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August 26, 2015

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

Re: RIN: 3133-AE37 Member Business Loans; Commercial Lending

Dear Mr. Poliquin:

Eastman Credit Union (ECU) is a federally insured Tennessee state chartered credit union that serves over 161,000 members. ECU has been serving its members with member business loans since 2004. We appreciate the opportunity to provide comments to the National Credit Union Administration (NCUA) on its proposed amendments to the Member Business Lending (MBL) regulations.

Our comment letter is segmented into three sections, as follows:

- Support and concurrence with the Proposed Regulation
- Specific items where ECU recommends earlier implementation
- Items where ECU recommends further clarification, modification, or inclusion by NCUA

Support and concurrence with the Proposed Regulation

1. We support the proposed regulation and NCUA's shift from prescriptive regulation to a principles-based approach. There are a wide variety of credit union MBL programs in the industry and this approach allows each credit union to tailor the program to fit its strategic goals and risk tolerances.

   Business lending is not as commoditized as consumer and mortgage lending and a "one size fits all" approach is not appropriate for all situations. The current rule eliminates creditworthy transactions from consideration by credit unions. An approach to identify and manage risks in a prudent manner is a worthy goal and proper protocol.

2. We back the elimination of the minimum two-year experience requirement for underwriting MBLs. One standard is difficult, if not impossible, to identify and use for all MBL circumstances. ECU has consistently maintained staff with multiple years of experience to underwrite and manage the risks of its portfolio. The change requiring experience commensurate with specific loan underwriting and portfolio risk is prudent and practiced by ECU. This change will make it easier for ECU to consider and develop additional talent under the supervision of senior, qualified staff. [Proposed 723.4 (d)]

3. We affirm and recognize the need for senior executives to have a comprehensive understanding of the risks of a commercial lending program. ECU's senior management is intricately involved in the business lending operations and has been paramount to the long-term success exhibited by our MBL program. [Proposed 723.3 (b) (1)]

4. We support the distinction between loans secured by 1-4 family residential properties and commercial loans which require greater scrutiny. [Proposed 723.2]

5. ECU supports the elimination of the waiver requirements which are not mandated by statute. This represents a major regulatory improvement that we fully support and expands service opportunities to credit union members. However, as described later, we believe retaining a waiver process for the maximum aggregate net member business loan balance to any one member or group of associated members under the current §723.10 (h) would be beneficial for the credit union industry.

Specific Items Where ECU Recommends Earlier Implementation

The Proposed Regulation states that an 18 month implementation timeline will be required before the regulation goes into effect. We understand the need for credit unions and examiners to understand and implement regulatory changes. However, we believe that this extended timeline is unwarranted for certain items that are relatively simple. These changes will have a positive, material impact on credit union MBL programs and put credit unions on a level playing field with other financial institutions. These can be implemented by updating the business lending policy and making appropriate changes in procedures. Examples of practices that may be enacted more expeditiously include:

1. Credit Risk Rating System – Most credit unions actively engaged in business lending already have a credit risk rating system in place. Those that do not have a robust system can establish and implement one as an integral part of their MBL policy update. [Proposed 723.4 (g) (3)]

2. Unsecured Lending – Credit unions can effectively identity circumstances where appropriate and well-supported unsecured lending limits can be utilized. Credit unions can also set unsecured loan limits for loans to one borrower and portfolio limits that tie to net worth. These can be established in a credit union's policy and practices in a relatively short time period. [Proposed 723.5 (a)]

3. Personal Guaranties – ECU agrees with the Preamble to the Proposed Rule in that credit unions should obtain personal guaranties whenever possible. However, credit unions today are forced to turn away many excellent lending opportunities because of the regulatory mandated guaranties. While eliminating guaranties does pose additional risk, we believe this change can be implemented sooner in various ways. There are transactions where credit unions can manage risk effectively with the use of limited guaranty options before waiving a personal guaranty altogether. For example, credit unions are often asked to allow proportional guaranties when a business or property is owned by several individuals. Permitting this limited guaranty is a better alternative than declining a well-supported loan request when the owners are not willing to provide joint and several guaranties and have alternative financing options outside the credit union system. Another option would be to allow "carve-out" guaranties that would give the

credit union the ability to pursue these limited guaranties for certain acts of default, such as the borrower filing bankruptcy. In certain ownership structures (e.g. limited partnerships with minors or trusts as limited partners), a guaranty only from a well-qualified guarantor that is key to the success of the business (e.g. a managing partner) is sufficient under prudent lending standards, even though that guaranty percentage is below the 51% required today. [Proposed 723.5 (b)]

4. Construction Loan Soft Costs – The regulatory definition that specifically identifies which costs may be included in construction soft costs is clearer, and this change can be implemented in a credit union's policy and practices in a timely manner. [Proposed 723.6 (b) (1)]

5. Loan to Value Definitions for Construction Loans – The new definitions that require using 1) the lower of the cost to build, or 2) either the projected "as-stabilized" or "as completed" values, are now clear and can be implemented in a credit union's policy and practices immediately. [Proposed 723.6 (b) (2)]

<u>Items Where ECU Recommends Further Clarification, Modification, or Inclusion by NCUA</u>

From our view, other provisions of the Proposed Regulation still need further clarification, definition, modification, or inclusion as follows:

1. Common Enterprise and Control – The Proposed Regulation is quite specific on the definitions and stated percentages for determining borrower associational relationships. This section of the new regulation seems to be more prescriptive rather than less so, as this portion of the new rule seems to run counter to the Control definition that should drive the Associated Borrower rules. In particular, the 50% Common Enterprise Rule and the 25% Control Rules are quite specific. We believe credit unions should be allowed to take a conservative approach and count any borrower who has a joint interest with another borrower or entity as an Associate Borrower. In addition, credit unions should be able to use prudent judgment to determine who has Control, as was suggested in Exhibit 3 of the *2013 Supervisory Letter on Evaluating Credit Union Requests for Waivers of Provisions in NCUA Rules and Regulations Part 723, Member Business Loans.* [Proposed 723.2 and 701.22(a)]

2. New Prescriptive Requirement in the Loan to Value (LTV) Definition –The Proposed Rule would supersede the industry standard LTV definition for real property as stated in the *Interagency Appraisal and Evaluation Guidelines* distributed by *NCUA Letter to Credit Unions Number 10-CU-23* by adding the caveat that a 12 month lookback period based on purchase price must be used. The industry standard for purchase transactions using the lower of sales price or appraisal is a universally recognized underwriting guideline. However, non-purchase transactions require a thorough understanding of the credit's dynamics and a "one size fits all" rule can be problematic and have undesired consequences.

   There are several states that are non-disclosure states for real estate transactions in which consideration of property transfers is not publicly available. In other states (e.g. Tennessee), the consideration statement on a publicly recorded deed does not necessarily equal the actual consideration. The TN affidavit for real property transfers certifies the “greater of the actual consideration or value” and may not be representative of the transferee’s purchase price.

This proposal will be burdensome and has the potential to create onerous recordkeeping and exceeds the abilities of even the most sophisticated core operating and credit management systems. Although the proposal does not impose a LTV restriction and the credit union’s Board can set its own LTV requirements, as seen below, certain transactions can have an astronomical LTVs. These are some examples where the lower of “purchase price within the last 12 months” verses a “market value” via an appraisal/evaluation would cause an exponential LTV for creditworthy transactions or extreme confusion in the determination of the LTV:

a. Gifts/Gifts In Kind/Transfers to Trusts.
   Recent inter-generational gifts to family members, gifts in kind to non-profit organizations, or transfer to trusts with little to zero consideration will result in distorted LTVs.

b. Inheritance of real property.
   As an example, consider a $1,000,000 property inherited with a $500,000 loan owed by the deceased where the heir must refinance the loan into their own name before achieving 12 months of ownership. The consideration of the inheritance transfer is $-0- although to be a binding contract the deed will typically reference of consideration of $10 or so. Although the heir is willing to assume liability for the $500,000, the liability may take place well after acquiring title. If a credit union makes a loan for $500,000 before 12 months of ownership, what is the LTV under the new regulation? Is it 50,000%, 100%, another figure, or mathematically zero since the consideration of zero is divided by the loan amount?

c. Disqualified Transfers and Other Non-Arm’s Length Transfers.
   ECU is actively involved with civic projects and redevelopment of blighted areas in our field of membership. In some cases the seller is a civic minded corporation or a governmental body. They seller will transfer property to a borrower for below market value. This incents the borrower by providing equity based on market value and makes renewal projects feasible.

d. Transfers between related entities with zero consideration.
   As part of mitigating risk, ECU may require a member to create a single-purpose entity that may not conduct any other business other than operating the credit union’s collateral (e.g. income-producing property). This protects the credit union from other lenders’ claims since our transaction is segregated in a separate legal entity. The real property deed transfer may list the consideration as $-0- for transfer taxes and a nominal amount (e.g. $10.00) in the deed to create a binding contract under law, although an accounting entry may move the cost basis from one entity to another.

e. Purchase of multiple assets in a lump sum purchase.
   If a borrower seeks financing of an asset acquired by a transfer within the last year involving other assets which are not collateral for the loan, how does the credit union determine the LTV of its collateral when the individual assets values

are not readily apparent? Members will object to any appraisal costs other than the collateral.

f. Multiple collateral with different acquisition dates.
There will be administration burdens and complexities in the calculation of LTVs for multiple pieces of collateral acquired at different times such as some collateral acquired less than 12 months and others more than 12 months securing the same transaction. For fungible collateral where units are capable of being substituted for each other (e.g. liquids, book entry marketable securities), it is practically impossible to identify a particular unit, its acquisition date, or purchase price if acquired over a range of dates at different prices.

g. Improvements after initial acquisition.
The proposed regulation does not appear to contemplate the cost of improvements made to the collateral within the first year of ownership between acquisition and a loan transaction.

h. Raw materials which are increased in value by labor or manufacturing processes.
What if $10.00 of raw materials is converted into an inventory item with a book value of $100? What are the correct numbers to calculate the LTV under the proposal? The company's financial statements will reflect the accumulated cost position of the collateral.

i. Present Value of Future Cash Flows.
ECU has loans secured by an assignment of future payment rights. The borrower may receive these payments by contract or by statute. In the case of several redevelopment authorities, they receive the payments by statute and there is zero consideration/cost to the borrower. How would the LTV calculation be calculated for future payments with a zero cost basis?

j. Transfers of equity interests in the collateral owner.
For example, although the collateral (e.g. real estate) may be owned by a corporation for several years, the ownership interests in the corporation could be transferred in lieu of a real property transfer. Thus the corporation would already meet the 12 month ownership requirement although the stockholders are recent owners. The corporation/borrower would meet the 12 month ownership and would be eligible to use market value of the collateral which could exceed the company's purchase price.

k. A subsequent event occurs within the owners first 12 months of ownership.
If a subsequent event like the signing of a credit tenant to a long-term lease occurs during the first year of ownership, the market value of the property will likely increase. The borrower will have multiple financing options at other lending institutions based on market value.

l. Partial ownership interests held for longer than 12 months but full 100% ownership interests obtained within the last 12 months with or without consideration.
How would the NCUA view a real property quitclaim transfer without consideration from a former joint owner to a surviving owner within the last 12 months? Will it matter if previous ownership was a minority or majority interest?

m. Equitable title holders to real property.
For borrowers who have held equitable title to real property for extended periods and have demonstrated historical actions corresponding to fee ownership (e.g. maintenance, taxes, etc.), it is a legitimate lending standard to treat the transaction as a refinance when the formality of the full ownership interest is acquired.

If a credit union is tracking an extraordinarily high LTV because of a zero or a low cost basis, what happens at the 12 month annual anniversary of the borrower's acquisition? Going forward, can the credit union then use a market value appraisal as the basis for the LTV? Theoretically, the end of a borrower's one year holding period could occur one (1) day after a loan closing to three hundred sixty-five (365) days after a transaction. If a credit union can "re-set" the LTV after the one year holding period, can they use the original appraisal? If so, how old can the appraisal be? Will it need to be re-validated after a certain aging period or will a new appraisal need to be obtained?

What is the basis for setting the lower of purchase price or market value at 12 months? For real estate transactions, if the NCUA has concerns about the appraisal industry, wouldn't those concerns apply to all non-purchase transactions regardless of the time period owned by the borrower? The 12 month period seems arbitrary and based on residential secondary market guidelines imposed when certain areas of the country (i.e. sand states) had unprecedented increases and eventual declines of property values.

The Board indicates the new requirements are to compensate for the possibility of inflated appraisals or borrowers overpaying for collateral purchases. An appropriate action for the appraisal concern is using a robust appraisal review and underwriting process to manage risk. In ECU's experience, business members are astute and make sound judgements in their decision making. We have not seen any evidence that credit union members disproportionately overpay in the marketplace.

The LTV calculation proposal seems counterintuitive and just the opposite of the stated goal to move from prescription rules to a thoughtful and documented principle based decision making process based on a current market value with consideration of the prior purchase price in the underwriting analysis. The LTV calculation proposal will create an unfair disadvantage for credit unions and cause administrative burdens. It will cause the tracking of multiple values, borrower's costs, assets acquisition dates, etc. which core and credit management system aren't currently programmed to track. ECU agrees that the level of "skin in the game" by the borrower is an important part of evaluating a credit transaction but this blanket LTV rule for non-purchase transactions is not a substitute for prudent underwriting, appropriate risk mitigation, and credit enhancements under a principled approach. [Proposed 723.2 and 723.6 (b) (1)]

3. Classification of an MBL vs. Commercial Loan – In reading the Proposed Regulation, loans that are included and excluded in these two definitions seems complex. If the new definitions need to remain as shown in the Proposed Regulation for call reporting purposes, we would recommend a table similar to "Table – Comparison of Member Business Loan and Commercial Loan Definitions" found in the Proposed Regulation Preamble be included in the finalized version of Section 723. This would provide the needed guidance to both credit unions and regulators when determining underwriting standards and call report classification of a loan. [723.8(a)]

4. Non-Member Participations – The Proposed Rule excludes these from the MBL Cap and each credit union can set its own portfolio limit on the amount of non-member participation loans that can be purchased. This is good for geographic diversification and balance sheet management. Therefore, a credit union's Board will set the level of participations as desired.

   Accordingly, we would suggest the Final Rule include similar direction to what was provided to the banking industry by their regulators in the *2006 Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*. In that publication the OCC, FRB, and FDIC strongly suggested commercial real estate concentrations held by banks be limited to 300% of net worth and construction loan concentrations be limited to 100% of net worth. The Interagency Guidance did not mandate these levels though, but went on to indicate that failure to abide by these limits could subject the offending institution to increased regulatory scrutiny. A recent regulatory review paper validated these thresholds by reviewing bank failures during the Great Recession, concluding that many banks with high levels of non-owner occupied commercial real estate loans either failed or threatened safety and soundness as commercial real estate market valuations significantly declined.

5. Construction and Development (C & D) Loans – The Proposed Regulation is quite specific and is more prescriptive rather than less so. These precise requirements will put credit unions at a competitive disadvantage for creditworthy transactions.

   a. Does the Board intend that all provisions apply to non-commercial (e.g. 1-4 family residential property) and commercial C & D loans? Proposed §723.6 (a) uses the term "residential housing for sale or rent". However, proposed §723.6 (b) and (c) refer to its "commercial loan policy" which implies relevance to only "commercial" loans.

   b. The proposed requirements prescribe detailed standards regardless of the size or scope of a C & D project. This proposal may restrict member's access to capital for simplistic small loans because a credit union's administrative costs to manage the loan under the rules are on par with complex commercial projects. It would be preferable for the credit union to establish and use a measured scale approach based on the size and complexity of C & D projects.

   c. Proposed §723.6 (c) (3) requires a credit union to obtain "certification that the remaining funds are sufficient to complete the project." In many cases there are already certifications from the general contractor and project architect/engineer. This requirement will add significant cost for small projects and it will not be economical for credit unions to operate in low dollar market segments. This will deprive members with access to capital needed for business expansion.

      Although ECU has not experienced this situation, if a C & D loan becomes distressed and/or classified and cannot meet the "sufficient funds to complete", must a credit union stops all future disbursements? A credit union needs the flexibility to determine its best course of action and exit strategy.

   d. Proposed §723.6 (c) (4) requires that "Each disbursement is subject to confirmation that no intervening liens have been filed." In TN, the priority of a construction lien can be established following a prescribed process with the filing of the deed of trust. Will subsequent title searches and additional costs be required?

If a C & D loan becomes distressed and/or classified and a credit union cannot "confirm that no intervening liens have been filed", must a credit union stop all future disbursements? What should a credit union do in the case of a preliminary "notice of lien" where the existence of a material's or mechanics lien may not technically be perfected and enforced until after a court proceeding is set and an order is issued by the court? A court proceeding may take months or failure by the claimant to file a timely suit may void any lien rights altogether. The validity of the lien may be contested by the borrower in court.

For what time periods does the term "intervening" apply? Some construction liens may have the potential to retroactively precede a lender's security interest. A lender's primary objective is to establish lien priority against any construction liens such as can be accomplished in our primary market of Tennessee through a prescribed process. A lender's actions may be different if a construction lien takes priority or is in a junior positon, whether it is disputed by the borrower, its amount, etc. Proper loan documents will give a lender multiple options on how to deal with liens issues.

e. The proposed rule defines C & D to include a "major expansion or renovation of the property types referenced in this section". How will "major" be defined? Would an existing property with sufficient "as is" value to support a transaction without including additional proposed improvements be a C & D loan? In this case, the "as-is" collateral valuation would not "depend on the satisfactory completion of the proposed construction or renovation".

f. The example in § 723.6 (a) of loan that is not a C & D due to "maintenance, repairs, or improvements to an existing income producing property that does not change its use….." only mentions an income producing property type. Shouldn't the same standards apply to an owner-occupied commercial property?

g. The commentary of Summary of the Proposed Rule on page 37908 of the Federal Register for C & D differentiates between an "income producing property" and a "commercial purpose". The use of a "commercial" is confusing since it is used elsewhere in the regulation in a broad encompassing context to also include income-producing property. A descriptive term such as "owner-occupied business" would be clearer than creating a new regulatory term "commercial purpose" that intuitively can have alternative meanings beyond the specific intent meant in the C & D rules. However, the term "commercial purpose" is never used in the proposed § 723.6 text and it's ambiguous of how the proposed 723.6 applies to a non-income producing/commercial purpose/owner-occupied business C & D project.

6. Retain the Waiver Authority for the maximum aggregate net member business loan balance to any one member or group of associated members under current §723.10 (h) – Although we do not see this issue having an impact on our institution, it would serve the credit union industry to retain a waiver process. Retaining a waiver would allow

credit unions to pursue high quality assets from member which they otherwise would be limited by the proposed hard cap. The waiver process will allow state supervisory bodies and the NCUA to monitor risks for concentrations above 15% of net worth while allowing credit unions to fund creditworthy loans. [Proposed 723.4 (c) and Existing 723.10 (h)]

7. We support Board Member J. Mark McWatters reassessment of the agency's interpretation of the meaning of the MBL statutory cap exemption language "has a history of primarily making, member business loans……." in The Federal Credit Union Act. The plain language in the act uses the present perfect tense verb "has" which implies it continues beyond the passage of the Credit Union Membership Access Act in 1998 into the present. A well-reasoned alternative interpretation of the statutory text suggested by Board Member McWatters would allow credit unions to use this exception on an ongoing basis after achieving the history prerequisites post 1998. [Proposed 723.8 (d)]

8. §723.4 (f)(5) requires underwriting standards to include a "borrower prepared projection when historic performance does not support projected debt payments" and "must include a balance sheet and income and expense statement". This may be appropriate in many situations and unnecessary in others. Consider a single-purpose entity borrower's purchase of a just completed triple-net (NNN) income-producing property leased to a credit tenant with a multi-year lease that exceeds the term of the loan. Because there is no historical performance, the borrower projection requirement is triggered. The lender can easily read the lease and determine the lease payments being made under the NNN lease and obtain a tenant estoppel agreement as appropriate. It is a rote exercise for a borrower to prepare a projection of this lease income and project a future balance sheet with depreciation and amortization schedules that an accountant would prepare at a future date. This would add an unnecessary regulatory burden for another piece of paper in the file that adds no value in determining the credit quality of the transaction. The projection requirements should be conditional and "as appropriate" but not an absolute requirement. [Proposed 723.4 (f) (3)]

9. ECU seeks clarification of the NCUA expectations during a periodic loan review arising from the sentence containing "must include a periodic reevaluation of the value…….of any collateral" under §723.4 (g) (2). Will this requirement require new Uniform Standards of Professional Appraisal Practice (USPAP) compliant appraisals for seasoned loans in stable markets or is an internally prepared analysis supporting the original value or a sufficient value satisfactory? The use of "must include" is an absolute requirement for what type of "reevaluation" documentation? An unconditional requirement for additional USPAP appraisals over the life of commercial real estate loans would put credit unions at a competitive disadvantage and add significant costs. Any requirements for a new USPAP appraisal should be on an "as appropriate" basis. [Proposed 723.4 (g) (2)]

Final Comments

1. We are concerned that the principles-based approach will rely in large part on subsequent "Supervisory Guidance" that will be used by examiners to interpret the Final Rule and carry out MBL exams. Without a pre-release of the guidance for comments, the industry and state examiners will have no input on how this guidance is put together

and may not understand or interpret the guidance in the same manner as federal examiners. It is imperative for credit unions to fully understand the areas of emphasis and expectations examiners will be focusing on in their work. [Preamble to Proposed Regulation]

As an example, we are aware of wide variances in regulatory expectations for the use of an ongoing independent loan review of a credit union's business loan portfolio. ECU's historical approach has been to conduct an independent review and risk rating validation on the vast majority of its outstanding balances in addition to its ongoing internal credit reviews and risk rating assignments. However, others in the industry may use a smaller statistical sampling. How will the NCUA weigh historical performance and credit quality in setting expectations for the timing and depth of third party independent loan reviews?

2. As a state charted credit union operating under the NCUA MBL rule, we are concerned about consistent training and implementation of the new rule by both the state regulators and the NCUA's staff. Will state regulatory staff have opportunities to receive consistent training on par with NCUA staff? This is another reason to consider putting the NCUA guidance out for comment by state regulators and the industry.

3. The principles-based approach will require a tremendous amount of judgment by field examiners. ECU recognizes NCUA has improved expertise and exam consistency over the past decade. It will be essential to continue developing true commercial lending expertise in examiners, as well as ensuring consistency in all credit union examinations. Classroom training provides theory and concepts but business lending is as much "art as science". Without real world experience in the practical application of prudent lending standards and regulations, the unique situations encountered in business lending cannot be fully replicated in a classroom setting.

4. If there are substantial changes made to the proposed regulation, it is requested that an additional comment period be provided by the NCUA.

We sincerely appreciate the opportunity to provide input on NCUA's proposed rulemaking amending the Member Business Lending regulations. We believe the modernization of the MBL rule and consideration of the issues raised in this letter will allow ECU to prudently serve member needs and will strengthen our local communities. The ongoing effort by the NCUA staff is greatly appreciated. Please feel free to contact ECU for clarification or further discussion on any of these important items.

Respectfully Submitted,

Olan O. Jones, Jr.
President/CEO

Thomas W. Kennedy
Director, Business Services