's start with the examiner’s evaluation of the credit union's written loan workout policies. Jeff, what's required there?

Jeff Marshall: The revised regulation outlines several elements that must be addressed in a credit union's loan workout policy. The next few slides elaborate on these required elements and what the examiner’s focus will be. Policy parameters should be reasonable based on the risk profile of the institution.

First, the policy should be commensurate with the 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, and volume of loan workout activity permitted.

Further, workout policies must be commensurate with the credit union's net worth, that is the ability to absorb risk 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.

The policy must define borrower eligibility requirements, that is 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. The policy should outline the types of loans that will be included in the workout program, how collateral is evaluated and will there be provisions for

requesting additional collateral. Does the borrower need to be delinquent on their loan for the credit union to consider a workout arrangement? If so, how delinquent? Is demonstration of a financial hardship sufficient for considering a loan workout? If so, what documentation will be considered acceptable for demonstrating the hardship? How will income be verified? Are there debt ratio limits or debt service coverage ratio limits in the case of member business loans? Will loans be considered for multiple restructures? If so, what must the borrower document?

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. Although some level of re-default is unavoidable, examiners should possess a healthy skepticism about workout strategies that relapse into past due status in nonaccrual. Examiners will review representative samples 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 statistical reports.

Another required element of the IRPS is that the credit union makes loan workout decisions based on the borrower's renewed willingness and ability to repay the loan. 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 the willingness to pay the debt supported by a signed agreement. Further, the ability to repay the debt is crucial and should be demonstrated as outlined in the loan workout policy.

This element is also addressed in NCUA Letter to Credit Unions 09-CU-19, titled Evaluating Residential Real Estate Mortgage Loan Modification Programs, and in letter number 10-CU-07, titled Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts. I also want to point out that Letter 09-CU-19 addresses the need to test for the financial impact of the workout. Once the credit union establishes the modification terms they should compare the cost of the concessions to the borrower with the estimated cost of repossession or foreclosure. This test supports the decision to move forward with a proposed workout.

The policy must establish sound controls to ensure loan workout actions are appropriately structured. This includes establishing authority levels and segregation of duties over the various types of workouts. In addition, the policy must specify volume thresholds relative to net worth 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. Unpaid interest and fees must be reversed or charged off when a loan becomes 90 days or more past due and may only be recognized when collected in cash. Examiners will assess internal controls and the adequacy of the enhanced reporting during the examination. Again, credit unions should refer to NCUA Letters 09-CU-19 and 10-CU-07 for additional guidance regarding sound controls.

Lisa Dolin: Thanks, Jeff. We're going to stay with you for this next question. What should the examiner be looking for with regard to credit union management information systems and the monitoring of loan workouts?

Jeff Marshall: 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. A sound system will also provide for consistent application of credit union policy and accurate financial reporting. As such, the lending functions should have ongoing communication with the financial reporting functions.

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. Examiners review the management information systems to ensure the credit union has the ability to appropriately identify and document loan workouts. 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 is working as expected or if adjustments to program parameters are warranted. The frequency of this type of reporting should be commensurate with the volume of loan workouts granted, as well as the risk exposure the workout program presents to the credit union's net worth.

Lisa Dolin: So let's pause here a minute and talk with Mark from Crowe. So, Mark, wouldn't an independent accountant conducting the financial statement audit of a credit union also be reviewing loan workout systems and what would the independent accountant conducting that audit be focusing on? Is there information that you could share with the examiner if he or she contacted you and would the independent account's approach be different if it was an agreed upon procedures engagement rather than a true financial statement audit?

Mark Taylor: Let me take the last question first. The agreed upon procedures engagement is exactly that, it's what the Supervisory Committee and the CPA firm agree to be done. So if this was an area that the Supervisory Committee was concerned about some of the procedures on these next few slides they might want to consider putting in the agreed upon procedures engagement. For an audit and in the current economic environment, the valuation of loan collectability with the ALLL and reporting of impaired loans, including TDRs, are certainly significant risks in many credit unions. And I think the auditor always has the concern -- we hear the term extend and pretend, and so the auditor always has concerns about delays in lost recognition or inappropriate income recognition.

The other thing before I talk about some of these steps, certainly in each audit there is a materiality level that the auditor uses. And so depending upon the volume of loan workouts and the materiality of them some of these procedures may be done, sometimes maybe they're all done, sometimes very few may be done. And I think these typical audit steps, not only are ones that external auditors consider, but also internal auditors at credit unions may also consider be doing these types of things or certainly want to think about them.

So on Slide 16, I won't go through each of these but a couple that are really important, I think the first bullet there understanding the types of loan workout programs a credit union offers. Some have very formal programs, some have informal ones. One of the things that the IRPS does

mention, a number of credit unions have skip-a-payment programs and those really aren't targeted for loan workouts those are generally offered to any member or borrow retention programs where maybe they're getting a lower rate because the environment has changed so dramatically.

So we're really focused on loan workouts and understanding how the credit union documents those and how they identify them so that you have the population to start with is important. Generally we find that that documentation comes from either all three sources or one of three, the lending area, the collections area, and the accounting folks and generally all three are involved.

We obtain a listing of loan workouts identified as TDRs, the key there is to test both a sample of what's on that list, does it make sense that it is a TDR, and maybe more importantly test a sample of modifications that were made that aren't classified as TDRs to see if they would meet the rule.

On Slide 17, again here the focus is testing the completeness of TDRs, and again I won't go through all the steps but some of them here -- the first one there comparison to regulatory report, so at the end of this calendar year credit unions will be reporting just TDRs on the call report. And so the auditor, whether it's internal audit or external auditor may want to compare that listing to the listing that they're testing and utilizing.

Another thing that we found very helpful is reviewing file maintenance changes, whether it's looking at due date modifications or interest rate changes and seeing if those are potentially changed because they are a workout that maybe has not been readily identified. And the other one I'd mention on this slide, comparing past due reports to loan renewal reports. In particular, if you find from one past due report a loan comes off and you see a loan renewal of that loan that's something that you may want to look at.

On Slide 18 the couple steps here, I know the IRPS talks a lot about evaluating subsequent performance of workout loans, and again I think whether you're external auditor or internal auditor you would want to have an understanding of how they have subsequently performed. Certainly I think in these situations is that unexpected to have some defaults, but I think if that is a high rate of defaults there may be some concern about the extend and pretend and whether or not the program is working and that's something I think both examiners and auditors would want to address.

And then the final bullet there, as we all know TDRs are impaired loans and so from an auditor's standpoint taking a look at now that it has moved from the FAS 5 the general reserve to the FAS 114 specific reserve making sure that that reserve is appropriate for that loan, whether it's based on expected cash flows or based on collateral values less estimate cost to sell.

The other thing, just to mention both I think for examiners and credit union management, I think it is important if this is an area that's of substance to the credit union talking with your external auditor, talking with your internal auditor to the extent they're doing testing to make sure that your systems and processes are working as you had intended. I would mention for examiners contacting the CPA firm, we always welcome that from our standpoint because of client

confidentiality we always seek a written authorization from the client prior to responding to the examiner, but I have not had any clients tell me that I couldn't respond.

And I think understanding the scope of work that the external auditor or internal auditor has done might help the examiner. I think the internal auditor understanding what the external auditor has done might help them in adjusting their scopes, whether it's doing less coverage because they feel it's been covered pretty well or whether it needs to be more coverage based on the facts and circumstances. And then the last item I would mention is looking at the management letter and the listing of posted or waived audit adjustments. You may see some constructive criticisms related to TDRs and workouts there that would be helpful for both examiners and management to address.

Lisa Dolin: Thank you, Mark. Karen, Mark mentioned the Call Report. Can you tell us what did the IRPS change about the information that will be collected on the Call Report?

Karen Kelbly: Sure, Lisa. Appendix C of Part 741 requires credit unions to calculate a past due status of all loans consistent with the loan contract terms, and this includes amendments through the formal restructure, but the credit union no longer is required to report delinquency for six months after amending a loan based on a prior contract term. This provision therefore changes how delinquent loans are reported on the Call Report and that change was effective starting with the June 2012 cycle.

The NCUA Board also indicated in Appendix C that NCUA's future Call Report data collection would be focused 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, and this change will go into effect for the quarter ending December 31, 2012.

The upcoming revisions to the Call Report will allow NCUA to focus on the subset of loan workouts that are most important to the safety and soundness, those that would require reporting under GAAP as TDRs. It would also provide data to aid in determining that nonaccruals align with reported past due status and it also would allow us to 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 Report, and during examinations examiners will review the credit union's processes for reporting TDR activity consistent with the revised Call Report instructions.

Lisa Dolin: Thanks, Karen. Okay, Mark, we're going back to you. Are there disclosures in the financial statement audit footnotes that may provide insightful information to readers of the credit union's financial statements, including examiners?

Mark Taylor: Yes, there is. Starting with calendar year-end 2011 audits there's a significant amount of TDR disclosures now in the footnotes to the audited financial statements. On the next couple of slides we've got some of the required disclosures. I'll just touch upon a couple of them. The first one I'd mention is TDRs that occurred during the period there would be required disclosures for those particular ones. What you would see is a discussion of the types of

modifications that were made in what we often see are reduction in interest rate, maybe a period of time where there's an interest only payment or an actual deferral of some payments, and at times you might even see a partial charge-off and so the disclosures show the pre-modified balance and the post modified balance.

In addition, there's a required disclosure for those TDRs that were restructured within the last 12 months that then have a payment default. And so that's good information if you're trying to understand how subsequent performance of TDRs are occurring you would have for that year those that did go in default, so that's useful information.

On Slide 23 some other additional disclosures. As of the balance sheet date there's a documentation of those loans that are impaired by class and those that have a related allowance, as well as those that do not have any allowance tied to them, so that information is in there. In addition, there's a requirement for disclosing the policy for recognizing interest income on impaired loans, which is useful information for readers of the financial statement.

And then finally on Slide 24 additional information that is disclosed, for each income statement period presented beginning with 2011you would have the average balance during the year of impaired loans. You would have the interest income recognized during that year for each impaired loan and the case basis interest income actually received, which that information will be useful particularly when we get later in the discussion about nonaccruals and understanding when interest income is being recognized on these workout loans.

Lisa Dolin: Thanks, Mark. We're going to move to a new topic area now. We'll talk a little bit about the IRPS requirements for placing loans on nonaccrual. So, Karen, can you tell us what the IRPS policy requires?

Karen Kelbly: So I encourage participants to again refer to the resource handout, the Federal Register publication of the final rule, and if you go to Page 32003 of that handout we have two tables that I think it would be helpful for us to refer to during this segment of the webinar. So Table 1 concerns nonaccrual criteria and basically the IRPS requires that when a loan -- for any loan, all types of loans -- if it's 90 days or more past due it must be placed in nonaccrual unless the loan is both well secured and in the process of collection and those terms are defined in the Glossary to the IRPS that I referred to before, so that's at the very back of the IRPS.

Then you also must maintain the loan in nonaccrual if it has to be maintained on the Cash or Cost Recovery basis under GAAP because there's a deterioration in the financial condition of the borrower or for which payment in full of principal or interest is not expected. And we'll be fortunate later in the webinar to have Sydney walk you through what GAAP requires in the area of Cash and Cost Recovery to help you become a little bit more comfortable with that.

Lisa Dolin: So to ensure we understand the meaning of these terms, Sydney can you give us some background on what the terms accrual and nonaccrual mean?

Sydney Garmong: Sure, Lisa, and I think that's a good idea to level set. If you think about the difference between accrual and nonaccrual I think there's maybe a couple different ways to think

about it. A loan that is placed on nonaccrual is one where we simply stopped accruing interest so there is no credit that's going to interest income. Another way I like to think about it is the difference between accrual and nonaccrual it's almost like a water faucet and so what you've chosen to do is turn off the water faucet you're just not going to accrue any more income.

And also I think it's important to remember that there is a difference between the concept of nonaccrual -- we have to remember is a financial reporting concept. This has nothing to do with the contractual amount per se. The member still owes the contractual interest but for financial reporting purposes we've decided because there are concerns about collectability that we're going to cease accruing income. So in other words, just because the income is ceased to have been recognized for financial statement purposes does not mean the credit union isn't still owed contractually those amounts.

Lisa Dolin: So are accrual and nonaccrual concepts set forth in GAAP?

Sydney Garmong: It is important to note that US GAAP does acknowledge the use of nonaccrual but it does not provide guidance on when to place a loan on nonaccrual. All throughout GAAP you'll find plenty of references to nonaccrual and so it is certainly a notion that is very widespread throughout GAAP, in fact it's addressed specifically in loan accounting and debt security accounting, and we've listed those here on the slides.

As an interesting side note, those of you that have been following the FASBs project on financial instruments, the FASB actually is going to -- as part of that project they've tentatively decided to provide specific guidance on what is nonaccrual. And basically it's consistent with what industry practices today and that is when you don't think you're going -- it's not probably that you're going to receive full payment of principal or interest. So that's kind of the foundation, but again I think it's important to understand that GAAP does refer to this notion. Now, I think there is guidance in revenue recognition section of GAAP and after all interest income is revenue so these concepts are helpful. Now, in this guidance there's two underpinnings as to whether revenue, this case interest income, is realizable and earned. So those are really the two key concepts.

So I realize on this next slide there's an awful lot of words here and I think what's very important is to focus on the very end of the paragraph. Now, given that there's little doubt that the interest income is earned, the more important piece to focus on, at least in my opinion, is whether the amounts are realizable. And as you can read here that last part of the sentence, revenue is realizable when assets are readily convertible to cash. Now, I realize that that doesn't exactly neatly fit in with the terminology that we're used to using, but the bottom line is what this is really trying to communicate is, is there doubt on whether the member can indeed pay. And then you have to question okay, well if we're not going to get cash in the door are the amounts realizable or not? So the first piece, again, realizability I think is far more important, but let me cover briefly the second piece.

The other piece to consider is whether or not revenue is earned. Now, to me given that we're talking about a financial instrument, a loan, and interest is earned with simply the passage of time I think there is very little doubt that this is earned. So again, I think the far more important piece to focus on is whether it's realizable, are we going to get our cash or not?

Lisa Dolin: Thank you, Sydney. We'll come back to how payments are applied during a period of nonaccrual, but for now let's move to the IRPS requirements for restoring loans that were previously placed in nonaccrual back to accrual status. Karen, can you tell us what the IRPS policy requires there?

Karen Kelbly: So again, if we would refer back to our Federal Register publication of the final IRPS and again to Page 32003 and now we're moving from Table 1 where we placed the loan on nonaccrual to Table 2 where we're talking about the requirements to restore it to accrual. And so we say that when the loan is past due less than 90 days or GAAP does not require it to be maintained on the Cash or Cost Recovery basis any longer and when the credit union is plausibly assured of repayment of the remaining contractual principal and interest within a reasonable period, you could return all loans, consumer and MBLs except for member business loan workouts, back to accrual. And again, you're looking for loans to be on accrual if they're both well secured and in the process of collection, and again those terms are defined in the Glossary.

Now, there are special requirements, additional requirements for member workout loans. For member business workout loans we're really looking for good documentation of the credit evaluation of the borrower's financial condition and an assessment of their prospects for repayment under the revised terms before we return those loans to accrual. And part of that evaluation for member business loan workout has to be the receipt of six consecutive timely payments of principal to interest in accordance with revised terms. So we're looking for two things, the current well documented credit evaluation of the borrower's financial condition and as part of that some period of demonstrated repayment performance which we're defining as six consecutive timely payments of principal and interest according to revised term.

Lisa Dolin: So, Mark, is the demonstrated period of payment performance set forth in the IRPS grounded in GAAP?

Mark Taylor: Yes, Lisa. The financial institution regulators, including NCUA, have focused on the notion of consecutive payment performance for returning loans to accrual status and I think we most often see six consecutive payments as sited in regulatory guidance. And this notion of payment performance is supported in the ASC 310-10-35-4, and the slide here talks about loans to financially troubled countries. So the citation is focused on loans to financially troubled countries but by analogy is being applied to all types of loans and the idea of payment performance comes through that analogy. And I would say often in GAAP not every fact and circumstance can be covered within the codification so it's quite often that auditors and other interpreters of GAAP would look at examples by analogy.

Lisa Dolin: Thanks, Mark. The IRPS prohibits the reversal of interest payments applied to reduce the recorded investment during a period of nonaccrual and likewise the IRPS prohibits the restoration of accrued but reversed or charged off interest at the point the loan was placed in nonaccrual from being recognized as income unless collected in cash from the member. Okay, that's a mouthful, Mark. Can you walk us through an example?

Mark Taylor: Sure. I would point out that often auditors and financial statement preparers look at regulatory guidance and other resources for industry practice and some of the Q&As that are in the slides here have been developed by some of the other financial institution regulators in the areas of TDRs, and they also have ones one nonaccrual loans that's good information for both the financial statement preparer and the auditor.

So in this first example here related to interest payment reversals the loan is placed on nonaccrual status and the credit union reversed previously accrued and unpaid interest because of doubt about collectability, certain interest payments were applied to reduce principal. Later we'll talk about that would be the Cost Recovery method. Although the loan is not yet contractually current, the credit union now expects full payment of contractual principal and interest.

So the question is can the application of interest payments to principal be reversed? And the response would be "no" and the thought process there is that when a loan is in doubt about collectability and you're applying the Cost Recovery method it's not appropriate to reverse those payments that were applied to principal later to interest income. In this situation previously foregone interest would be recognized as interest income is received and this concept is directly cited in the IRPS. And if the loan did eventually return to accrual status that interest income would be recognized on the effective yield to the maturity of the loan and so in essence what you're doing is accreting that additional amount of interest over the remaining term of the loan.

Lisa Dolin: I think it would also be helpful to walk through a return to accrual example. We have two examples in the presentation but in the interest of time we'd like to move to the second example. Participants listening online can review the first example later on your own if you'd like. Mark, could you please help us see a practical implementation of the return to accrual policy through this second example?

Mark Taylor: Yes. So here the question is the loan is currently on nonaccrual status as a result of being delinquent in principal and interest payments for a period exceeding 90 days. The estimated uncollectable portion of the loan has been charged off. The remaining balance is expected to be collected. Because the recorded balance of the loan is expected to be collected in full, may it be returned to accrual status? And the answer, as we can see on this slide, is "no" because full payment of contractual interest and principal is not expected therefore accrual of interest on the loan would not be appropriate.

Now, you could do a tweak to this and there's a concept known as an A/B note structure that this scenario might be appropriate for. In such a structure the original note would be converted into two notes. The A note would be at a market rate of interest with typical underwriting terms related to LTV, amortization period, debt service coverage so it would be a normal underwritten loan. The B note may be at below market rate of interest and have other non-typical terms, such as interest only. Generally in these instances the B note is charged off for reporting purposes and at that time it may be -- once you have six consecutive payments on the A note it might be able to be returned to accrual status because it would then be a loan that full repayment of principal and interest is expected.

Lisa Dolin: Thank you, Mark. What sort of audit testing would an independent accountant perform around accrual and nonaccrual practices?

Mark Taylor: The items on this slide are typical audit steps that the external auditor or an internal auditor may perform, and I would say particularly in the environment we've been in the last few years I think you've seen them quite often. The first step there is the delinquent loans properly included or excluded from the nonaccrual listing. Obviously there's a bright line of 90 days with some possible exceptions if it's well secured and in process of collection. Obviously making sure that the reversal of previously recorded income in the accrued interest field is reversed is important. And then the third bullet there, testing the accuracy of system generated reports for both delinquency and nonaccrual, is critical. And there's a few different ways that one can approach this.

From a manual standpoint you can take a look at payment histories and see whether or not it's over 90 days past due and so forth. This is also an area where either the external auditor or internal auditor might consider the use of computer assisted audit testing to increase the audit coverage. So examples might include computing the number of days in accrued interest for each loan to determine if the number of days is excessive and the loan is not being reported as nonaccrual, or another one would be looking at last payment date to make sure that that loan is properly reflected in the delinquent loan report.

Lisa Dolin: So in summarizing loan nonaccrual and return to accrual policy areas, Karen, what are the examiners responsibilities?

Karen Kelbly: The examiners are going to focus on appropriate nonaccrual treatment that's in line with revised Part 741 and the IRPS and also GAAP and they're going to be focused on the amount and trending of nonaccruing TDR as a risk indicator of workout strategies that do not improve loan collectability. So if credit unions are working with members of modest means they will provide concessions to members in financial difficulty and that's good as long as it's safe and sound. What we're looking for is those restructured loans returning to accrual and performing, and if that is happening the examiner will move on to other risk areas.

Lisa Dolin: Sydney, can you help our credit union audience understand how a credit union should apply cash payments on a loan during periods of nonaccrual before return to accrual criteria are met? What happens to cash payments received from these members and how are they applied?

Sydney Garmong: Sure, Lisa, happy to do that. Well, GAAP really does not provide guidance on which method of income recognition to use when a loan is on nonaccrual and we do have payments come in, but throughout GAAP you'll find these various methods listed here on the slide. Actually for those of you that are still not in codification compliant land like me, the first two come from FASB statement 118 and they're rarely used in practice, and in fact I think on the first one you have systems challenges to deal with on that. The two most prevalent methods are Cost Recovery and the Cash Basis methods and those are the two that I'm going to focus on the most.

Now, the one place in GAAP which does provide explicit guidance is the loans to financially troubled countries, and Mark had mentioned this particular reference before. Not to suggest that this is common in credit unions, but the point here is that this is one place grounded in GAAP where if ultimate collectability of principal is in doubt it says to use the Cost Recovery method. So again, this is one place in GAAP where this is very explicit.

I mentioned previously the FASB financial instruments project and they've tentatively decided to provide guidance on how to treat payments that are on nonaccrual. And essentially what they have -- it's very consistent with, again, industry practice basically saying that if it's not probable you're going to collect full payment of principal use Cost Recovery. If it's probable that you will receive full payment of principal but not interest then you use the Cash Basis method. And again, that is consistent with existing industry practice.

So let's take a look at these alternative income methods. Now, remember these methods only come into play for loans that are actually on nonaccrual. The first one is really exactly what the name implies. All the payments are going to be applied against the recorded investment. So what you're really trying to do is recover, if you will, your investment and that again is used when there's doubt on whether the principal amount is going to be collected or not.

The Cash Basis method can actually be used in a variety of ways with some or all of payment applied to income. Now, that method is used when the recorded investment, and I'm going to define that in a couple of minutes by the way, is fully collectable. So what that means is that we think we're going to collect all the principal but not all of the contractual interest. And also remember this is when we think about the term recorded investment that is after any charge-offs.

So I promised to actually define what recorded investment means and on the slide here you can see the definition. So in order to determine whether there actually is impairment, you would go through and the recorded investments is simply a recap, if you will, of all the debits and credits that are associated with a particular loan. Now, the loan balance would be the unpaid principal balance, and again that's the contractual amount due gross of any charge-offs. So again, this is just when you're trying to figure out what exactly do we mean when we use the term recorded investment or net carrying amount, this is actually how that is defined.

So what I do want to jump to next is let's take a look at the various ways that one can allocate those cash payments received under the Cash Basis method, and again which is only used if the recorded investment is deemed to be collectable. Now, a credit union could choose to allocate the payment between interest income, reduction in the recorded investment or as I like to think of it principal reduction, or even recovery of a charge-off. And so if you would use this method the amount of income that would be recognized would actually equal that that would have been accrued on the remaining -- if income would have been recognized on the recorded investment at the contractual rate.

So that's one way to recognize it under the Cash Basis. Alternatively, another way a credit union could choose to account for the payment entirely as income, entire as a principal reduction or entirely as recovery of a charge-off. So the other thing that I think in making a determination on

how you actually treat the cash payments under the Cash Basis method is to really put in place a good accounting policy and make sure that there is consistent application.

Now, as I have thought about trying to navigate all this we thought it actually might be helpful to provide kind of a decision tree. Being more of a visual person it's a little easier to navigate than trying to dissect all the words, so we included a flowchart. Now, again, the first question that one has to ask is whether or not that recorded investment is deemed to be collectable and that is actually what is going to drive whether you use the Cash Basis or the Cost Recovery method.

Lisa Dolin: Thank you, Sydney, that's a lot of good information. So, Mark, is there any helpful information on the credit union's audited financial statements that may shed some light on the credit union's policies and applying cash payments during periods of nonaccrual?

Mark Taylor: Yes, there is. There's a number of new disclosures in the footnotes to the audited financial statements that relate to both nonaccrual loans and impaired loans. And I might mention particularly from the credit union standpoint, during this past year both the TDR disclosures and these disclosures we're going to talk about some credit unions did an excellent job of having good systems and processes to gather this data and I think some are finding that they need to develop those, and I can't overemphasize that enough the importance of that.

So on Slide 49 there some of the disclosures actually cover the policy. So when is a loan placed on nonaccrual, how do we handle recording of payments received on nonaccrual loans, and what is our policy or how do we handle resuming accrual of interest? So there are some specific policies in the footnotes now required for that.

On Slide 50 some of the information that you'd find in the footnotes to the financial statements, the amount of recorded investment in nonaccrual loans is there. The second bullet, the recorded investment loans past due 90 days or more and still accruing, and that bucket should be kind of more the exception than the rule. As we know that from the IRPS that a loan should be placed on nonaccrual after 90 days unless, again, well secured and in process of collection. The other disclosures there on impaired loans, we talked about interest income recognized versus case basis and obviously if you see a large difference between the amount being recognized much higher than the cash basis it might be an area for further investigation.

Lisa Dolin: So what is the practical implication of the Cash and Cost Recovery methods? I know we have two examples in our presentation but in the interest of time I think we need to move through the first example and go to the second one we have in our slide deck. Mark, could you walk us through that second example that we have here?

Mark Taylor: Sure. So in this situation a credit union has a $50,000 loan, $40,000 is deemed to be doubtful and $10,000 is substandard. A $1,000 payment designated by the borrower as interest is received. The credit union applies $800 to reduce principal and $200 as interest income with the rationale that the proration reflects the collectability of the differently classified portions of the loan. The question being is this acceptable? Answer would be “no” that in this instance the Cost Recovery method would be the one that should be used because there is doubt

about the ultimate collectability of the recorded loan balance, and so in this case all the payments should be reducing the principal balance.

Lisa Dolin: Thanks, Mark. So, Karen, what is the examiner's responsibility to analyze each loan workout fact pattern in light of the FASB's TDR accounting guidance to determine if the credit union has properly identified the workout is, or is not, a TDR and to document that?

Karen Kelbly: Lisa, it's the credit union's sole responsibility for the TDR designation analysis and decision. It's their responsibility for financial reporting and they need to understand GAAP's TDR guidance. And I think in the interest of time I'm going to move to this next slide. This is where the examiner is going to focus. He's going to focus on -- who in a credit union is responsible for the TDR determination and then he's going to look for the documentation of financial difficulty. Did someone analyze financial difficulty and draw a conclusion about that condition, and did someone document whether a concession was granted and draw a conclusion about that condition, and did someone look then at those two evaluations together, financial difficulty and concession, and make a decision that it is, in fact, is or, is not, a TDR?

Is there a process within the credit union to flag that as a TDR and then to track it in the system going forward, including tracking whether it's been placed on nonaccrual and whether it's retained there or whether it's restored to accrual? And we want the examiner to verify the system source and the uniformity of the data entered into the Call Report at a point in time to match it to the credit union's system. So that is the main focus and of course understanding what is, or is not, a TDR is very important.

Lisa Dolin: In the TDR designation analysis one of the troublesome elements is the concession notion, in particular how to analyze the credit union's granting of a delay in payments. So, Sydney, could you revisit the two elements that lead to TDR designation and especially revisit that insignificant delay element of a TDR concession?

Sydney Garmong: Sure, Lisa, happy to do that. Now, as Lisa said, there are those two conditions that must be present. The borrower, in this case the member, is experiencing financial difficulty and the credit union grants a concession that it otherwise wouldn't except for the members having financial difficulty. Now, circling back to my previous comments the FASB was receiving many questions on how to interpret these two criteria and, Lisa, as you mentioned in particular on what exactly does insignificant delay mean and I mentioned that the FASB did provide additional guidance in the form of ASC 2011-2.

So when they provided that guidance let's first look at financial difficulty and the first caveat I need to give you is these are indicators. So what you can't do is look at any one of them in a vacuum and so the FASB was trying to provide kind of guidelines, if you will. If you're seeing these kinds of things that probably means that, yes, the member is experiencing financial difficulty.

So just a couple of points here -- and this is not an all inclusive list from the standard, but a couple of key points and you can't say okay, the member is not in default now. You have to consider whether there is a possibility that the member will be default in the foreseeable future.

So you can't hang your hat on they're current for now you have to be a little bit forward-looking. You can't just say well, they're not in default on a loan at my credit union you have to consider that there could be loans involving other lenders and so if you become aware that they're having problems that might also be a signal.

You also have to evaluate it from the member's current capabilities. What is their ability today to service the debt? You can't say well, this person is going to get a pay raise in the next couple of months. Another sign that there is financial difficulty is that the member is unable to refinance somewhere else at a market rate. And as I said, this is not an all inclusive list there's an awful lot of judgment that comes into play in making this determination.

Let's turn now to whether or not a concession has been granted. Now, this is I think personally a little easier to determine but maybe not. FASB really did the same thing here trying to provide a list of things to think about. Now the one thing that they did clarify is that you can't use the borrowers test. Remember that TDR accounting actually applies to both the creditor and the debtor and in the debtors accounting there is a test to determine whether or not the borrower received concession or not.

Now, I understand why people were maybe using this because basically you would calculate the effective yield both before modification and -- before and after workout and compare the two to see if anything had been given up. So I understand why, but the problem with doing that is it may not be at a market rate and that is a very important concept. So you can't use the borrower's effective rate test. You can't hang your hat on the fact that you got additional collateral. You have to figure out okay well -- you can't say well, it's not a TDR because I got some additional collateral you have to evaluate whether or not you are being adequately compensated.

You have to evaluate whether or not the member does really have access to a market rate. If not, the restructure may actually be at a below market rate. And the last point I'll make is that you can't assume just because you increased the rate that it's not a TDR, again, that may actually not be at market. So again, the point here is that these are all things to think about. Again, I know that that's a lot to swallow but the FASB really was trying to be helpful.

Let me turn now to, Lisa, what part of your question was dealt with insignificant delays. Now, I will tell you that some found these guidance that was issued not quite as satisfying as maybe they had hoped for but they did provide at least I think some things for people to think about. The reason FASB took this up is they were getting an awful lot of questions. What exactly does insignificant delay mean? There's a couple ways to think about this. You need to think about it from both the amount and timing when we're talking about a delay. So let me give you n example.

So let's say that you maybe had a short-term delay in payment, maybe there was a loan that was in process of being renegotiated and there was a very short period of time and that may not be significant if it's just something that happened while we were waiting to renegotiate the loan. However, I mean it's far different if you're talking about a short-term modification like maybe you're also talking about a month -- maybe there's a payment that has been missed for one month

but if it's only a six-month loan that is far different. So you have to look at it from the context of both the amount and the timing

Now, if you look at it -- let's also take a look at I want to talk more on timing and, again, although none of this is supposed to be bright line guidance, again, all things to think about you have to think about all right, the frequency of the payments due under the debt. So again, as I mentioned, skipping two payments on an annual pay loan is far different than skipping two payments on a 15-year monthly mortgage loan, again, just trying to get in the context here.

Also, look at the original contractual maturity. A two-month extension on a 30-year loan is far different than a six-month extension on a two-year loan. So what the FASB was doing is giving us kind of end post, if you will, and from there there's an awful lot of interpretation that needs to go into it.

I also wanted to cover, because I think it's helpful, although I'm not sure how realistic this is, but I do want to cover an example that's actually included in the ASU. So in the example, and I won't read through this verbatim but just tell you at a high level, in this case let's say that the member has a 30-year mortgage it's a monthly pay. You're four years into the mortgage and the member misses two payments. As part of the renegotiation the credit union decides they make a deal with the member. They say all right, we need you to catch up your two missed payments and you're going to do that over the next four payments, and because of that agreement that would deem to be an insignificant delay. Again, I think this example may be a little unsatisfying but this at least provides some context.

So what you can see here is there is an evaluation, okay understanding the entire picture is very important. Two monthly payments out of a 30-year mortgage this is a monthly payment, like most of them are, and we're only talking two payments and we have certainly a long way to go if you look at it from a contractual standpoint we're in year four and this is a 30-year mortgage. So I think that's what's important to remember. Again, people will often ask is it okay can I just miss one payment. I say it's going to depend on these things. It depends on the frequency of the payment and how long do we expect the loan to be around. So you have to weigh all of those facts and circumstances.

Lisa Dolin: Thank you, Sydney, for that information. The last topic we want to touch on today prior to taking questions from the audience relates to charge-off practices, both from a policy perspective and in relation to the ALLL. So, Jeff, what should the examiner consider with regard to charge-off policy and practice?

Jeff Marshall: Okay, Lisa, for this slide and for simplicity reasons, I will refer to the allowance for loan and lease loss as the ALLL and ASC-450-20 as FAS 5. Based on previously cited interagency ALLL guidance, for those small balance homogenous loans evaluated in pools under FAS 5 (that are not TDRs) credit unions must properly factor historical net charge-offs into their ALLL methodology. If an examiner determines that a credit union does not properly and timely grade loans or portions thereof as Loss and/or charge-off amounts graded Loss timely against the ALLL when they are deemed uncollectable, its ALLL methodology needs adjustment.

If this condition exists, the historical loss factors based on net charge-offs by pool segment apply to loans evaluated for impairment under FAS 5 must be adjusted upwards in the examination as if the credit union charged off loans according to the parameters set forth in its own policy, if reasonable, or alternately the parameters provided in the FFIEC's Uniform Retail Credit Classification and Account Management Policy. This policy is referenced in the IRPS and closely mirrors NCUA's Letter To Credit Unions Number 03-CU-01 titled Loan Charge-Off Guidance.

This practice is necessary to ensure estimated probable losses on pools of loans are appropriate and reasonable and is an internal qualitative and environmental factor that must be considered in the credit union's ALLL methodology.

Lisa Dolin: And, Mark, could you weigh in on how an independent accountant would address this circumstance in his or her audit process?

Mark Taylor: Sure. I would say both an external auditor and I even think internal auditors would often assess whether loan charge-offs are recorded on a timely basis. Charge-offs, as we know, should be taken when a loss event has been confirmed. So one example of a confirmation of a loss event may be the receipt of a current appraisal on a nonperforming real estate loan where the appraisal value is lower than the outstanding balance.

So some of the tests that might be considered, one would be taking a look at the impaired loans particularly ones with large specific reserves and see if any portion of that should have been charged off by now. Another test would be taking a look at some of the charge-offs that did occur and assess whether that charge-off was recorded in the appropriate period, i.e., when the loss event was confirmed. And I think Boards of Directors, management, examiners and auditors all have similar interest in ensuring the historical loss ratios are not understated or that if there are slowness to the charge-off process that there are some appropriate adjustments being made either to the historical losses itself or to the qualitative and environmental factors.

Lisa Dolin: Thank you, Mark. Well, we're well into our allotted time here today so let's move to some of the questions that have come in from the audience as we've been talking. For those of you listening in, we'll likely go over our 90 minutes to get to a few more questions. So I want to introduce Debra Pockat from the Office of Examination and Insurance who is here monitoring our questions today. Deb, I'll hand it over to you.

Debra Pockat: Thank you, Lisa. There are quite a few questions out there and so we're not going to be able to get to them all but we will do our best to answer some that actually may be like repeats that we received. But the first one I'd like to start off with, Mark, can there be a skip-a-pay on a modified loan?

Mark Taylor: I guess my response would be generally I would see a skip-a-payment program being a standalone program that you would offer to membership. I guess to me it would seem unusual to offer a skip-a-pay plan to a modified, a troubled debt restructure would be my response.

Debra Pockat: Thank you. And, Jeff, got one here for you on the policy. Does NCUA have a sample policy that a credit union can use as a guide?

Jeff Marshall: No, we do not. Really no specific policy is going to be appropriate for all credit unions. The number of times a loan can be worked out should be determined by credit union management and the Board of Directors. The IRPS actually references the FFIEC's uniform retail credit classification and account management policy, which says that loans should not be modified more than once in a year or worked out more than twice in five years. And examiners will typically use those parameters in selecting the loans that they will want to review.

Debra Pockat: Okay, great. I'm going to stick with you. I've got another one here and if anybody else -- some of these may be thrown out and the panel can choose who's going to answer but, Jeff, are we talking just about MBL and real estate loans or are we also talking about consumer, auto and unsecured loans when we're talking about in relationship to the TDRs?

Jeff Marshall: Any loan could be modified, and any loan could be a TDR. So we're talking about all loans as far as establishing workout policies.

Debra Pockat: All right, great. I have another one and this one is kind of lengthy. If we go back to Slide 45 for the panel you may have already answered this but Slide 45 actually shows a recorded investment in the loan as the dollar amount prior to the application of the ALLL. On the decision tree, though, on Slide 48 the cost recovery method is used if there is doubt as to the collectability of the recorded investment. If there is an allowance on the loan would it be accounted for using the cost recovery method?

Sydney Garmong: I want to make sure I understand the question, so if there is an allowance the question is, is it automatically required to be accounted for on the Cost Recovery method?

Debra Pockat: If there is doubt as to the collectability of the recorded investment.

Sydney Garmong: If there's doubt on the collectability you would have to use the Cost Recovery method. The way I like to think about it -- and again, this is a separate decision. It doesn't matter whether there is or is not an allowance, at least the way I'm thinking about it. But kind of an easy way to think about it is I look at the loan, let's forget the differed fees and costs and all that noise, but if I look at the loan and I say I think I'm going to get all of my principal but I have doubt on whether or not I'm going to collect my interest. In those cases -- so if you think that you're going to collect your principal but not your interest you would use Cash Basis. If I have some concern that I'm going to collect my principal that's where I go to Cost Recovery.

Mark Taylor: Debra, I might have a clarification too. On Slide 48 it starts with recorded investment collectable and on Slide 45 the recorded investment in the loan is prior to the allowance for loan loss, so I think that might be where the question was coming from.

Debra Pockat: Okay, great. I've got another one here for Jeff. In the final rule it states that loan workouts should be adequately controlled and monitored by the Board of Directors. Can you recommend what should be included in the loan workout report to the Board?

Jeff Marshall: Yes, Deb. The Board should see, and examiners as well will want to see, reports that indicate that the workout program is operating as expected. So some type of reports that provide a picture of the workout portfolio's credit quality, some of those reports might be net losses by loan type, number and volume of workouts that have relapsed into nonaccrual, number and volume of loans with multiple restructures; that sort of thing.

Debra Pockat: All right, great. I'm sure that'll be helpful for them out there. This is a long one too and I'm going to throw it out there for the panel to decide. The question is what steps or procedures would you suggest for a credit union looking at reducing a FAS 114 impairment on a TDR loan where an updated post TDR property valuation that was done 24 months after the initial TDR indicated a lower 114 FAS loss reserve and the borrower is marginally performing on the TDR with no improvement to its financial standing?

Sydney Garmong: I guess one question that I would have is in that case if we're using the fair value of the collateral, if I'm following the question correctly, the only time we can use the fair value of the collateral is if the loan is collateral dependent, and if the loan is collateral dependent if you expect repayment to be based on or come from the underlying collateral. So I'm not clear, I suspect that this is not -- it doesn't sound to me like it's a collateral dependent loan because the other thing that I think about is if you're talking about in particular a workout if you -- why would you workout the loan unless you expect that the member is going to be able to repay it. So I'm suspect whether or not you could really use the fair value of the collateral but you'd have to first make that determination on whether or not it is a collateral dependent loan because if it's not you can't use it.

Debra Pockat: Okay, great. Another one that I'll throw out to you, if there is sufficient collateral to cover the principal of the loan such that there is -- and this follows in line with what you were just saying. If there is sufficient collateral to cover the principal of the loan such that there is no loss, if they have to repossess or foreclose is it a TDR?

Sydney Garmong: Can you read the question to me one more time, unless somebody else has --

Mark Taylor: Let me just answer it this way. A TDR, we've got the two criteria. One is that you've got a member who has financial difficulty, and the second is you gave a concession. So if in that fact pattern these two things occurred it is a TDR. The next question might be, and I think this is what it's getting to, is do you need a specific reserve or how much specific reserve you need on it. But I think if it meets the first two it is going to be a TDR.

Debra Pockat: Okay. Thank you, Mark, and thank you, Sydney. Some of these are confusing just because of the length of the question so bear with me as I try to work through it. This one I had originally assigned for Sydney. If we do a workout loan for a member who is 12 months past due are we only supposed to include 90 days of the overdue interest and late fees into the new loan?

Sydney Garmong: I would say GAAP does not cover that answer, and I'm not sure that the policy statement does either on whether or not -- I don't think it tells you what to roll into a renewed loan or a modified loan.

Mark Taylor: If I'm understanding the question correctly, I think the IRPS does talk about not capitalizing interest on a loan and I think in general auditors frown upon that as well. It would be probably a unique set of circumstances where you could maybe support capitalization of interest but I would say generally speaking I don't think you would capitalize any interest. And as we were talking about in one of the questions that I went over, that interest might ultimately be recognized over the effective yield method over the term of the loan.

Karen Kelbly: And I would just reinforce that if you look again at the published Federal Register notice again on Page 32003 Table 2 *Restoration To Accrual,* the IRPS very clearly says that you cannot capitalize interest at the restructure point you could only recognize it if collected in cash from the member. I think that -- again, just agreeing with Mark.

Debra Pockat: Great, thank you very much. Jeff, prior TDR definition was real estate or commercial loans. Has this change broadened TDR to consumer loan? And I think we already answered that. You mentioned just real estate and commercial specifically in your particular portion.

Jeff Marshall: I don't know that that definition was ever targeted towards real estate or commercial - that's what our guidance came out as in the form of the two letters that I had mentioned during the presentation. And I said earlier, any loan could be a modified loan or workout, and any loan could be a TDR.

Debra Pockat: All right, great. This is kind of a broader question. In what areas do you see the most confusion or lack of consistency in reporting and how can credit unions remedy that?

Karen Kelbly: Well, I can start with this one and, Crowe, you can jump in if you want to add because you might see something different from the auditing side. But on the regulatory side, there's just a lot of confusion as to what a modification is and so we avoided that term in the IRPS and in the Supervisory Letter. We defined the term as workout very specifically and then TDR according to the GAAP definition, so a lot of confusion about what we mean by modification, workout, TDR.

And then a lot of confusion about which restructures require this special financial reporting which is why we spent time today in the webinar with Sydney walking us through the two criteria, financial difficulty and concession. And then I think also getting our systems up and running to track the TDRs and the different elements, the principal reductions and the charge-offs and the payments all of that.

And then this whole notion of accrual and nonaccrual, I think Sydney's point was very important that we're talking about a financial reporting concept in nonaccrual it doesn't change what the member legally owes. So some of those concepts and how they all work together, you've got to determine is it a TDR, and then you've got income recognition which is the nonaccrual, and then

you've got impairment which is the allowance. So those are some of the moving parts that can confuse credit unions.

Jeff Marshall: The comment I might add, I don't know if its confusion, but I would say a challenge. And that is, some of the existing credit union systems do not really handle some of the concepts that are being discussed, putting a loan on nonaccrual and applying it on a Cost Recovery basis to principal, when you return it to accrual that you're not picking up all the past interest, items like that, if there were an A/B note structure, partial charge-offs. A lot of the systems don't really deal with some of these issues and so in the short-term there may be a need to do some manual systems or Excel spreadsheets to handle some of this.

Debra Pockat: Thank you. There's a lot to cover here, we've got a lot of questions and we're going to take one more here. I'm throwing this out to all of you. I have seen guidance which states that TDRs must be on nonaccrual status for six months after restructure with no exceptions. I have seen other guidance which states that they may be kept on accrual once restructured if an analysis is performed that shows the customer or member can pay and has. This is typically when the loan was current before restructure and is adequately collateralized. Is this acceptable to NCUA as well as assuming that adequate documentation is available?

Karen Kelbly: So what we're trying to do both in the IRPS and then you'll see again in the Supervisory Letter is to add some clarity here and to narrow our expectations. And so this six-month requirement now only applies to accrual and nonaccrual not to delinquency and it only applies to member business loan workouts. So for member business loan workouts we're looking for a current well documented credit evaluation of the borrower's financial condition and their prospects for repayment. And part of that evaluation for a member business loan workout has to be the receipt of six consecutive timely payments of principal and interest according to restructured terms and it is okay to look at recent performance prior to the restructure to reach those six consecutive payments. And we do have an example of how you can look back to previous performance in the IRPS, again, on the same page as the tables that we've been talking about.

So this has been an area of a lot of confusion and the IRPS does narrow the practice of the six consecutive payments now just to member business loan workouts. And so we're hoping with the IRPS and with the Supervisory Letter that you'll soon be seeing that there will be some consistency in practice, a better understanding and a better application.

Lisa Dolin: Thank you, Karen and Debra. We are out of time for today. I want to extend my sincere thanks to Mark and Sydney and to Jeff and Karen for sharing their expertise and addressing many of the issues related to the recent revisions to Part 741 and Appendix C. I also want to extend my thanks to Debra Pockat of E&I who did a great job reviewing all of the questions that you submitted.

And certainly last but not least I want to thank our IT staff, Curtis Crabbe and Fred Haines who were here with us today who did a tremendous job in making sure that this webinar ran as smoothly as possible. We always appreciate their assistance. We also appreciate the support of On24 in delivering the webcast.

Just as a reminder, as I indicated at the beginning of the webcast, it will be archived so if you missed part of it or you wanted to share it with some of your colleagues, you may revisit the material. We will issue a media advisory in about two weeks notifying you that it is available to view and you can just go back to the same URL you used for this webcast to access the archive. Thank you very much for your attention and have a great afternoon.