CUNA
Credit Union National Association
cuna.org
601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-638-5777 | FAX: 202-638-7734

Filed via regcomments@ncua.gov

February 16, 2012

Ms. Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Re: Comments on NCUA Proposed Rulemaking for Parts 701 and 741, Loan Participations Proposal; 76 Fed. Reg. 79,548, proposed Dec. 22, 2011

Dear Ms. Rupp:

This letter represents the views of the Credit Union National Association regarding the National Credit Union Administration Board's proposal to place further restrictions on the use of loan participations, particularly by purchasing credit unions.

Our letter was developed with the CUNA Examination and Supervision Subcommittee, the Federal Credit Union Subcommittee, the American Association of Credit Union Leagues' Regulatory Advocacy Advisory Committee and Leagues not currently serving on that committee, members of the CUNA CFO Council, and other credit union officials. While we have had many discussions about the proposal with a number of experts on this issue, we particularly appreciate the additional input and guidance we received from credit union officials who manage loan participation programs, large and small.

CUNA is the largest credit union advocacy organization in this country, representing about 90% of the nation's 7,300 state and federal credit unions, which serve 94.5 million members.

CUNA <u>Urges</u> the Board to *Withdraw* the Proposal

In the strongest terms appropriate, CUNA urges the Board to withdraw the proposal as issued for comments.

In today's overregulated environment, this proposal would add to the regulatory burden of affected credit unions in a manner that is wholly disproportionate to the risks associated with loan participations. While the proposal seeks to address concentration risks and other issues the agency has identified concerning loan participations, it would do so at the price of severely limiting, if not eliminating, sound participation programs that serve credit unions, their members, and other credit unions well. The proposal would also seriously undermine lending programs and even earnings for some credit unions. Moreover, through the application of concentration and underwriting limitations, it would – contrary to the agency's goal of risk management –actually **minimize** the ability of credit unions to mitigate risk through diversifying sources and types of loan participations.

In addition to these concerns, the proposal's shortcomings extend to its one-size-fits-all approach. *All* credit unions would be subject to the same arbitrary caps, which is at odds with the agency's stated goal to tailor regulations to reflect real risk.

We are hopeful that NCUA Board members will agree that these results are unacceptable, given the relatively low real risk associated with loan participations and the uncertainty among credit unions that the proposal will actually mitigate risks from loan participations.

Our more specific concerns with the proposal are discussed below. We also provide, beginning on page 11, recommendations to the agency on steps it could take to address loan participation issues but without the unduly negative impact that the proposal would inflict should it be adopted as issued for comments.

The Proposal Would Make Loan Participations More Complicated and Could Result in Fewer Credit Union Loans; Small <u>and</u> Large Credit Unions Will be Affected

At the very time when the economy, communities, small businesses, and consumers could benefit from sound lending programs, and credit unions could benefit from providing them, this proposal would limit the ability of credit unions to sell and purchase loan participations, historically an important mechanism that has facilitated loan production.

Among other things, the proposal would introduce several new limitations. These restrictions for all federally insured credit unions would include:

- A ceiling of 25% of the purchasing credit union's net worth on loan participations from one originator, with no possibility of a waiver;
- A limit of 15% of the purchasing credit union's net worth on loan participations from one borrower;
- A requirement that federally insured credit unions that are selling loan participations must retain a 10% interest in the loan originated (FCUs already must meet this requirement);

- A requirement that loan participations would have to conform to the same underwriting standards that a federal credit union employs when originating a loan; and
- A requirement that loan participations be purchased from an eligible organization.

During numerous conference calls, CUNA and the Leagues have heard from credit unions of all sizes who oppose the proposal. That is because, regardless of their size, credit unions fear it will substantially impact their lending efforts and/or their earnings, all without sufficient countervailing benefits in terms of safety and soundness.

The concentration limits regarding participations purchased from a single originator have drawn the highest levels of concerns from the largest number of credit unions that discussed the proposal with CUNA. This approach of setting a regulatory limit on loan participations from one originator seems to be unique within the financial system, as we did not identify a similar restriction on bank loan participations. Since there does not seem to be a greater risk within the credit union system regarding loan participations than there is for banks, this proposed limitation would arbitrarily disadvantage credit union loan participation programs. Also, as mentioned below, it is unclear as to why the 25% level is appropriate and how this limitation will indeed address risks, except through reduced lending and fewer loan participations.

Smaller credit unions are particularly concerned that the 25% of net worth limit on loan participations from one originator may disrupt if not upend their loan participation programs. These credit unions do not have the resources to initiate and conduct ongoing monitoring of a number of loan originators. As a result, smaller credit unions often focus on purchasing loans from a single originator.

Moreover, large credit unions that sell loans and loan participations to smaller credit unions will be penalized. That is because in a number of cases, larger credit unions may be reluctant to sell participations to smaller credit unions if the amount they can sell to each is limited to 25% of the purchasing credit union's net worth. Also, the proposal if adopted could mean that fewer loans would be originated if selling credit unions are concerned about having to find a number of additional credit unions to which they can sell their loan participations.

Credit unions are concerned about the limitations on loan participations involving loans to one borrower or group of borrowers. Like the limits on loans from one originator, NCUA seeks to impose limits involving loans to one borrower that are not required by the statute or needed in the regulation in order to address substantiated safety and soundness concerns.

The risk retention requirements that would apply to all federally insured credit unions are also a concern, even though the Federal Credit Union Act requires that selling federal credit unions retain a 10% interest in the loans that they sell. We think that even with the statutory requirement for federal credit unions, NCUA could use its incidental powers to provide for waivers from this limitation for federally insured credit unions selling loan participations.

Credit unions are likewise very worried about the provision in the proposal that would limit their loan participation purchases to those involving loans that the purchasing credit union is authorized to originate. This provision would severely curtail loan participation programs because it would prevent credit unions from investing in participations that involve loans that the purchasing credit union cannot make -- even if that credit union has the resources to monitor the performance of the loans. This would undermine the ability of purchasing credit unions to diversify their loan participations and limit the pool of credit unions to which originating credit unions could sell participation interests. In our view, from a safety and soundness standpoint, this provision would be counterproductive.

No matter what their asset size, credit unions are working very hard to serve their members well, but this proposal and the limitations addressed above will make credit unions' efforts all the more difficult and complicated during these precarious economic times. Moreover, it will prevent otherwise worthy loan participations from being sold and purchased.

The Proposal Is Not Needed For Systemic Risk Purposes

Below is the reaction of one observer to NCUA's proposal.

> The National Credit Union Administration (NCUA) has become very fond of tossing about the term "systemic risk" when justifying changes to its regulations.
>
> Sometimes the use of systemic risk is warranted, as in the case of the new corporate credit union regulations. But in other cases, it appears that this [sic] agency has not done the necessary analysis to justify the regulatory change -- so it leans on systemic risk as a justification for the regulatory changes.
>
> The latest example is where the agency justifies it [sic] loan participation proposal by stating that "loan participations ... create more systemic risk to the share insurance fund (NCUSIF) due to the resulting interconnection between participants."
>
> …While I recognize that some credit unions have gotten into trouble due to loan participations, I don't believe that at this time loan participations represent a systemic threat to the NCUSIF.

These are not the comments of anyone in the credit union system, although we have not talked with any credit union official who would disagree. These conclusions are from a recent blog posting of Mr. Keith Leggett of the American Bankers Association, an organization whose routine support for limitations on credit unions has apparently been overcome by its incredulity that the agency thinks the proposal is necessary to tame “systemic risks.” As these comments show, even the arch enemy of credit unions (when it comes to the tax exemption and new powers) does not accept NCUA's use of systemic risk to justify the proposal.

CUNA’s Economic Analysis of the Level of Risk Associated with Loan Participations

The agency’s participation proposal seems to be a “solution” in search of a problem. The problem, however, most certainly is NOT systemic risk, which is generally understood to mean a risk to the entire financial system. Credit union participation loans account for only 2.3% of total credit union loans (0.2% of depository institution loans) and just 1.3% of total credit union assets (0.08% of depository institution assets). As a practical matter, credit union loan participations have a zero percent probability of bringing the financial system down and an imperceptibly higher risk of causing a collapse in the depository sector or even just the credit union sector.

In fact, in this case, the agency has expressed no compelling rationale for the imposition of additional regulation on all credit unions involved with loan participations for the possible excesses of a handful of credit unions. The existence of recent high losses on some participation loans is a definite concern, but it does not justify implementation of the agency’s proposal as issued for comments.

Credit Union Loan Participations

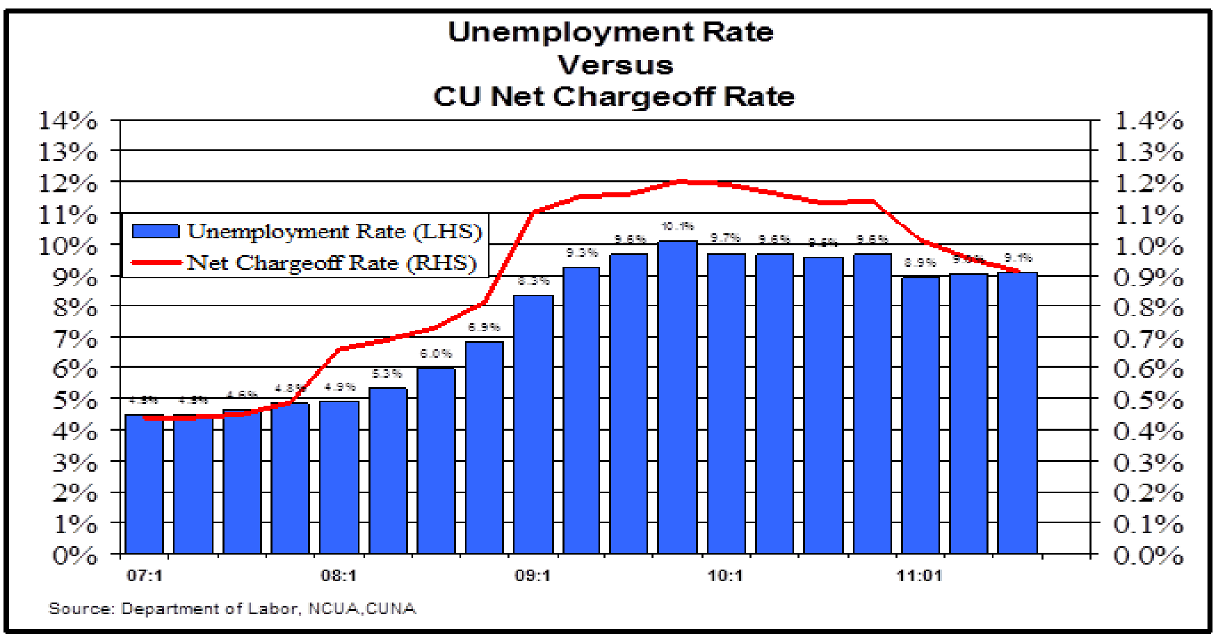
September 2011 ($ millions). Source: NCUA, CUNA.

Participations / Net Worth	# of CUs	Assets	Total Loans	Participations	Part/Assets	Part/Loans
0%	5,717	$356,329	$195,000	$0	0.0%	0.0%
0-10%	559	$310,480	$197,000	$872	0.3%	0.4%
10-25%	316	$122,368	$77,382	$1,978	1.6%	2.6%
25-50%	251	$75,169	$44,030	$2,544	3.4%	5.8%
50-75%	125	$36,490	$21,690	$2,009	5.5%	9.3%
75-100%	95	$26,948	$16,672	$2,156	8.0%	12.9%
100-200%	88	$18,925	$11,759	$2,287	12.1%	19.4%
200-300%	7	$620	$504	$150	24.2%	29.8%
>300%	20	$3,602	$2,463	$764	21.2%	31.0%
Totals	7,178	$950,932	$566,500	$12,759	1.3%	2.3%

Current participation-loan charge-off rates are not out of line with -- in fact are substantially lower than -- the loss rates on many other credit union (and bank) loan products. As of September 2011, participation loan charge-offs were 1.29% of total participation loans. This compares to 3.16% for credit union credit cards and 1.25% for home-equity loans. U.S. banking institutions report substantially higher net charge-offs in just about every major loan-type as shown in the following table. The current level of participation net-chargeoffs is a function of the greatest financial and economic crisis in eighty years and does not necessarily reflect assumption of inordinate risks per se.

Net Chargeoff Rates Through September 2011 Annualized Sources: NCUA, FDIC, CUNA.		
	Credit Unions	**Banking Institutions**
Participation loans	1.29%	N.A.
Total loans	0.92%	1.61%
Consumer- credit card	3.16%	6.28%
Consumer – non-credit card	0.99%	1.38%
Total consumer loans	1.35%	3.85%
Home equity loans	1.25%	2.12%
All Real estate loans	0.61%	1.36%
Commercial loans	0.86%	0.93%

The U.S. economy now appears to be in the midst of a sustainable though slow recovery. As the economy improves, loss ratios most likely will decline.



We are concerned that the proposal's possible unintended consequences have been ignored. In fact, if implemented as proposed, the effect may likely be to increase rather than reduce risk exposures. That is because the proposal would undoubtedly lead to less diversified loan portfolios as credit unions – unwilling or unable to shoulder the additional burdens - exit the market and magnify their concentrations in existing portfolios. The overall riskiness of a portfolio can actually be reduced even if a relatively "high risk" asset is added so long as the return on the new asset is not positively correlated with the existing assets. Loan participations are a valuable tool for credit unions to incorporate geographical diversification into their loan portfolios. This does not mean participations can be purchased carelessly. But, they also should not be arbitrarily limited.

In addition, the rule could lead to less effective monitoring activities. By essentially requiring relationships with many sellers the agency could very well cause the overall quality of monitoring of loan sellers to decline. For example, a credit union that currently has a 200% participation-to-net-worth ratio would in the future be required to use eight different loan sellers to maintain that ratio. The credit union would therefore need to complete due diligence on eight different financial institution-sellers.

Of course, those that choose to maintain highly effective monitoring efforts of these additional entities would naturally need to allocate more resources toward this activity. By definition, this leads to an increase in operating expenses, lower efficiency, income declines and lower contributions to capital. The costs of multiple monitoring efforts would be particularly burdensome for smaller credit unions.

Also, some have noted that because the 5300 Call Report does not separate reporting of purchased from sold loan participations, the charge-offs and delinquencies reported for loan participations are likely overstated. Before moving to adopt a new rule based on the 5300 Call Report data, NCUA should review the report to ensure it solicits precise information that will provide a more accurate depiction of any problems with loan participations.

NCUA Has Not Provided Any Other Specific Data or Concrete Rationale to Support the Limitations in The Proposal

In addition to the agency's concerns regarding "systemic risk," NCUA provided, in the Supplementary Information accompanying the proposal, the following three general reasons as a basis for the specific limitations on loan participations that it seeks to impose:

(1) "[L]arge volumes of participated loans in the system tied to a single originator, borrower, or industry or serviced by a single entity have the potential to impact multiple credit unions if a problem arises."

(2) "[I]t is important to the safety and soundness of the NCUSIF that *all* federally insured credit unions (FICUs) adhere to the same minimum standards for engaging in loan participations."

(3) "[T]he agency has encountered confusion concerning the application of the current loan participation rule …." 76 Fed. Reg.79,548, (proposed Dec. 22, 2011).

NCUA has provided no data or other information to substantiate any of the limitations the agency is seeking to impose on loan participations under the proposal, including information as to why, for example, the proposed 25% limitation is preferable to a 20% or 30% limitation. More to the point, there is absolutely no discussion of how NCUA selected the specific concentration limits included in the proposal.

In addition, NCUA states repeatedly in the Supplementary Information that it appreciates that loan participations can help mitigate credit unions' risks but it does not address the extent to which risk mitigation will be impacted by the limitations on loan participations that the proposal will impose. Further, NCUA does not offer any explanation as to how the agency's concerns will be addressed without undermining the use of loan participations throughout the credit union system.

We believe a more complete discussion of the real and documentable concerns that the agency is trying to address with the proposal as well as how the substantive changes will address those specific concerns must be provided to the credit union system if NCUA proceeds with the proposal, in order to overcome concerns that the proposal is arbitrary and capricious under Section 706 of the Administrative Procedure Act.

The Proposal is Inconsistent with the Letter and Spirit of Executive Orders Addressing Regulatory Relief

Last year, in January and July, President Obama issued two Executive Orders directing federal agencies to address and improve their regulatory processes (Executive Orders 13663 and 13579, respectively.   With the issuance of Executive Order 13579, it is the President’s intent that independent agencies, such as NCUA, should be in full compliance, consistent with other legal requirements and practical considerations).

These orders expressly supplement Executive Order 12866 issued in October 1993. That order provides that each agency must, among other things:

(1) propose or adopt a regulation **only** upon a **reasoned determination** that its benefits justify its costs (recognizing that some benefits and costs are difficult to quantify);

(2) **tailor its regulations to impose the least burden on society**, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations;

(3) select, in choosing among alternative regulatory approaches, those approaches that **maximize net benefits** (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity);

(4) **to the extent feasible, specify performance objectives, rather than specifying the behavior** or manner of compliance that regulated entities must adopt; and

(5) **identify and assess available alternatives to direct regulation**, including providing economic incentives to encourage the desired behavior, such as user fees or marketable permits, or providing information upon which choices can be made by the public. (Emphasis added.)

Despite the clear directives of the orders, NCUA has not complied with their terms in developing the loan participations proposal. It has not provided a reasoned determination that the costs of the proposal outweigh the benefits; it has not tailored the proposal to be the least costly alternative; it has not demonstrated that the agency has considered alternatives and chosen the one that maximizes benefits; it has not focused on performance objectives rather than specifying the manner of compliance; and the agency has not indicated that it has considered means of compliance to achieve its objectives that do not involve another new rule.

We urge the agency to consider that the proposal undermines NCUA's efforts to comply with the spirit as well as the letter of the executive orders.

The Proposal Would Undermine Dual Chartering

CUNA proudly represents federal and state credit unions with equal vigor and strongly supports a well-balanced dual chartering system, which benefits both types of credit unions.

Under a separate Executive Order, 13132, federal agencies are required to consider the impact of their actions on state and local interests; we believe this reasonably would encompass the effect on dual chartering within the credit union system. The Supplementary Information does not discuss dual chartering directly but does state:

> The proposed rule may have an occasional direct effect on the states, the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The proposed rule may supersede provisions of state law, regulation, or approvals. The proposed rule could lead to conflicts between the NCUA and state financial institution regulators on occasion ….
> 76 Fed. Reg. 79,551 (Dec. 22, 2011).

While the agency is seeking comments on these effects, the language cited above is seemingly provided to demonstrate some level of compliance with the letter of the order, but it does not include any analysis. Further, it wholly underestimates the impact that NCUA's proposed regulatory approach -- which excludes state regulators from the regulatory process involving the regulation of loan participations -- will have on the ability of states to exercise their regulatory authority in this area.

Dual chartering, under which credit unions have a meaningful choice between following the policies and regulations of their state as a state-regulated institution versus the federal government as a federally-regulated entity, has been a longstanding hallmark of the credit union system. Until recently, credit unions felt the balance between state and federal regulation was fairly stable, in contrast to the erosion that has characterized dual chartering in the banking system for a number of years.

Yet, increasingly, credit unions have expressed concerns to us about the future of dual chartering within the credit union system, pointing to requirements of and consequences for noncompliance with the CUSO proposal and the final rule regarding interest rate risk to support their concerns.

The loan participations proposal would further damage the delicate balance between state and federal credit union regulation by requiring all federally insured credit unions to conform to the same limitations and underwriting standards that apply to loans originated by federal credit unions.

CUNA is seriously concerned about the impact of this proposed requirement on dual chartering. That is because not only would state regulators be generally denied the opportunity to regulate or deal with these issues with their credit unions, but also they would not even be permitted to determine whether their institutions are entitled to the limited waiver opportunities provided under the proposal. Credit unions' request for waivers would be reviewed and determined exclusively by NCUA.

While no one questions the authority of NCUA to administer and protect the NCUSIF, it is important that the authority of states to set regulatory standards for their credit unions that are consistent with safety and soundness not be diminished in the process, as would be the case if the loan participation proposal is adopted.

Concerns with NCUA's Waiver Process

If federally insured credit unions are subjected to a new rule on loan participations that contains concentration limits and the requirement that loan participations conform to underwriting standards, then we urge NCUA to allow credit unions to obtain waivers from these provisions.

The agency has asked for comments about its waiver process. Credit unions that have discussed the use of waivers with CUNA have uniformly reported that they have had problems that include the following: examiners have discouraged credit unions from seeking a waiver; delayed responses from the agency regarding the waiver application; and a lack of adequate explanations for agency denials of the waiver request.

We support the agency's efforts to review the wavier process, and we urge NCUA to seek comments from the credit union system to identify all material problems with the process and to ensure any changes will result in improvements to address problem areas. Meanwhile, CUNA's Examination and Supervision Subcommittee is looking into how the process can be improved and will provide further input to the agency on this matter.

CUNA's Recommendations to Address Loan Participations Through Much Less Intrusive Means Than the Proposal

Some of the comments you have received or will receive from credit unions recognize that aspects of the proposal have merit, particularly if they are not contained in a new regulation that limits loan participations arbitrarily. CUNA generally agrees, although some of our members urged us to simply oppose the proposal without offering any additional comments regarding the regulation of loan participations.

Nonetheless, we think issues such as concentration limits and underwriting standards should be addressed, but primarily by credit unions, subject to review by examiners, as opposed to additional regulatory requirements.

In our view, rather than proceeding with new regulatory restrictions that impose the same limitations on all federally insured credit unions involved with loan participations, regardless of the credit union's risk, we urge NCUA to take the following steps.

Steps regarding loan participations that CUNA would support include:

- NCUA should resend its 2008 Supervisory Letter (LCU 08-CU-26) regarding loan participations to all federally insured credit unions and examiners.
- The Letter spells out what is expected of credit unions that sell and purchase loan participations and addresses the key issues that are the subject of the proposal.
- The Letter also clarifies that credit unions purchasing loan participations must adopt board policies that address core issues involving the proper management of loan participation programs, such as limitations on participations from one originator, participations involving one borrower, underwriting standards, and loan participation agreements. The Letter also reinforces that credit unions must perform initial and ongoing due diligence as it relates to loan participations and addresses the importance of loan participation agreements and elements that should be addressed in them.
- In addition, NCUA should recognize and communicate to credit unions and examiners that:
    - Each affected credit union should set the parameters for its loan participation program that are appropriate for its operations, resources and capacity to manage risks associated with loan participations.
    - A credit union's board policies should require that as the credit union reaches progressively higher concentration levels regarding loan participations, the credit union must undertake additional monitoring and other due diligence steps.
    - Examiners should be instructed that credit union boards must have flexibility to design their loan participation programs, consistent with safety and soundness.
    - Purchasing credit unions should not be limited to loan participations that strictly conform to the credit union's loan origination standards.

- NCUA should provide additional training for examiners on loan participations and work collaboratively with state regulators to ensure problem areas are addressed promptly but without undermining robust loan participation programs or the ability of state regulators to supervise their institutions.
- NCUA should revise the 5300 Call Report to ensure information is captured that only reflects charge-offs and delinquencies for loan participations that are purchased.
- Using webinars and other communications, in coordination with CUNA and the Leagues, NCUA should focus credit unions' attention on their responsibilities in engaging in loan participations.

Given the fact that loan participations are not a systemic risk to the credit union system, we believe these steps would sufficiently address the agency's concerns and facilitate the ability of credit union boards, management and examiners to fulfill their proper duties when it comes to loan participations.

If NCUA Proceeds With A New Rule

While we oppose the proposal, if the agency does decide to go forward with a regulation in this area, we strongly urge NCUA to incorporate the following revisions and improvements.

- Leave it to credit union boards to determine concentration limits that are appropriate for their credit union, to address those limitations in their board policies and to implement them, subject to examiner scrutiny as part of routine examinations. As we stated earlier in this letter, this approach will achieve NCUA's objective that any risks associated with loan participations be identified and well managed but without imposing regulatory limits that may not fit the credit union's situation.
- If NCUA will not allow credit unions to determine these limitations, the agency should raise the 25% and 15% concentration limits substantially and allow these limits to be flexible. Credit unions that have higher levels of net worth could reasonably take on greater levels of risk without impairing an institution's safety and soundness. A credit union with a 14% net worth ratio, for example, could risk 50% of its net worth in a participation, lose it all, and still be well capitalized.
- Allow credit unions to obtain waivers from those limits on a program basis and not be required to seek a waiver for each purchase. Likewise, if NCUA pursues the requirement that loan participations must confirm to underwriting standards, then waivers should be permitted from this provision as well.
- Differentiate between recourse and non-recourse participations because these entail different levels of risk.
- Recognize participations from a single originator could be a single loan, or a part of a pool of thousands of loans – a difference that translates to real differences in risk exposure.
- Exempt small credit unions. Collectively, small credit unions have very low loan-to-asset ratios and are experiencing resulting earnings challenges. The

proposal would magnify these difficulties: The arbitrary cap limits small credit unions from participating as it makes the dollar amount available to participate too small to interest larger credit unions in including them in participations. On the other hand, small credit unions represent little risk to the insurance fund -- many could fail spectacularly with little effect on the overall health of the NCUSIF.

- Credit unions have raised concerns about several of the proposed definitions, and we urge the agency to revise some of them if the rule proceeds. For example, we urge NCUA to change the definition of a loan participation to: "a loan where more than one eligible organization participates in ownership of the loan pursuant to a written agreement with the originating lender."
- We also request that NCUA change the definition of originating lender to mean "the lender with which the member contracts for a loan or, in the event such lender is no longer an owner of the loan, who, thereafter or concurrently with the funding of the loan, sells participations to other lenders."
- Allow credit unions ample time to prepare for compliance. Depending on how extensive the changes would be, we do not think 12 months is unreasonable for compliance with new concentration limits.
- Reissue the revised proposal for further comments from the credit union system.

Conclusion

We urge NCUA to withdraw this proposal, which cannot be justified in its current form, at least not based on the limited information that NCUA has provided in the Supplementary Information to the proposal.

Rather than going forward with the proposal, which credit unions fear will needlessly limit sound loan participation programs, we urge the agency to consider the alternatives CUNA is recommending to address safety and soundness issues adequately but without unduly disrupting loan participation or lending programs. If NCUA determines that a new rule must be issued – which we do not agree is necessary – we urge the agency to make the revisions we have identified, at a minimum.

We would welcome the opportunity to discuss CUNA's concerns about the proposal and our recommendations with agency officials.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
CUNA Deputy General Counsel and Senior Vice President