California CREDIT UNION LEAGUE NEVADA CREDIT UNION LEAGUE

Filed via: regcomments@ncua.gov

February 13, 2012

Ms. Mary Rupp
Secretary to the Board
National Credit union Administration
1775 Duke Street
Alexandria, VA 22314

Re: Comments on Proposed Rule on Loan Participations

Dear Ms. Rupp:

On behalf of the California and Nevada Credit Union Leagues, I appreciate the opportunity to comment on the Board's proposal to amend NCUA's loan participation rules. In addition to expanding loan participation requirements to federally-insured, state-chartered credit unions, the proposal would impose new limitations on participations and add minimum requirements regarding loan participation policies and agreements. By way of background, the California and Nevada Credit Union Leagues (Leagues) are the largest state trade associations for credit unions in the United States, representing the interests of more than 400 credit unions and their 10 million members.

**The Leagues' Position**

The Leagues' strongly oppose the proposed changes and urge NCUA to withdraw them. We find the data presented in the proposal that is intended to support this regulatory action to be flawed and unconvincing, and the claim that loan participation activity creates more systemic risk to the share insurance fund to be unsupportable. Beyond these fundamental—yet critical—flaws, we believe that some the specific proposed requirements reflect a misunderstanding of loan participation relationships, and will have a significant, negative impact on credit union participation lending. Last fall, Chairman Matz affirmed her support of President Obama's Executive Order 13579 (*Regulation and Independent Regulatory Agencies*) by stating that "regulatory modernization means effective regulation, not excessive regulation." We believe this proposal is antithetical to that stated approach, and will provide details of our concerns in the balance of this letter.

**Flawed Data Provided in the Proposal**

It is critical to point out that ambiguity contained in the Call Report instructions has resulted in an overstatement of loan participation delinquency and charge off data. The instructions state:

2855 E. Guasti Road, Suite 600 • Ontario, CA 91761-1250 • 909.212.6000
PO Box 51476 • Ontario, CA 91761-0076 • 800.472.1702 • www.ccul.org • league@ccul.org

> **10b. Participation Loans.**
> Report the total outstanding loan balance of all delinquent loan participations.
>
> **10. Participation Loans**.
> Report the dollar amount of loans charged off year-to-date from loan participations on the left. Report the dollar amount of recoveries year-to-date from loan participations in the right column.

The instructions do not clarify whether these loan participations are those sold or purchased. In reviewing Call Report data, it seems that most credit unions report delinquency and charge off figures for loan participations purchased. However, it appears that several credit unions report delinquency and charge off figures for the retained portion of loans which have been sold. *(Note: these credit unions were identified by noting that their reported participation loan delinquency was higher than the total loan participations purchased.)* As a result, loan participation delinquency and charge offs are overstated. Correcting this issue for September 2011 data lowers the industry-wide loan participation delinquency ratio by 13 percent and the net charge off ratio by 25 percent.

In actuality, net charge offs for participation interests have generally been better than non-participation loans held by credit unions. The average annualized net charge off ratio since December 2007 is 0.84 percent for participation interests and 0.95 percent for other credit union loans. In 2011, 90 percent of all credit unions with loan participation portfolios experienced a charge off ratio of less than one percent. In addition, 84 percent experienced no charge offs at all. This has been consistently true even as all financial institutions saw increased credit risk from 2009 to 2011.

The few credit unions which incurred charge offs in their loan participations portfolio had the earnings and capital necessary to absorb these losses. In 2011, the average amount of the annualized charge offs for these credit unions was 1.8 percent of their net worth, or 0.097 percent of total assets. Only nine credit unions experienced participation related charge offs which exceeded 10 percent of net worth. Obviously, the vast majority of credit unions are able to adequately underwrite participation loan purchases and have sufficient capital to absorb related losses if they occur. For more information, the Leagues direct NCUA to the substantive data provided in comments submitted by Evangelical Christian Credit Union.

In our opinion, not only does NCUA not provide conclusive support for the presumption that participated loans are riskier than non-participated loans, but the corrected data shows that the delinquency and charge off performance of participation interests held by state-chartered credit unions is almost identical to federally chartered credit unions.

**NCUA's Claim of "Systemic Risk"**

In the proposal, NCUA invokes the concern of systemic risk to the share insurance fund as justification for expanding it loan participation requirements to federally-insured, state-chartered credit unions, as well as imposing new limitations on participations. However, NCUA provides no data to support this assertion. According to Call Report data, 1,458 federally-insured credit unions reported almost $12.8 billion in outstanding loan participations as of September 2011. This is equal to 2.25 percent of the credit union loan balances. In addition, there are 117 federally-insured credit unions (approximately four percent of all federally-insured credit unions) that have outstanding loan participations in excess of their net worth. Outstanding loan participations at these credit unions equal $3.2 billion. Finally, there are only 20 credit unions with a risk exposure greater than 300 percent of their net worth, with approximately $764 million in outstanding balances. We believe it stretches the limits of credulity to suggest that such amounts rise to the level of systemic risk.

Further, as we indicated in the previous section, the vast majority of credit unions are able to adequately underwrite participation loan purchases and have sufficient capital to absorb related losses if they occur. Several factors contribute to low charge off rates:

- In general, loan participations are individually and carefully underwritten by both the originating credit union and each participant purchaser, as opposed to desktop or automated underwriting with consumer mortgage, auto, and credit card financing.
- Most loan participations—whether consumer or commercial—are secured by real estate. Although real property values have fallen over the past few years, the recovery value of the collateral is still superior to auto loans and unsecured credit, such as student loans and credit cards.
- The majority of participation loans are real estate secured business loans to members who are owner-users. These borrowers have a stronger interest in retaining the property than an investor would.

If NCUA intends to impose new restrictions on this segment of lending based on perceived "systemic risk," fairness and reasonable rulemaking demand that NCUA provide a definition of such a term, along with careful qualitative analysis supporting the claim that participation loans create more systemic risk. Until NCUA sufficiently addresses this issue, as well as the issue of overstated delinquency and charge offs, the Leagues remain firmly opposed to this change as proposed and urge NCUA to withdraw it.

**The Proposal Threatens Dual Chartering**

The Leagues are very concerned that the proposal would usurp each state's right to exercise authority in this area, and would serve to seriously undermine the dual chartering system. A strong, diverse dual chartering system allows the system to work together on common challenges affecting the entire system and the continued strength and growth of credit unions. It ensures that the federal and state credit union systems challenge each other to constantly improve.

Through the dual chartering system, state governments were able to pioneer innovative new financial services. It was through the dual chartering system that the NCUSIF 1% recapitalization came into being, having been first created by private share insurers. The dual chartering system also brought share drafts, ATMs, real estate mortgage lending, home equity loans, and field of membership diversity to credit unions. In fact, it is important to remember that it was on the state level that credit unions were first created in the United States.

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, and denying state regulators the opportunity to regulate these issues with their credit unions (including involvement in waiver requests), the proposal would further erode the traditional and essential role that dual chartering plays as a part of the national system of credit unions. The Leagues oppose efforts—such as this proposal—to preempt state authority without a clear and certain threat to the share insurance fund.

**Limit on Purchases Involving a Single Originator**

While we believe that the concerns raised above are more than sufficient to justify withdraw of the proposal, we have an additional concern with regarding NCUA's proposal to limit loan participation purchases involving a single originator to a maximum of 25 percent of a FICU's net worth. In our view, the shortcomings and negative consequences of this requirement underscore NCUA's misunderstanding of loan participation relationships, and strengthen our opposition to the proposal.

The Leagues believe that imposing an arbitrary 25 percent of net worth cap on loan participation purchases will have a negative impact on the loan participation market, reducing financing available to credit union members, without mitigating the associated risks. In fact, it is unclear what risk is being mitigated by this proposed restriction. This restriction does not mitigate credit risk, which is quantified and addressed through the application of underwriting standards set forth in the loan participation policy. The risk that this limitation appears to address is the potential failure of the servicer. If that is the case, that risk is more appropriately mitigated through the appropriate due diligence by the purchasing credit union of the loan servicer.

Effective loan participation programs are built on ongoing due diligence and time-tested performance. In most of these relationships, credit unions have done extensive due diligence on each other; they tend to know each other well, and have a high confidence level in the quality of the loan products they buy from each other. Many credit unions limit the number of entities that they purchase from in order to adequately monitor them a regular basis. Some of these relationships are built around a commonly owned CUSO, where the CUSO provides uniform origination, underwriting, and servicing.

This requirement would force credit unions from dealing with one or two stable, reputable participation originators to having to work with multiple, lesser-known originators. This will serve to increase risk, not mitigate it, and to increase due diligence costs. Small credit unions, in particular, may not have the capacity or expertise to underwrite and monitor multiple originators.

As a result, many credit unions will have a much more difficult time acquiring and maintaining quality earning assets. Ultimately, the proposed restriction will result in fewer loans available to small businesses and non-profit organizations. This will have the opposite result of President Obama's Executive Order that requires new regulations, among other factors, to "promote economic growth, innovation, competitiveness, and job creation."

Rather than imposing such an arbitrary and harmful standard (which, it should be noted, has no parallel in the federal banking regulations), credit unions should be encouraged to adopt a loan participation policy with a limit on loan participations purchased from a single originator, without prescribing what that limit should be. This is similar to the approach the NCUA utilized in the recently finalized Interest Rate Risk Rule.

In closing, the Leagues urge NCUA to carefully consider the positive benefits that loan participations provide credit unions, and to recognize the significant negative impact the imposition of such requirements would have on credit unions' earnings, costs, liquidity, and member financing needs. We do not believe it is unreasonable for NCUA as a safety and soundness regulator to consider whether additional rules are required to address current or potential problems. However, by utilizing flawed Call Report data and providing no valid argument as to how participations create systemic risk, NCUA has not sufficiently demonstrated the need for further regulation in this area.

Thank you for the opportunity to comment.

Sincerely,

Diana R. Dykstra
President/CEO