CREATING OWNERSHIP AND ECONOMIC OPPORTUNITY

February 21, 2012

Ms. Mary Rupp
Secretary to 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 FR 79548

Dear Ms. Rupp:

We are submitting these comments on behalf of Self-Help Credit Union and Self-Help Federal Credit Union (collectively "Self-Help") regarding NCUA's proposed amendments to NCUA's loan participation regulations. Between the two credit unions, Self-Help serves nearly 90,000 members across North Carolina and California and manages $950 million of assets on behalf of its members. Self-Help has substantial experience with participation loans that is relevant to this proposal.

While we commend NCUA's efforts to ensure that loan participation practices are updated as a result of the experiences of the Great Recession, we strongly urge the NCUA Board to substantially alter the proposal for the following reasons:

1. The proposal to apply the rule to federally-insured state-chartered credit unions (FISCUs) over-steps NCUA's role as the insurer of FISCUs to regulate the powers of state-chartered and supervised corporations. We believe the proper role for NCUA is to supervise the exercise of those powers through examination, enforcement and guidance, rather than to proscribe the activities themselves, which inappropriately federalizes state-chartered institutions.

2. The general intent of this rule to reduce participation loans may actually increase risk for credit unions rather than reduce it. In our experience, well-underwritten participation loan purchases and sales can help credit unions reduce risk. Purchasing credit unions use participation loan acquisitions to prudently deploy excess liquidity into higher-yielding, high-quality assets, thereby increasing their net income and net worth when loan demand from their own members may be low, while also reducing concentration risk. Similarly, the sale of loan participations grants credit unions with liquidity constraints the ability to continue serving their members without taking undue risk through additional leveraging of their net worth with high-rate deposits and outside borrowings.

In particular, NCUA should not establish a uniform, hard limit on the amount of loan participations that a credit union – federal or state-chartered – can purchase from a single originator. Such limits should be left up to the board of individual credit unions based on the credit union's assessment of risk associated with buying participation loans from any given originator, subject to state and federal supervision. While we support NCUA requiring credit union boards to establish such limits, we do not believe a "one-size fits all" regulation on this limit is appropriate, particularly at the extremely low threshold of 25 percent of net worth.

3. Self-Help encourages NCUA to use this opportunity to support Treasury-certified community development financial institutions (CDFIs) by expanding the eligible organizations from which federal credit unions can purchase participation interests to include CDFIs. Doing so is consistent with Congressional, Administration and NCUA efforts to increase community development impact via CDFIs.

4. Self-Help asks NCUA to clarify language in the proposed regulation on what constitutes the purchase of a part or all of a member loan subject to §701.23 as distinct from a participation loan subject to §701.22. The regulation should clearly state that the purchase of any interest in a member loan, whether a participation interest or whole loan, is governed by §701.23, whereas the purchase of any non-member participation is governed by §701.22. The proposed language is ambiguous and subject to multiple interpretations.

<u>1. The participation regulation should not apply to state-chartered credit unions.</u>

<u>NCUA has not documented its legal authority to apply its participation regulation to state-chartered credit unions.</u>

Self-Help Credit Union was chartered in 1983 by the state of North Carolina. Since that time, the credit union has, with some frequency, purchased participation loans from, and sold participation loans to, our sister non-profit CDFI loan fund, Self-Help Ventures Fund. During the past 29 years, we have had no indication from either NCUA or the North Carolina Credit Union Division that our participation program or the state's supervision (or lack thereof) of those activities has created safety and soundness issues for our credit union.

As a state-chartered credit union, our legal authorities – to lend, provide savings, service member accounts, acquire assets, etc. – derive from state law. NCUA's role is generally limited to ensuring that we exercise those powers in a safe-and-sound manner.

<u>The proposed regulation over-reaches in defining who a state-chartered credit union can buy participation interests from and what on-going role the originator must play in participated loans.</u>

As proposed, §701.22(b), would read: "a credit union may purchase a loan participation from an *eligible organization*" (emphasis added), which is defined in §701.22(a) to mean a credit union, bank, governmental agency or CUSO. As such, our purchase of participation loans from our sister CDFI loan fund, which is a North Carolina charitable non-profit corporation, would be prohibited because the seller would not qualify as an eligible organization under the proposed regulation. We do not believe NCUA has, or should have, the authority to determine what type of lender a federally-insured, state-chartered credit union (FISCU) can buy loans from, as that authority derives from state law.

NCUA also proposes requiring the "*originating lender's* continuing participation throughout the life of the loan" (emphasis added). We do not believe NCUA has the legal authority to mandate that a FISCU only participate in a loan with an originator. NCUA should not prohibit a FISCU from participating in a loan that another lender has purchased in its entirety from the originator.

We similarly do not believe NCUA can or should require originating lenders to maintain a 10 percent interest in a loan that is participated to a FISCU. This limitation is specifically enumerated in the Federal Credit Union Act for federal credit unions only. The fact that Congress expressly established that specific statutory standard for federal credit unions while being silent on a similar mandate for FISCUs indicates an intention to defer to state law on the continued participation role for originators and sellers of participation interests to FISCUs.

Congress generally has not expressed its intent to apply the Federal Credit Union's Act Title I provisions to FISCUs. The fact that Congress has limited the powers of all federally-insured credit unions including FISCUs in particular cases, as with the cap on member business loans, indicates that there is no general Congressional intent to apply other FCU limitations to FISCUs.

<u>NCUA has not adequately demonstrated that FISCUs, as a whole, engage in unsafe and unsound participation lending.</u>

In order to apply the standards of an existing regulation promulgated under Title I to FISCUs, NCUA should be required, at a minimum, to demonstrate that FISCUs are inherently likely to take undue risks because their legal authorities are not adequately defined and/or they are inadequately unsupervised in those activities on a broad basis, i.e., in most states. Otherwise, NCUA should supervise the activities of FISCUs on a case-by-case basis and/or through guidance, rather than proscriptive regulation. The facts that NCUA establishes in its proposal fail to establish a pattern of undue risk taking and inadequate supervision.

NCUA cites that FISCU loan participation delinquency and charge-offs have been consistently higher than FCU loan participation delinquency and charge-offs since 2007. This analysis is intended to imply that there is a causal relationship between being a FISCU and having higher loan participation delinquency. Based on the same data, one might hypothesize that FISCUs have historically invested in participations more often in states that have suffered more severely in the Great Recession, such as California, rather than that participation loans, *per se*, caused greater FISCU loan defaults and losses.

NCUA cites systemic risk as a reason for federalizing regulation of participation loans, but there is little data to back-up that concern. According to NCUA's data, the charge-off ratio for loan participations, at 0.84 percent from December 2007 to September 2011, has actually been lower since the onset of the recession in 2007 than for other credit union loans, which have averaged 0.95 percent charge-offs.

If the issue is limited to a relatively small number of FISCUs, such as the 68 FISCUs that had loan participation delinquency in excess of 10 percent as of June 30, 2011, NCUA should use its supervisory authority over those credit unions to help them resolve their specific problems, rather than applying a "one-size-fits-all" regulation to 3,000+ FISCUs that have demonstrated no deficiencies in this area.

<u>In lieu of applying regulations to FISCUs, we encourage NCUA to provide updated guidance to all federally-insured credit unions, including FISCUs, on best practices in participation lending.</u>

Even when participation loans are re-underwritten by a purchasing credit union, Self-Help agrees with NCUA that participation loans create unique risks that cannot simply be resolved by re-underwriting the loans and having a good participation agreement with the selling institution. In particular, there are multiple parties involved in approving any non-standard actions, e.g., modifications, workouts, and foreclosure. As such, we encourage NCUA to provide updated guidance on best practices, based on NCUA's experience supervising credit unions since NCUA last issued guidance on loan participations in 2008.

Some of the proposed requirements in this regulation are appropriate guidance for FISCUs. It is our experience that both examiners and credit union leaders are hesitant to over-step NCUA guidance. As such, NCUA guidance has the appropriate effect of limiting exceptions, while permitting credit union boards to prudently manage their own institutions in the best interest of their members if such exceptions are warranted, subject to on-going supervision.

<u>2. The proposed limits on participations, particularly the limit on purchases from a single originator, are too low, even when applied only to federal credit unions.</u>

<u>Participations can increase net income, net worth and diversification for credit unions.</u>

Purchases of participation interests in loans can enhance the financial stability of credit unions. Developing a relationship with a sound third party to acquire interests in good loans can be beneficial to struggling credit unions. In two cases, Self-Help Credit Union sold some of our strongest loans to other North Carolina credit unions that had excess liquidity and income challenges. In both cases, the loan sale helped the acquiring institution stabilize earnings. We have seen other credit unions do this as well. The fact that there was a single, strong seller actually reduced risk for the purchasing credit union by ensuring operational simplicity, consistent underwriting and reliable servicing. The purchasing credit unions were familiar with our practices and systems and therefore did not have the pressure to buy from multiple originators in the name of originator diversification.

<u>The proposed limit on purchasing participation interests from a single originator of 25 percent of net worth is too low and a uniform limit via regulation should not be established.</u>

Self-Help, including Self-Help Federal Credit Union, does not support NCUA establishing a single originator limit based on a percentage of net worth. Instead, any credit union that purchases participations in loans should address the risk of single originator concentration in a board-approved policy, as the risks involved vary by credit union, subject to prudent supervision. NCUA's proposed limitation on single-originator limits appears to be unique in financial regulation, as we are not aware of any federal or state banking regulator that establishes a single-originator purchase limit in statute or regulation.

In some cases, purchasing institutions acquire participation interests in loans from credit unions whose activities are unfamiliar to the purchaser. In such a case, it would be prudent for the board of directors to set a relatively low initial threshold, either as a percentage of net worth and/or absolute dollar amount. In other cases, a purchasing credit union may have deep familiarity with the underwriting and servicing practices of a seller, in which case, the board of directors might establish a higher threshold.

Credit unions are inherently concentrated entities. Every credit union was chartered to serve a single employer, association or narrow geography. Purchasing loan participations can help diversify credit unions' loan portfolios, since the selling institution is likely to have a somewhat different field of membership. Assuming purchasing credit unions perform adequate due diligence and are protected by a good participation agreement, acquiring loans from a single originator with a different field of membership (or customer base for non-credit unions) reduces concentration risk. Doing so with multiple sellers may appear to further reduce concentration risk but may inadvertently lead credit unions to purchase participations from institutions with which they are less familiar. The potential lack of a willing seller may prevent loan participation purchases that could otherwise stabilize the purchasing credit union's net income and net worth.

<u>The proposed limit is particularly onerous for small credit unions.</u>

While we do not support the general intent of the proposed rule to curtail participations as a whole, we particularly believe that the proposed 25 percent limit is onerous on small credit unions, which have less capacity to underwrite and negotiate with multiple originators. Take, for example, a credit union with $20 million in assets and $2 million of net worth. The proposed limit would preclude that credit union from purchasing more than $500,000 of participations from a single seller. The inefficiency of having to assemble multiple loans that aggregate less than $500,000 will discourage sellers from considering a participation sale to this relatively small credit union.

In the proposed regulation, NCUA acknowledges that the Regulatory Flexibility Act requires NCUA to analyze the impact of the regulation on small credit unions of any proposed regulation. We believe NCUA's analysis is inadequate in assessing the impact on small credit unions, in that it provides no data of the current or potential participation loan activity of small credit unions and only defines small as institutions under $10 million in total assets. Instead, NCUA provides a broad assertion "[g]enerally, smaller credit unions are not actively involved in loan participation transactions." NCUA should be required to identify small credit unions that are, or might become, involved in loan participation activity and assess the impact on those credit unions of the proposed regulations.

It is our experience that many credit unions under $50 million asset range would generally be deemed to be small in that they have a single branch with limited staff. These credit unions are the very institutions most in the need of the regulatory flexibility necessary to survive and adapt. As an example from our own history, Self-Help Credit Union's ability to partner with its larger sister non-depository CDFI was critical to our credit union's growth when the credit union was relatively small.

Smaller credit unions disproportionately bear the brunt of new regulations, as their resources are limited. In this instance, any such credit union wishing to purchase participations is particularly hampered by the single-originator limit. They would have to identify multiple sellers willing to sell relatively modest participation portfolios; perform due diligence on the seller and the loans; negotiate numerous participation agreements; and track their investments from multiple originators.

<u>If FCUs are subject to a hard limit on participations from a single originator, it should be much higher than 25 percent of net worth.</u>

In the event that NCUA finds it necessary to establish a limit on purchasing participation loans from a single originator, we recommend NCUA establish a substantially higher limit than 25, or even 100, percent of net worth. We suggest a figure of 400 percent of net worth, comparable to NCUA's derivatives pilot program limit on the notional amount of interest rate swaps that a participant can have outstanding.

As noted previously, Self-Help Credit Union has sold whole loans to smaller credit unions twice in the past ten years to help stabilize those credit unions financially. More recently, we are aware of a struggling state-chartered credit union with $25 million in assets that purchased about $7 million of whole loans from another credit union. In this instance, had the purchase been a participation purchase rather than a whole loan purchase, a cap even as low as 100 percent of net worth from a single issuer – $2.5 million, or 10 percent of assets, for the purchasing credit union – would have been harmful. In that case, the purchasing credit union would have had to forego the income on $5 million of high-quality mortgage loans because of an artificial cap on the originator itself that has nothing to do with the quality of the originated loans.

NCUA already has two significant tools that prevent credit unions from taking undue concentration risk. First, the maximum amount that can be loaned to a single borrower or associated borrower group is 15 percent of net worth. In the above loan sale, where the small credit union used a single source seller for roughly 30 percent of assets, the loans themselves were from a broadly diverse set of borrowers, effectively eliminating any concentration risk associated with single source origination. Second, NCUA has the member business loan (MBL) cap that limits credit union ownership of business loans to the lesser of 12.25 percent of assets or 175 percent of net worth.

Beyond matching liquidity needs between credit unions, the single most common motivation for selling participation loans is to comply with the statutory cap on MBLs. Indeed, one analysis indicates that over 60 percent of all participation loans are either member business loans or business-purpose loans that do not meet the MBL definition. As such, credit unions are already effectively limited in the amount of business loan participations they can purchase by the MBL cap, which make up all, or most of, their participation activity. There is no need for an additional cap just for participations.

To the extent that credit unions buy participation interests in non-business loans, the generally smaller loan size of residential mortgages, auto loans and unsecured loans creates a diversity of end borrowers that largely offsets any single-originator concentration risk, such that we do not believe any cap on purchasing participation interests in non-business loans from a single originator is required.

If NCUA believes that a hard single-originator cap is necessary, we suggest 400 percent of net worth. This figure has precedence in NCUA's derivatives pilot program, whereby participating credit unions are permitted to have the notional amount of derivatives outstanding equal 400 percent of net worth. Similar to single-originator quality risk in participation loan purchases, the notional amount of interest rate swaps outstanding is a proxy for an uncertain, unquantifiable risk, as interest rate swap counterparties are required by regulation and prudent management to collateralize any actual exposure.

<u>If FCUs are subject to a hard limit on participations loan purchases from a single originator, the Regional Director should be allowed to waive the limit on a case-by-case basis.</u>

Self-Help sympathizes with NCUA's challenge of balancing a need to avoid "one-size fits-all" regulations that create straight-jackets for well-run credit unions with the need to protect the National Credit Union Share Insurance Fund from the mistakes of a handful of credit unions with inadequate controls. While we believe the appropriate solution to such a problem is strong supervision and clear regulatory guidance, we strongly encourage NCUA to provide for waiver authority if a hard limit is imposed.

As we have described in this letter, we believe that loan participation purchases can often be beneficial for credit unions, and that establishing a modest number (one or more) of relationships reduces operating costs for both purchasers and sellers and can reduce risk for both. As such, we believe it is appropriate for NCUA to grant a waiver from the single-seller cap if a purchasing credit union can adequately demonstrate that it has performed adequate due diligence on a particular seller, properly re-underwrites the loan participations being acquired, and addresses how exceeding the cap does not create undue concentration risk for the purchasing credit union.

<u>If FCUs are subject to a hard limit on participation loan purchases from a single originator, Treasury-certified CDFI and low-income credit unions should be exempt from the cap.</u>

The FCU Act recognizes that low-income and/or certified CDFI credit unions often have a history of investing in community development-focused business, consistent with Congressional policy goals of strengthening low-income and disadvantaged communities. As a result, Congress expressly exempted certified CDFI credit unions and low-income credit unions from the statutory cap on MBLs when it established the MBL cap in 1998.

As any credit union – CDFI, low-income or otherwise – that originates MBLs must have demonstrated experience in business lending, granting CDFI and low-income credit unions an exemption from a cap creates no greater risk to the credit union than that same credit union otherwise exceeding 12.25 percent of assets for its MBL program through direct originations. Providing such exception authority for CDFI and low-income credit unions increases community development impact, which is consistent with Congressional and Administration intent to not restrain the MBL activity of such credit unions. At the same time, granting greater participation volume authority provides a critical avenue for these credit unions, many of which work in communities with particularly low loan demand during and since the onset of the recession, to diversify their loan portfolios and enhance net income and net worth.

3. Self-Help recommends amending the participation loan regulation to permit purchases of participations from Treasury-certified CDFIs.

Self-Help appreciates NCUA's goal of establishing a minimum threshold for the soundness of the practices of a seller, which presumably drives the requirement that selling institutions be credit unions, CUSOs, banks or government agencies, all of which have some level of governmental supervision. At the same time, Congress and the Administration have invested substantial public resources over the past two decades, particularly in the last three years, to strengthen communities via the CDFI program of the U.S. Treasury.

These efforts include consistent funding for the CDFI Fund grant programs, which has been increased by Congress in recent years; the creation of the CDFI Bond Guaranty program in 2010, which authorizes the Treasury to guarantee bonds issued by CDFIs; and the Administration's Community Development Capital Initiative, which invested nearly $90 million in CDFI credit unions as secondary capital in 2010. The CDFI Fund of the U.S. Treasury has had a formal certification program for CDFIs that provides partial government oversight of CDFIs since 1994.

We believe that it is consistent with these public efforts to strengthen communities through the CDFI program for FCUs to be permitted to buy participation loans from CDFIs. While CDFI loan portfolios have performed remarkably well through and since the Great Recession, many non-depository CDFIs have found their biggest challenge to be liquidity during this time of financial market dislocation. As such, providing liquidity to non-depository CDFIs by acquiring loan participations would strengthen CDFIs and the communities that CDFIs serve. As noted earlier in our comment, some non-depository CDFIs, such as Self-Help's sister organization, Self-Help Ventures Fund, routinely partner with credit unions. We strongly encourage NCUA to strengthen these partnership opportunities by extending FCUs authority to purchase participation loans to loans sold by CDFIs.

Non-depository CDFIs are almost exclusively structured as not-for-profit, charitable corporations. As such, they do not have a profit motive that would justify their taking undue risks with their lending that might be otherwise passed-on to a credit union that purchases a participation interest in their loans. Federal and state law have long recognized that not-for-profits, including lenders, merit broader discretion because of this lack of profit motive.

<u>4. Self-Help asks NCUA to clarify the language in the proposed regulation on what constitutes a purchase of a whole loan subject to §701.23 as compared to a participation loan subject to §701.22.</u>

NCUA proposes amending the participation regulation to read: "[g]enerally, a federally-insured credit union's purchase of all or part of a loan made to one of its own members, where no continuing contractual relationship between the seller and purchase is contemplated, is governed by §701.23 of this chapter." We do not understand the language in this sentence. We assume NCUA wishes to delineate between participated <u>non-member</u> loans, which are governed by §701.22, and the acquisition of any interest –whole or part – in a <u>member</u> loan, which is governed by §701.23.

First, we do not believe there should be a prohibition against a "continuing contractual relationship" between seller and purchaser of a member loan, whether whole or part. We can imagine at least three on-going "contractual relationships" that could arise in the situation this sentence is describing – shared-ownership/participation in a member loan, servicing and recourse – and all three should be permitted.

<u>Buying a part (participation) of a member loan implies an on-going contractual relationship.</u>

We do not believe the phrase "or part of a loan" can be consistent with having no "continuing contractual relationship". Presumably the purchase of "part of a loan" indicates that the seller will retain a share of the loan itself. Any loan that is owned by two or more lenders must be governed by a legal contract, and as such, there is a continuing contractual relationship.

<u>Servicing all or part of a member loan for a credit union is a continuing contractual relationship.</u>

We assume NCUA is not suggesting that purchases of whole member loans be governed by §701.22 if the originator retains servicing. If a credit union can contract with a third party to service loans it originates, presumably a credit union could contract with the third party who sells it a whole member loan or participation interest in a member loan to service those loans. In fact, it is probably beneficial to do so, as the borrower has an on-going loan payment relationship with the seller, which may well reduce credit risk for the purchasing credit union.

<u>Having the seller retain a recourse obligation in a loan is a continuing contractual relationship.</u>

When the selling institution has a right or obligation to repurchase a member loan, that reduces the credit risk to the purchasing credit union. For example, if a credit union buys 90 percent of a <u>member</u> loan, with recourse to the originator, wouldn't that be of benefit to the purchaser and NCUSIF, especially if the seller is a non-credit union? As such, seller recourse on a member loan seems like a contractual relationship that NCUA should encourage. More obviously, if a credit unions buys a whole member loan with recourse to the originator, that loan could not fall under §701.22 since it's not a "participation" and as such, the regulation should state unambiguously that it is governed by §701.23.

We assume that NCUA's primary intent with this proposed sentence is to clarify that the §701.22 only applies to purchases of participation interests in loans to non-members. In addition, we have already articulated our belief that the definition of what participations a FISCU can purchase should be excluded from this regulation. As such, we recommend that the sentence read: "A federal credit union's purchase of all or part of loan made to one of its own members is governed by §701.23 of this chapter." Eliminating the word "generally" and the second clause would provide substantial clarity to regulator and regulated, alike.

Summary

Thank you for the opportunity to comment on this important issue. While we commend NCUA's efforts to clarify the participation loan regulation and ensure that credit unions are engaged in safe and sound participation lending activity, we do not believe the proposed regulation strikes an adequate balance between prudent regulation and providing credit unions with the tools to strengthen their financial condition. We further believe that the regulation's proposed application to FISCUs exceeds NCUA's authority and appropriate role as the insurer of state-chartered credit unions, improperly federalizing the powers of state-chartered credit unions.

We therefore encourage NCUA to either substantially re-write the proposed regulation to reduce its impact on state-chartered credit unions and eliminate or otherwise increase the limit on participation loan purchases from a single originator. We would be glad to provide additional suggestions on otherwise revising the participation regulation. We encourage NCUA to take this opportunity also to look at ways to update its regulation by adding certified CDFIs to the group of institutions from which credit unions can purchase participation interests.

Sincerely,

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President, Self-Help Credit Union

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