Thomas M. Petro
President and Chief Executive Officer
215-682-4101 phone
215-682-4144 fax
484-467-6322 cell
tpetro@foxchasebank.com

FOX CHASE BANK®
ESTABLISHED 1867

August 19, 2015

Gerard S. Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

Re: Comments on Proposed Rulemaking for Part 723

Dear Mr. Poliquin:

I am writing in response to the National Credit Union Administration's (NCUA's) proposed rulemaking for Part 723[1]. As President and CEO of Fox Chase Bank, a 148-year old $1.1 billion asset bank chartered by the Commonwealth of Pennsylvania, the proposed rulemaking for Part 723 will expand the unfair advantage that credit unions enjoy and will bring harm to community banks, like Fox Chase Bank, that specialize in offering commercial loans and making business credit available to businesses. It appears the NCUA is offering new regulations for the purpose of circumventing Congressional authority and expanding the member lending cap.

There have been instances where some credit unions have failed to adequately manage the risks of their business lending activities and this has led to their failure and, in some cases, losses to the National Credit Union Share Insurance Fund. Poorly managed business lending activities were a contributing factor in the failure of at least five credit unions since 2010. The balance of my letter addresses a select group of the safety and soundness concerns raised by the Proposed Rule.

Small Lender Exemption Constitutes Unsafe and Unsound Business Lending Practice

The Proposed Rule would significantly alter NCUA's overall approach to regulating and supervising credit union commercial lending activities. It exempts from the requirements of proposed § 723.3 and § 723.4 credit unions with both assets less than $250 million and total commercial loans less than 15 percent of net worth that are not regularly originating and selling

[1] Federal Register Volume 80, No. 126, July 1, 2015.

4390 Davisville Road | Hatboro, PA 19040 | 866-369-2427 | www.foxchasebank.com

or participating out commercial loans (qualifying credit unions). Accordingly, qualifying credit unions, especially smaller institutions, which are only occasionally granting a loan(s) that meets the proposed commercial loan definition would be alleviated from the burden of having to develop a full commercial loan policy and commercial lending organizational infrastructure. The intent is to avoid the inclusion of credit unions that infrequently originate minimal amounts of loans that technically meet the proposed commercial loan definition, or that infrequently reduce their risk profile by selling or participating part of their loan portfolio.

There is no such exemption for banks and thrifts, either on account of the small size of the institution or for those who infrequently reduce their risk profile by selling or participating part of their loan portfolio. Business and commercial lending are risky activities that should only be undertaken with a thorough understanding of the risks involved, the enterprise-wide risk management capabilities to manage the risks effectively, and the expertise to identify credit deterioration and resolve problem credits through prudent workout strategies. Proposing to exempt the least experienced and most incompetent credit unions business lenders from rules and regulations that constitute safe and sound business lending practices is a supervisory failure on the part of the NCUA. This will lead to adverse selection thereby increasing the risk of loss to the insurance fund because the least sophisticated lenders end up writing the poorest quality and riskiest loans because they do not know any better and do not have the sophistication to understand the risks they are accepting. It appears to be at odds with the NCUA's primary mission to protect the insurance fund. What analysis has been conducted by the Board to determine that the losses on business lending for exempted institutions would not cause losses for the insurance fund?

Widening the Loopholes to Member Business Lending Cap Constitutes Unsafe and Unsound Practice

The Proposed Rule will widen the loophole to the member lending cap by specifying that non-member business loan participations do not count toward the statutory cap and by eliminating regulatory oversight of concentrations of such loans in credit union portfolios. This raises serious safety and soundness concerns for the credit union industry as a whole and especially for those credit unions that engage in risky commercial lending through participations[2]. The NCUA identified these risks in 2010 when it wrote, "Loan participation credit and concentration risks are increasing rapidly. Since 2005, purchased business loans and participation in non-members loans have more than doubled from $2.8 billion to almost $6.7 billion."[3]

[2] A participation is an arrangement in which a bank or credit union makes a loan to a borrower and then sells all or a portion of that loan to a purchasing bank or credit union. All documentation of the loan is drafted in the name of the selling bank. Generally, the purchasing institution's share of the participated loan is evidenced by a certificate which assigns an interest in the loan and any related collateral.

[3] NCUA Letter to Credit Unions 10-CU-02.

Given the magnitude and complexity of business loan participation risks, I wonder why it is prudent and beneficial for NCUA to weaken oversight and regulatory requirements, especially in light of the NCUA's acknowledgment and recognition that the risks involved and the magnitude of aggregate risk posed to the insurance fund, which the NCUA has primary responsibility to protect, have markedly increased.

In addressing the risks posed to banks and thrifts, the prudential banking regulators have strengthened underwriting and concentration requirements over such loans originated by banks and thrifts. For example, the Office of the Comptroller of the Currency (OCC) in its oversight of nationally-chartered banks and thrifts recognizes the purchase of loans and participations in loans may constitute an unsafe or unsound banking practice in the absence of satisfactory documentation, credit analysis and other controls over risk. The absence of satisfactory controls[4] over risk may constitute an unsafe or unsound banking practice and is cause for the OCC to seek appropriate corrective action through its administrative remedies. Satisfactory controls over the purchase of loans and participations in loans ordinarily include, but are not limited to, the following:

- written lending policies and procedures governing these transactions;
- an independent analysis of credit quality by the purchasing bank;
- agreement by the obligor to make full credit information available to the selling bank;
- agreement by the selling bank to provide available information on the obligor to the purchaser; and
- written documentation of recourse arrangements outlining the rights and obligations of each party.

In addition to these minimum requirements for engaging prudently in participations, the Federal Deposit Insurance Corporation (FDIC), Federal Reserve Board of Governors (Board) and OCC (collectively "the Agencies") have issued guidance concerning concentration limits and the requirement that the board of directors of institutions that engage in business lending participations ensure that management has appropriate oversight over the broad array of risks associated with this business activity. These prudent regulatory requirements which apply to banks and thrifts do not apply to credit unions and the proposed rule would further weaken safety and soundness for credit unions.

By contrast, the Agencies specify protocols in their respective examination handbooks which provide supervisory guidance to field examiners for the proper inspection and evaluation of compliance with the business participation lending risk management. Among the other risks identified with business loan participations is the counter-party risk[5] associated with the risk of default by one or more counter-parties to any business lending participation. The Agencies have issued guidance concerning how banks and thrifts must, *on a continuing basis*, perform detailed

[4] Office of the Comptroller of the Currency Bank Issuance BC-181 (REV).

[5] Federal Register / Vol. 75, No. 85 / Tuesday, May 4, 2010 / Notices, Pg. 23764.

credit and liquidity analysis of counter-parties to ensure that they are able to discharge their obligations pursuant to a participation agreement.

The Agencies have also issued Concentration of Credit Risk Guidance (CCR Guidance) that outlines the Agencies' expectations for financial institutions to identify, monitor, and manage credit and funding concentrations to other institutions on a standalone and organization-wide basis, and to take into account exposures to the correspondents' affiliates, as part of their prudent risk management practices. The guidance specifies that institutions also be aware of their affiliates' exposures to correspondents as well as the correspondents' subsidiaries and affiliates. In addition, the CCR Guidance addresses the Agencies' expectations for financial institutions to perform and document appropriate due diligence on all credit exposures to and funding transactions with other financial institutions.

The Proposed Rule ignores the high risks associated with business loan participations, does not hold credit unions to the same standards as banks and thrifts, relaxes oversight and inspection of these risky extensions of credit instead of strengthening it, and removes prudent concentration limits that would otherwise establish appropriate boundaries on the level of capital that credit unions may commit to this type of lending. As such the proposed rule threatens the Insurance Fund by exposing it to risks that would otherwise be avoided if credit unions were held to the same high standards as banks and thrifts. The elimination of regulatory oversight of concentrations raises serious questions about NCUA's supervisory role in managing safety and soundness risks associated with business loan participations.

Undermining the Statutory Cap Thwarts Congressional Authority

The Proposed Rule will nearly double the statutory cap on credit union business lending without Congressional approval. As drafted, the Proposed Rule will make the statutory cap on credit union member business lending meaningless by allowing certain credit unions to significantly exceed the member business loan statutory cap set by Congress. In 1998, Congress made it clear that credit unions should be focused on consumer lending, not commercial lending. Congress instituted restrictions on business lending deliberately: "to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings need of consumers, especially persons of modest means, through an emphasis on consumer rather than business loans."[6]

Over the last ten years, credit unions' business loan portfolios have experienced significant growth. Total business loans including unfunded commitments at federally insured credit unions grew from $13.4 billion in 2004 to $51.7 billion in 2014, an annualized growth rate of 14 percent. Business loans have also become a larger share of credit unions' loans and assets. During the same time period, business loans outstanding as a percentage of total assets grew from 1.9 percent to 4.3 percent, and business loans as a percentage of total loans grew from 3.0 percent to 6.8 percent. The percentage of credit unions offering business loans also increased significantly.

---

[6] Senate Banking Committee Report (105-193).

The NCUA has already strayed from Congressional intent by facilitating the rapid growth of business loans by credit unions. The Proposed Rule further circumvents Congressional authority with a new definition to distinguish between the commercial lending activities in which a credit union may engage, and the statutorily defined Member Business Loans (MBLs), which are subject to the aggregate MBL cap contained in the Federal Credit Union Act.[7] The Proposed Rule states that "only MBLs are subject to the statutory limits on the aggregate amount of MBLs that may be held by a credit union, per § 723.8 of the Proposed Rule. The Proposed Rule generally defines a ''commercial loan'' as any credit a credit union extends to a borrower for commercial, industrial, agricultural and professional purposes, with several exceptions. Specifically, the proposed definition expressly specifies that the following loans are <u>not</u> commercial loans: (1) Loans made by a corporate credit union; (2) loans made by a federally insured credit union to another federally insured credit union; (3) loans made by a federally insured credit union to a credit union service organization; (4) loans secured by a 1- to 4- family residential property (whether or not it is the borrower's primary residence); (5) loans secured by a vehicle manufactured for household use; (6) any loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions; and (7) any loan(s) to a borrower or an associated borrower, the aggregate balance of which is equal to less than $50,000."

By excluding from the definition of MBLs certain lending activities that would otherwise be deemed commercial loans and that would be treated as business loans by the Agencies, the NCUA effectively increases the amount of business lending in which a credit union may engage. This redefinition appears to be designed to circumvent the Congressionally-mandated cap by excluding certain business loans from the definition.

Lax Lending Policy and Procedures Constitutes Unsafe and Unsound Practice

While total business loans grew rapidly from 2004 to 2014, the NCUA has permitted unsafe and unsound business lending practices by means of lax regulatory requirements and supervision of credit unions compared to the standards to which banks and thrifts are held. Rather than strengthening prudent standards for credit union business lending commensurate with the rapid growth of credit union business lending, the Proposed Rule removes important safety and soundness checks and balances that the Agencies have long held as the minimum standard for safety and soundness.

<u>Personal Guarantees</u>

An example of lax lending policy and procedures which constitute unsafe and unsound practice is the Proposed Rule eliminating the requirement for personal guarantees.[8] Bank and non-bank

---

[7] 12 U.S.C. 1757a.

[8] A personal guarantee is an unsecured written promise from a business owner and or business executive guaranteeing payment on an equipment lease or loan in the event the business does not pay. Since it is

business lenders require a personal guarantee as an "added assurance" that the owner or executive is committed to the business and is committed to repaying the equipment lease or loan. A personal guarantee demonstrates to a lessor or lender that the owner is responsible and intends to repay all of their business loans or leases.

Loan-to-Value Ratios

A second example of lax lending policy and procedures which constitute unsafe and unsound practice is the Proposed Rule relaxation of the "loan-to-value ratio" (or "LTV") by excluding from the denominator outstanding exposures from other lenders that are subordinate to the credit union's lien position.

Credit Risk Rating

A third example of lax lending policy and procedures which constitute unsafe and unsound practice in the Proposed Rule is the credit risk rating system for commercial loans. It is true that the NCUA in its guidance[9] to credit unions references the OCC's 69-page "Rating Credit Risk," however, examination and inspection practices of the NCUA are not commensurate with those applicable to banks and thrifts as embodied in the various handbooks of the Agencies. Banks and thrifts are required to have credit risk ratings independently verified by qualified and competent independent third-parties on account of the importance of such ratings to a rational understanding of the risks embodied in their portfolios and proper reporting and accounting for the allowance for loan and lease losses, as well as accurate assignment of CAMELS ratings for supervised institutions.

NCUA properly notes that "an effective, accurate, and timely risk-rating system provides a foundation for the credit unions to assess credit quality and, ultimately, to identify problem loans. Risk ratings should be risk sensitive, objective, suitable for the types of loans underwritten, and reviewed regularly for appropriateness." The Proposed Rule defines "credit risk rating system" as a formal process to identify and measure risk through the assignment of risk ratings. That the Proposed Rule must now address credit risk ratings after credit union's business lending has swollen to nearly $52 billion of exposure indicates that the present credit risk rating system is inadequate and is cause for supervisory concern, especially given the rapid increase in credit union commercial lending activities and exposures. It also suggests that before the statutory lending cap is relaxed by operation of regulation, credit unions be given time to implement and prove that effective commercial credit risk management rating systems are in place and are effective.

Maximum Loan Amounts

A fourth example of lax lending policy and procedures which constitute unsafe and unsound practice in the Proposed Rule is the relaxation of the rules that govern maximum loan amount.

---

unsecured, a personal guarantee is not tied to a specific asset. However, in the event of non-payment a lender can go after the guarantor's personal assets.

[9] NCUA Letter to Credit Unions 10-CU-02.

The Agencies have established a maximum of 15 percent of a bank's or thrift's unimpaired capital as the limit of credit extensions to any single borrower or group of related borrowers. However, the proposed rule will allow credit unions to exceed the general limitation by 10 percent of the credit union's net worth, if the amount above the 15 percent limit is fully secured by readily marketable collateral.

The Proposed Rule is <u>not</u> consistent with the limit allowed by other regulators because, for a bank or thrift to qualify for the additional 10 percent limit, the bank or thrift must perfect a security interest in the collateral under applicable law and the collateral must have a current market value *at all times* of at least 100 percent of the amount of the loan or extension of credit that exceeds the bank's or savings association's 15 percent general limit. The Proposed Rule makes no such requirement on credit unions.

<u>Loan Approval Processes</u>

A fifth example of lax lending policy and procedures which constitute unsafe and unsound practice in the Proposed Rule relates to the loan approval process for business loans. It specifies that the credit union's policy must establish lending authority for approving credit decisions. A credit union must establish a process that assigns credit approval authority to individuals or committees making such decisions commensurate with the individual's or committee's experience in evaluating and understanding commercial loan risk. In addition, the approval authorities and system should ensure an adequate level of review and approval by senior management prior to the loan decision for complex and/or large loans or credit relationships. All lending authority limits should be assigned based on the aggregate loan relationship of the member and associated borrowers. The system should provide for adequate oversight and review of the loan approval process, with all loan approvals or denials tracked by loan department management and periodically reported to senior management. This is all well and good, but raises serious questions about the NCUA's oversight and inspection of $51.7 billion worth of business loans extended by credit unions through the end of 2014. That credit unions have been allowed to engage in risky business lending without the requirements for formal loan approval processes and board oversight is disturbing and raises concerns about the risks already embedded in the credit union industry that may threaten the Insurance Fund.

Finally, there are a myriad of other examples contained in the Proposed Rule that clearly demonstrate that credit unions are held to a very low standard of prudent business lending practices. The Proposed Rule only serves to highlight and emphasize that the credit unions are not supervised with the same high standards, nor inspected with the same rigor as banks and thrifts. This is cause for concern because the business lending practices of credit unions do not constitute safe and sound practices to which the Agencies hold banks and thrifts.

As noted previously, adverse selection results when the riskiest business loan opportunities migrate to the least capable and most inexperienced business lenders who do not perceive the risks they are accepting and are not sophisticated enough to understand that their "success" is driven by lax standards, weak underwriting and mispricing of the risks they are accepting. The lax standards to which credit unions that engage in business lending are held by the NCUA places the Insurance Fund in jeopardy of incurring significant future losses in the next market downturn, a phenomenon largely missed in the 2008-2009 by the credit union industry because of the relatively small aggregate exposure credit unions had to business loans in that cycle, which as the NCUA notes, is no longer the case. Even so, there were a number of credit union failures in the last cycle. Those that failed were operating with concentrations in business loans.

Furthermore, it clearly demonstrates that the NCUA's reporting of credit union CAMEL ratings is done on a basis that is incompatible with and not comparable to bank and thrift CAMEL ratings as published by the Agencies since credit unions are not held to the same business lending standards as are banks and thrifts.

Summary

The Proposed Rule poses serious safety and soundness concerns. NCUA has not established that it is prepared to supervise credit unions engaged with expanding business loan portfolios, and the credit union industry has proven ill-equipped to make such loans as evidenced by the lax business lending standards proffered by NCUA to date and the failure of at least five credit unions since 2010 because of unsafe and unsound business lending practices. For this reason, and the others cited in this letter, the NCUA should significantly enhance its member business lending proposal to ensure safe and sound business lending practices.

Sincerely,

Thomas M. Petro
President and CEO

cc:

The Honorable Robert P. Casey, Jr.
The Honorable Patrick J. Toomey
The Honorable Patrick Meehan
The Honorable Michael G. Fitzpatrick
The Honorable Brendan Boyle
The Honorable Ryan Costello
The Honorable Keith J. Rothfus
Mr. Duncan Campbell, President and CEO, Pennsylvania Bankers Association
Mr. James Ballentine, American Bankers Association