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August 26, 2015

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

Re: Comment Letter on the Proposed Amendments to NCUA's MBL Rule

Via Overnight Delivery

AUG28'15 AM 7:40 BOARD

Dear Mr. Poliquin:

California Credit Union ("CCU") is pleased to comment on the NCUA's Notice of Proposed Rulemaking for 12 CFR Part 723 regarding potential changes to the Member Business Loan ("MBL") regulations. We commend the Board on considering these regulations to assist credit unions in better serving their business members' expanding needs.

CCU serves over 85,000 members and currently has assets over $1.4 billion. CCU is an active MBL lender. As of 6/30/15, CCU's balance in outstanding MBL's totaled $121 million. As of 6/30/15, outstanding commercial real estate loans originated by CCU totaled $223 million and CCU's balance related to this was $64 million. The collateral for the commercial real estate loans was located in 27 states. CCU is an active lead lender and has approximately 93 different credit union participants located in 22 states. CCU also has a substantial portfolio of non-owner occupied residential loans, non-owner occupied lines of credit, small business loans and small business lines of credit in addition to a wide variety of non-MBL loans. Our staff of business services professionals has a wide range of banking, credit union, and commercial lending expertise and we believe we are well-qualified to provide good feedback to aid the NCUA in shaping the new MBL regulation.

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

- Commendations on the Proposed Regulation (items CCU agrees with);
- Specific items where CCU recommends earlier implementation timing (relates to additional items CCU concurs with); and
- Items where CCU recommends further clarification or modification by the NCUA.

Commendations on the Proposed Regulation (Items CCU Agrees With)

First, we commend the proposed regulation and the 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 its program to fit its strategic goals and risk tolerances. The new rule will allow CCU and the entire industry to focus on credit administration rather than worry about monitoring a program with prescriptive rules that are not always relevant or appropriate. The proposal as presented will allow for not only an increase in business lending production but improve service to our membership and the community. Overall, the changes as presented are positive steps.

We also commend the elimination of the minimum two-year experience requirement for underwriting MBLs. The variation in complexity makes one standard difficult, if not impossible, to identify and use for all circumstances. Frankly, CCU has always been of the opinion that two years of experience is not enough to underwrite certain loans and manage the risks of a portfolio. The change requiring experience commensurate with specific loan underwriting and portfolio risk is a positive step forward. Along the same lines, we also commend the need for the Board of Directors and senior executives to have a comprehensive understanding of the risks of a commercial lending program. CCU has always viewed this as paramount to the long-term success of an MBL program. [723.3(a)(2), 723.3(a)(3), 723.3(b)]

Additionally, we commend the clarification related to Board of Director's oversight in relationship to commercial loan policy. It is customary and appropriate for a credit union's board to review and update the commercial loan policy on a regular and periodic basis as needed. [723.3(a)(1)].

Further, we also commend the elimination of the waiver process. The current regulations do not allow sufficient flexibility. This elimination will help tremendously and provide better member service. [Elimination of certain current sections of 723]

Additionally, we also commend broadening the provision that allows loans made under SBA-guaranteed loan programs to follow those provisions if less restrictive than the MBL rule for any federal or state guaranteed loan programs. [723.1(c)(2)]

Finally, we commend the inclusion of all prohibited activities in one section. [723.7]

<u>Specific Items Where CCU Recommends Earlier Implementation Timing (Relates to Additional Items CCU Concurs With)</u>

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 and for certain credit unions that the NCUA agrees have successful, large, top tier MBL programs. We recommend that for this latter subset of credit unions (which we believe includes CCU) that the NCUA should allow implementation of the new rules as soon as the impacted institution deems it is capable of doing so. If the NCUA does not agree to this, we recommend earlier implementation of the changes identified below for all institutions since this will have a positive, material impact on credit union MBL programs and put credit unions on a level playing field with banks and other financial institutions. These can be easily implemented by updating the business lending policy and making appropriate changes in procedures. Examples of practices that can be enacted more expeditiously include:

<u>Credit Risk Rating System</u> – Most credit unions already have a credit risk rating system in place and simply need to shore up measurement and reporting. Those that do not have a robust system can establish and implement one as an integral part of their MBL policy update. [723.4(g)(3)]

<u>Elimination of LTV Requirements -</u> The proposed rule replaces the current rules' prescriptive loan-to-value requirements with the principle that sufficient collateral is obtained when warranted and in relation

to risk. We concur with the concept that credit unions should have flexibility in setting their own loan-to-value requirements and that regulatory waivers should no longer be needed. It should be easy for credit unions to establish and document their own limits and loan-to-value requirements. Most credit unions with a robust system already have such LTV limits in their policies or procedures. [723.5(a)]

Unsecured Lending – Credit unions can relatively easily define 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. [723.5(a)]

Loans to One Borrower Limit – The new regulatory definition will allow a credit union to exceed the current 15% of net worth limit by an additional 10%, as long as the higher advance is fully secured by marketable securities or cash accounts. This 15% limit is still prescriptive in nature so we recommend that it be eliminated or continue to allow credit unions to obtain waivers for this (despite eliminating waivers in other cases). However, if the NCUA does not concur, we believe the new rule is clear and can be quickly implemented in a credit union's policy and practices. [723.4(c)]

Personal Guaranties – CCU agrees with the Preamble to the Proposed Rule (page 48) which states that "...having the principal(s) of the borrower commit their personal liability to the repayment obligation is, in most cases, very important for commercial lending". While eliminating guaranties does pose additional risk, we believe this change can be implemented sooner in various ways. Credit unions could revise their policies to require a graduated scale for guaranties, where they would use other 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. Another graduated scale 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. A third option is to require a guaranty only from the guarantor that is key to the success of the business, e.g. a managing partner, even though that guaranty percentage is below the 51% required today. In certain cases, we foresee that it is entirely safe and supportable to eliminate the guarantee requirement altogether (e.g. a very low loan-to-value and a very high debt service coverage ratio based on one or more long-term credit tenant leases). This would be done by many of our bank competitors and would allow us to compete on an even playing field for these exceptional types of loans that can stand on their own without the need for a guarantee. [723.5(b)]

In CCU's opinion, the guaranty issue is clearly the most important timing change that should be made in the new regulation. Credit unions today are forced to turn away many excellent lending opportunities because of the regulation-mandated guaranties, and 18 months is far too long to wait for this change.

Items Where CCU Recommends Further Clarification or Modification by NCUA

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

Exemption of Certain Credit Unions from Rules – The proposed rule exempts credit unions with both (a) assets less than $250 million and (b) total commercial loans less than 15 percent of net worth that are not regularly originating and selling or participating out commercial loans (qualifying credit unions) from the requirements of proposed 723.3 (Board of directors and management responsibilities) and proposed 723.4 (Commercial loan policy). Blanket exclusions seem unwise and likely to result in increased lending by these institutions, some of which may be very risky and may have significant deleterious impacts on the impacted credit unions. Due to the possibility that some smaller credit unions may lack of understanding of commercial lending, they may not know what they don't know, resulting in significant potential losses. All should manage their business lending program within the same regulatory framework. However, if our preceding recommendation is not followed, we alternatively recommend a set of reduced requirements from those existing currently but more than those proposed that include required affiliation and use of third party commercial lending professionals (as needed) if internal management and staff is not able to personally develop and apply applicable guidelines. [723.1(b)]

Loan-to-Value Ratio – The proposed clarifications in how to calculate loan-to-value ratios seem appropriate with the exception that it is overly prescriptive and incorrect in 723.2 to mandate that the denominator of the LTV ratio is the lesser of the purchase price and the market value for collateral held 12 months or less which the preamble on page 18 states is meant "...to ensure that credit unions have appropriate collateral protection in the event that the appraisal value is inflated or the borrower overpays for the purchased collateral". Given the new requirements for credit union management and staff expertise, market value should be the appropriate value for collateral held 12 months or less. There could be very valid situations where the purchase price is understated and not representative of market value. For example: (a) the purchase price is an allocated value from a blanket portfolio sale and not representative of the real market value; (b) there is a related party sale, with the sale price having no relation to market value; (c) the seller may be willing to sell at a below-market price to facilitate a "quick" sale for a variety of reasons including distress, estate sale, desire to "assist" a buyer, etc.; and (d) improvements may have been added that have increased the value of the collateral. For example, a business may purchase unimproved land and within a few months, subdivide it, add utilities and gain tenants. [723.2]

Audited or Reviewed Financial Statements – The preamble (page 40) states that for more complex and larger borrowing relationships, such as those involving borrowers or principals with significant loans outstanding or multiple or interrelated operations, the credit union should require...(i) an auditors review...or (ii) an independent financial statement audit. This sounds very prescriptive. Given the new requirements for credit union management and staff expertise, this should be left to each credit union's discretion. For example, there may be multiple operations (e.g. 10 small commercial loans of $50,000 average size) but it would be highly unlikely that such small loans would be audited or reviewed. The actual language in Section 723.4(f)(4) says the "...financial statement quality and degree of verification sufficient to support an accurate financial analysis and risk assessment" which is sufficiently principles oriented." However, the preamble suggests that a prescriptive Supervisory Letter is forthcoming. [723.4(f)(4)]

Credit Union's Commercial Loan Policy – Section 723.4 requires that a credit union's commercial loan policy must address many areas. 723.4 and the preamble (pages 36-45) are very comprehensive and calls for many things that are more procedural than policy oriented. We recommend that the language be modified so that 723.4 requires that either the commercial loan policy OR the commercial loan procedures address the indicated items or that 723.4 be scaled back to only address the few items that really need to be in policy as opposed to procedures. Many detailed items are more appropriately handled in commercial loan procedures so that details can be revised as needed rather than undergoing the time, delay and formality of making so many items policy, which may require approval by a committee and subsequent approval of the board, a process which may take a prolonged period of time and not facilitate rapid response changes that may be needed to appropriately respond to changing markets and market conditions. [723.4]

The proposed requirements of Section 723(f)(3) that require a projected balance sheet and income and expense statements may be appropriate for construction and improvement loans, however, in many real estate purchase loans, projected balance sheets are not necessary and, in some cases, borrower-prepared income and expense statements may not be necessary (e.g. newly leased up property supported by a current rent roll). We recommend amending the language to read as follows: "Projected income and expense or other projections commensurate with the particular transaction type should be obtained."

Common Enterprise and Control – The Proposed Regulation is quite specific on the definitions and stated percentages for determining borrower associational relationships. We question why 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 Associated 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.* [723.2 and 701.22(a)]

Calculation of the MBL Cap – The Proposed Regulation eliminates the 12.25% of assets Cap, with the sole definition of the MBL Cap changed to "the lesser of 1.75 times a credit union's net worth or 1.75 times the minimum net worth requirement to be considered well-capitalized." We would request a clarification of what is intended by this change. Will the 7.0% definition of well-capitalized (under §1790d(c)(1)(A)(i) of the Federal Credit Union Act remain in place, or will the paragraph that follows [§1790d(c)(1)(A)(ii)] leave room to redefine "well-capitalized" at a higher level once the pending Risk Based Capital ("RBC") rules go into effect? The former interpretation would seem to leave most credit unions' current Portfolio Caps in place. However, if there is a higher threshold for well-capitalized under RBC, it may allow for more space under the MBL Cap. Naturally, most credit unions including CCU would prefer the second option to take effect and believes this interpretation would be appropriate. [723.8(a)]

State Regulations on Loan to Value – The Proposed Rule calls for each credit union to set its own loan to value limitation by product type while maintaining adequate collateral cushions. However, no maximums are set in the regulation, which may bring some credit unions into conflict with state regulations that do have maximum loan to value ratios. This potential conflict would not be limited to only the seven states that have their own MBL regulations, but could also apply to many state chartered credit unions. The NCUA could have the Proposed Regulation direct the credit unions to set their LTV limits no higher than allowed by their respective state regulations. [723.4(f)(5) and 723.5(a)]

Classification of an MBL vs. Commercial Loan –If the new definitions need to remain as shown in the Proposed Regulation for call reporting purposes, we would recommend the table found on page 56 of the Proposed Regulation Preamble be included in the finalized version of Section 723 along with expansion of the table to be inclusive of all types of MBLs. 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)]. Additionally, more types of loans should be exempt from the definition of a commercial loan, including loans that present zero or only a remote risk of loss to a credit union. For example, loans fully guaranteed by a federal or state agency should also be excluded from the commercial loan definition because they are risk free and thus do not present any safety and soundness concerns.

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. Therefore, a credit union could potentially buy as many non-member participations as desired. This is good for geographic diversification and balance sheet management. However, these participations are most often far outside a credit union's geographic field of membership or home state. From a safety and soundness perspective, it would seem to carry more risk for a credit union to hold a large amount of its portfolio in non-member participations, while they are constrained by the MBL Cap on member business loans within their core market area.

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.

Of course, there will need to be exceptions to this general guidance, specifically for those credit unions that have been grandfathered in with no MBL Cap.

Clarification is needed as to what should occur when a borrower could be a member of multiple credit unions, which is certainly possible. What would be the impact of a credit union participating in a loan where the borrower, or guarantor, is a member of both the originating and the participating credit union? While not intentional on the part of the participating credit union, would this loan now be included in the MBL cap for that credit union as well as in the MBL cap for the originating credit union?

Proposed Section 723.8(b)(2) briefly discusses trading MBL's to circumvent the aggregate limit. Participating in and out of loans is an effective way to mitigate credit, balance sheet and concentration risk. Often, credit unions participating in loans are of a similar risk-mindset and they will look to buy and sell participation interests in order to strengthen their risk profiles. By buying and selling loans they can diversify their MBL portfolios and lower overall risk. We would understand the NCUA's concern if two credit unions were swapping similar types of loans, however when the participations are done to reduce risk, swapping one asset class for another, they shouldn't be restricted. The acceptability of this type of activity should be clarified. [723.8]

Prepayment Penalties – We feel it is necessary to bring up one issue that was not directly addressed in the Proposed Rule, but which we believe warrants high consideration by the NCUA for regulatory revision. Federally chartered credit unions are prohibited by regulation from having a prepayment penalty on any type of loan. CCU understands the rationale for prepayment penalties to not exist in consumer lending. However, business lending is very different and is most often a longer, more costly process requiring specialized expertise and systems. The investment made in originating and managing a commercial real estate loan, for example, will typically be thousands of dollars in staff time, systems, and third party costs.

If a business member takes out a commercial real estate loan with no prepayment penalty, then refinances or pays off that loan a few months later, the credit union which by regulation could not charge a prepayment penalty has not had sufficient time to earn interest and recoup the high costs of making the loan. This results in an economic hardship for the credit union that was strictly caused by regulations. Many state chartered credit unions can charge prepayment penalties, yet federally chartered credit unions cannot. This uneven playing field within our own industry is difficult to understand and, further, becomes unwieldy in participations involving both state and federally chartered institutions.

We do understand that NCUA regulations allow for a "cost recovery" clause, which acts similar to a prepayment penalty. In practice, this is rarely, if ever, used. It is confusing to credit unions and certainly to borrowers, versus a prepayment penalty which is standard practice in commercial lending. Frankly, the cost recovery clause does not substitute for even the most simple prepayment penalty.

We suggest that an easy solution to rectify this unintended regulatory burden is to allow loans defined as MBLs under Regulation 723 to be exempt from the prepayment penalty prohibition. We respectfully request that the NCUA consider this important revision to the Proposed Regulation. [701.21(c)(6)]

<u>Leeway Provision or Leeway Bucket</u> – A leeway provision or leeway bucket should be created for credit union's CAMEL rated 1 or 2 in order to provide them with extra lending flexibility. It is my understanding that the banks we compete against already have such a provision. For example, such a credit union could be allowed to originate MBLs which don't satisfy all the regulatory parameters but only up to 10% of the credit union's net worth. Such loans would have to be approved by the Loan Committee and reported to the Board of Directors.

<u>Regulatory Training</u> – Money and time is allocated to train NCUA staff. Many credit unions (such as CCU) are state chartered. As part of this training, we think it is essential to also make sure that state regulators also trained by the NCUA so there is appropriate consistency by each party.

<u>Safe and Sound Member Business Lending Program</u> – The proposed rule would shift to credit unions the responsibility to develop a commercial lending program that is safe and sound and meets examiner approval. The NCUA should detail the minimum requirements that are acceptable for establishing a safe and sound MBL program.

<u>Final Comments</u>

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. It is possible that the industry will have no input on how this guidance is put together and may not understand or interpret the guidance in the same way examiners do. It is imperative for credit unions to fully understand the areas of emphasis and expectations examiners will be focusing on in their work. [Reference: Page 36 of Preamble to Proposed Regulation]. We recommend that the Supervisory Guidance be provided to the industry for review and comment, preferably prior to issuance of the final rule.

It is our fear that the areas being de-centralized will simply migrate over into the Supervisory Guidance, thereby nullifying the ability of the individual credit union to establish reasonable policy limits based on their risk appetite and book of business. The NCUA needs to take great care to ensure this does not occur.

Our final area of concern is that the principles-based approach will require a tremendous amount of judgment by field examiners. NCUA has improved expertise and exam consistency over the past decade, but it will be essential to continue to develop true commercial lending expertise in examiners, as well as ensuring consistency in all credit union examinations. Further, good communication with the credit union industry is needed so that there is alignment in the meanings and approach between examiners and credit union industry executives. If this alignment doesn't exist, the absence of specificity could cause escalating examination issues and conflicts between examiners and credit union industry executives

We sincerely appreciate the opportunity to provide input on NCUA's proposed rulemaking amending the Member Business Loan regulations. Thank you for considering our views and for your desire to make credit unions more relevant to their members and the community at large. Please feel free to contact me for clarification or further discussion on any of these important items.

Sincerely,

John Bretthauer
Executive Vice President, Chief Operating Officer

Cc:
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