NASCUS
National Association of State Credit Union Supervisors

August 31, 2015

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

Re: NASCUS Comments on Proposed Rulemaking for Part 723

Dear Mr. Poliquin:

The National Association of State Credit Union Supervisors (NASCUS)[1] submits the enclosed comments in response to the National Credit Union Administration's (NCUA's) proposed changes to 12 CFR Part 723, Member Business Loans (MBLs). NCUA's proposal would amend its member business loan rule by replacing the current "prescriptive" and waiver-based regulation with a "principle" based regulation that relies on the supervisory process to evaluate a credit union's MBL program on an individual basis. NASCUS has carefully reviewed the proposal with state regulators and state chartered credit unions. We support NCUA's efforts to modernize its MBL rule, and offer the following recommendations and observations for NCUA's consideration.

State Specific MBL Rules

NCUA solicits comment on how to approach the issue of state specific MBL regulations going forward. Pursuant to existing § 723.20 of the current rule, a state may seek an exemption from NCUA's member business lending rule for its federally insured state chartered credit unions if the state promulgates a state specific MBL rule that NCUA determines minimizes the risk and accomplishes the overall objectives of NCUA's MBL rule.[2]

Currently, seven states have state specific MBL rules approved by NCUA.[3] Since the promulgation of the first of these rules in 1999, the credit union system has benefitted from the diversity in MBL regulation that these states represent. For example, most of the state specific rules had long removed the personal guarantee requirement as a regulatory mandate. Four years after the state specific rules reconsidered the regulatory need for the personal guarantee, NCUA followed with a corresponding 2003 amendment to its "Reg. Flex" program.[4] While NCUA would later limit its "Reg. Flex" approach to personal guarantees, the proposed rule now out for

[1] NASCUS is the professional association of the nation's state credit union regulatory agencies.
[2] 12 CFR 723.20.
[3] Texas, Washington, Wisconsin, Oregon, Maryland Connecticut, Illinois. In addition, Missouri had a state specific rule but chose to rescind it.
[4] 68 FR 56537 (October 1, 2003).

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comment would once again emulate the state specific rules by relaxing the personal guarantee as a regulatory mandate.[5] That states might lead the way for regulatory innovation has been acknowledged by NCUA before.[6]

By preserving the ability of states to offer varying, and sound, regulatory approaches to supervising commercial lending, the final rule would contribute to the future health of the credit union system by fostering regulatory innovation and competition between charters and regulators.[7] The U.S. Department of the Treasury recognizes as much, noting that diversity of regulation "increases the chances that innovative approaches to policy problems will emerge… [a] sole regulator, not subject to challenge from other agencies, might tend to become entrenched, conservative, and shortsighted."[8]

We recommend NCUA incorporate into the final revised MBL rule the existing provision of current § 723.20(a) as follows:

> The NCUA Board may exempt federally insured state chartered credit unions in a given state from NCUA's member business loan rule if NCUA approves the state's rule for use for state chartered federally insured credit unions. In making this determination, the Board is guided by safety and soundness considerations and reviews whether the state regulation minimizes the risk and accomplishes the overall objectives of NCUA's member business loan rule.

Incorporating the above portion of existing § 723.20(a) into a final MBL rule would allow the states with existing state specific rules to maintain, repeal, or amend those rules while also allowing any additional state to come forward in the future with a state specific rule.

When NCUA re-incorporates the provision providing for state specific rules, the agency will also have to make corresponding changes to proposed §7 41.203. Under existing regulations, Part 741.203 acknowledges the existence of state specific MBL rules and the fact that those states are exempt from NCUA MBL rules. However, as proposed, new § 723.203 has deleted the reference to state specific rules as well as the reference to the exemptions for those FISCUs.

Another important issue regarding the state specific rules involves those FISCUs that have developed extensive commercial lending programs pursuant to the previously approved NCUA state specific regulations. Regardless of the regulatory approach taken by NCUA in a final commercial lending rule, FISCUs in the states with state specific rules must be grandfathered in their current exemptions.

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[5] See proposed §723.5.

[6] " States have done a better job than the federal government of keeping pace with changes in the marketplace." NCUA board member Rick Metsger, discussing field of membership, March 17, 2015, available at http://www.ncua.gov/News/Pages/NW20150317FOM.aspx.

[7] See "The Benefits of a Viable Dual Chartering System for Credit Unions," A White Paper prepared by the Credit Union National Association, Inc., October 1987.

[8] U.S. Department of the Treasury, Modernizing the Financial System, February 1991, page XIX-6.

Member Business Loans and Commercial Loans

Proposed Parts 723.1, 723.2, and 723.8 would create a new NCUA regulatory distinction between member business loans (MBLs) and commercial loans. Under the proposal, an MBL would be defined pursuant to statute for the purposes of calculating the statutory aggregate MBL limit of the lesser of 1.75 times the actual net worth of the credit union, or 1.75 times the minimum net worth required under section 1790d(c)(1)(A) of the Federal Credit Union Act (FCUA).[9]

NASCUS supports reorganizing the rule to distinguish between statutory limits imposed on MBLs by the H.R. 1151, the *Credit Union Membership Access Act,*[10] and safety and soundness concerns related to commercial lending. Such a distinction will facilitate the ability of credit unions, and examiners, to focus on the risk mitigation issues related to commercial lending. Furthermore, reverting to the statutory language for purposes of defining the aggregate limit on MBL lending acknowledges that the statutory threshold may change if, and when, NCUA promulgates a final risk-based net worth requirement pursuant to FCUA.

As noted above, §1757a of the FCUA limits the aggregate MBL lending of a credit union to "1) 1.75 times the actual net worth of the credit union; or 2) 1.75 times the minimum net worth required under section 1790d(c)(1)(A) of this title for a credit union to be well capitalized." In turn, §1790d(c)(1)(a) of the FCUA specifies that a well-capitalized credit union must meet *either* a 7% net worth requirement or meet "any applicable risk-based net worth requirement under subsection (d) of this section." Subsection (d) directs NCUA to promulgate a risk-based net worth standard for complex credit unions. In general, NCUA's Prompt Corrective Action regulations are to be comparable to those for banks. Pursuant to that statutory mandate, NCUA has proposed a risk-based capital standard for complex credit unions, borrowing the "risk-based capital" terminology and structure from banking regulations. Should that proposed rule be finalized, amending NCUA's Capital Adequacy regulation, then the MBL aggregate limit for complex credit unions would be the lesser of 1.75 times actual net worth or 1.75 times the final risk-based capital requirement. NCUA's use of the statutory definitions for the aggregate limit makes this clear, is an improvement to the existing rule, and is consistent with the statutory parameters for MBL regulation.

Likewise, NCUA's shift to the commercial loan terminology distinguishes between loans counted for the statutory aggregate limit and the commercial loans subject to safety and soundness regulation. We support this regulatory structure, but have several concerns with specific elements of the proposal.

Under the existing § 723.1, credit union loans to other "credit unions" are exempted from the definition of MBL and not subject to the rule. However, under proposed § 723.1(b)(2) NCUA has narrowed that definition in the proposal to exempt only loans to "federally insured credit unions." In the preamble, NCUA has provided no explanation, justification, or discussion for this

[9] See proposed §723.8 and 12 U.S.C. 1757a.
[10] Pub. L. 105-219 (1998).

change. Privately insured credit unions are supervised and examined by state regulators to the same extent as other state chartered credit unions. There is no historical data to support a conclusion that loans to privately insured credit unions present a greater risk. NCUA should restore the broader exemption to exclude loans made to any credit union, amending proposed § 723.1(b)(2) to read "Made by a federally insured credit union to any credit union."

NCUA should also amend proposed § 723.1(c), Other regulations that apply, for clarity. As currently drafted, the provision is unnecessarily confusing, mixing federal credit union (FCU) specific requirements with requirements applicable to FISCUs:

> (c) Other regulations that apply. (1) The requirements of § 701.21(a) through (g) of this chapter apply to commercial loans granted by a federally insured credit union to the extent they are consistent with this part. As required by part 741 of this chapter, a federally insured, state-chartered credit union is generally not required to comply with the provisions of § 701.21(a) through (g) of this chapter, except it must comply with § 701.21(c)(8) of this chapter concerning prohibited fees, and § 701.21(d)(5) of this chapter concerning non-preferential loans.
>
> -Proposed §723.1(c)

The above provision highlights the difficulties presented by NCUA's use of incorporation by reference for regulations applicable to FISCUs. The provision begins with a reference to applicability to "federally insured credit unions" followed by a carve-out for FISCUs. At the same time, existing § 741.203 makes no mention of the carved out provisions of § 701.21(a) through (g).

A better approach would be to bifurcate proposed § 723.1(c) into subsections applicable to FCUs and FISCUs as follows:

> (c) Other regulations that apply. (1) For federal credit unions, the requirements of § 701.21(a) through (g) of this chapter apply to commercial loans granted by a federal credit union to the extent they are consistent with this part. (2) As required by part 741.203 of this chapter, a federally insured, state-chartered credit union must comply with § 701.21(c)(8) of this chapter concerning prohibited fees, and § 701.21(d)(5) of this chapter concerning non-preferential loans.

The remaining sub-parts of the provision could then be re-numbered accordingly.

Proposed § 723.2 would exclude from the definition of commercial loan any loan for a vehicle manufactured for household use. Generally, we believe that distinguishing feature to determine applicability of commercial lending due diligence should be whether the underwriting for the loan considers income from the commercial purpose. However, we acknowledge that vehicle lending for a generally manufactured vehicle, regardless of the purpose, is more akin to consumer lending then commercial lending. In that context, this exclusion makes sense.

Requirements for Safe and Sound Commercial Lending

NCUA's proposed rule replaces the current threshold based prescriptive rule with a policy and program based requirement. Specifically, proposed § 723.3 and § 723.4 establish compliance criteria for credit unions engaged in commercial lending. The criteria include requirements for the credit union board (board) to approve a comprehensive written commercial loan policy that is reviewed at least annually and updated as needed, and for the board to receive periodic briefings on the commercial lending program and portfolio. At a minimum, the board approved commercial loan policy must address the types of commercial loans and trade areas that will comprise the portfolio and the maximum amount of assets allowed in secured, unsecured, and unguaranteed commercial loans that will be allowed. The policy must incorporate the regulatory limit on loans to one borrower and specify the qualification requirements for credit union personnel engaged with the program. The policy must also address, in detail, all elements of the commercial loan process from underwriting, approval, valuation, collateral management, monitoring, and other risk management processes such as use of loan covenants.

The proposed regulations also specify that the credit union must employ "qualified staff" with experience in underwriting and processing the types of commercial lending conducted by the credit union, overseeing and evaluating the performance of a commercial loan portfolio, use of a commercial credit risk rating system, and collection/loss mitigation activities. The proposed regulations allow for use of a third party to meet the experience requirements provided the credit union exercises sufficient third party due diligence in managing the relationship.

With respect to the Board approved policy, we recommend NCUA amend the proposal to clarify that the commercial loan policy required by proposed § 723.3 may be approved by a committee of the board.

NASCUS has long emphasized the need for sound board governance in state chartered credit unions, and we agree that the "board" must be involved in providing direction from the top in the form of setting policies for management. However, if boards will be expected to take their regulatory expectations seriously, those expectations must be realistic. Unless boards are allowed to divide work among various committees of their membership, the board as a whole will be overloaded. Credit union directors must review and approve a comprehensive anti-money laundering and counter terror financing policy, a policy for compliance with the Office of Foreign Asset Control, a lending policy, a fidelity bond policy, a commercial loan policy, an identity theft red flag policy, a cyber-preparedness self-assessment policy, a liquidity policy, an investment policy, a fixed asset policy (in some cases), and in some cases a capital stress testing policy. If a board is truly expected to give these important policies the attention needed, the regulation must allow the board to split the functions among board committees.

NCUA proposes creating an exemption from the above policy and program requirements for credit unions that both 1) are less than $250 million in assets, and 2) total commercial loans less than 15% of net worth that are not regularly originating and selling or participating out commercial loans.

Credit unions exempted from the policy and program requirements would still have to comply with proposed rules regarding collateral standards and construction and development lending. In addition, all FISCUs are subject to robust supervisory oversight by their prudential state regulator, and by NCUA as share insurer. However, the proposed exemption, as drafted, raises some concerns for NASCUS.

Commercial lending presents an elevated level of risk compared with consumer lending, requiring specialized underwriting, monitoring, workout, and collections expertise. Any financial institution engaging in commercial lending must understand the nature of the inherent differences between consumer and commercial credit. Such an understanding should be evident in policies, processes, and staffing utilized by the financial institution to govern and manage its commercial lending portfolio. We believe that the exemption as proposed minimizes the importance of these differences in a manner that may have negative consequences for the safety and soundness of the credit union system.

We understand that the requirements of proposed § 723.3 and § 723.4 represent a dedication of resources that might foreclose commercial lending to many credit unions. We are sympathetic, but remain convinced that All commercial lending requires specialized attention. Any credit union engaging in commercial lending above the most de minimis of portfolios should have a commercial lending policy, procedure and program in place commensurate with its activity.

Credit Risk Rating System

Proposed § 723.4(g)(3) would require the use of commercial loan credit risk rating system. NASCUS supports this provision. Classifying credits has long been a staple of a sound commercial lending program. Extensive guidance has been issued on credit risk rating systems by federal bank regulators. We recommend NCUA substantially rely on existing guidance as it prepares its guidance on the commercial lending rule.[11]

Prohibited Activities

Existing §723.2 and proposed §723.7 both prohibit commercial loans to senior management employees and their families or other associated borrowers. We continue to believe that these prohibitions are overly, and unnecessarily, prescriptive.

Of course, loans to insiders present an opportunity for abuse and elevated risk to the financial institution. However, as noted by the Comptroller of the Currency, personal and business transactions between a financial institution and an insider can be done safely and soundly while serving the needs of both parties.[12] Addressing the supervisory challenge of separating

[11] See guidance issued by federal bank regulators: http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/rcr.pdf
http://www.federalreserve.gov/pubs/bulletin/1998/1198leadw.pdf
https://www.fdic.gov/regulations/safety/manual/section3-2.html

[12] Comptroller of the Currency Handbook M-!A, "*Safety and Soundness*," (November 2013). Available at http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/_pdf/m-ia.pdf.

"legitimate insider financial relationships from those that are, or could become, abusive, imprudent, or preferential" may be accomplished by way of enhanced due diligence, reporting, and policy requirements combined with prudent aggregate lending limits. Outright prohibition however is unnecessarily harsh.[13]

For banks, Regulation O (Reg. O) governs lending to insiders.[14] Rather than prohibit all commercial/business loans to insiders, Reg. O only prohibits the loan if the terms would be more favorable to the insider than generally granted other borrowers or if the loan involves more than the normal risk of repayment or present other unfavorable features. [15] If a prospective loan to an insider satisfies the above requirements, Reg. O establishes additional due diligence, board responsibilities, and aggregate limits, but allows the loan to be made.

We urge NCUA to amend proposed §723.7 to adopt the Reg. O approach to commercial loans to insiders rather than outright prohibiting all such activity.

Loan Participations

Proposed § 723.8(b)(2) clarifies that non-member participation interests do not count toward the aggregate statutory MBL cap unless the credit union is trading MBLs with another credit union for the purpose of evading the statutory aggregate limit. It is not uncommon for like-minded credit unions to establish an ongoing participation relationship as a means of diversifying their portfolios and mitigating their risk. It will be important for NCUA to use guidance to establish a presumption in favor of risk mitigation rather than aggregate limit evasion for credit unions trading participations as a risk mitigation strategy.

Supervisory Guidance

NCUA notes that finalization of the proposal rule would be accompanied by supervisory guidance to assist credit unions, and examiners, with implementation of a "principle based" approach to commercial lending supervision and regulation.[16] NCUA also proposes a delayed implementation of 18 months from publication of a final rule to provide examiners and credit unions time to adjust to the new rule.[17] We agree that issuing guidance to examiners and credit unions will be essential to facilitate the transition to the principle based approach and that 18 months should be a sufficient adjustment period. We offer the following recommendations regarding the supervisory guidance.

NCUA should draw heavily on existing guidance related to commercial lending as promulgated by the other federal banking agencies.[18] In particular, NCUA should incorporate the Federal

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[13] Ibid.
[14] Regulation O, 12 C.F.R. 215.
[15] 12 C.F.R. 215.4(a)(1)(i) & (ii).
[16] 80 FR 37898 (July 1, 2015).
[17] Ibid. 37912.
[18] "Commercial Real Estate Lending," August 2013, Office of the Comptroller of the Currency, http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/cre.pdf; "Policy Statement on

Deposit Insurance Corporation (FDIC) guidance provided in Appendix A of Subpart A of Part 365.[19] We also recommend NCUA review FDIC's *Supervisory Insights*, "Examiners Report on Commercial Real Estate Underwriting Practices."[20]

Not only is it important for NCUA to rely on existing guidance that has been vetted by other regulatory agencies and used by banks and even credit unions actively engaged in commercial lending, it is vital that NCUA release a draft version of its guidance in conjunction with publication of the final rule. As previously noted, NCUA is proposing an 18 month delayed implementation to allow credit unions and examiners to adjust to the principle based rule. However, a delayed implementation alone will not suffice to help examiners and credit unions adjust unless they are also provided the guidance that will frame supervisory evaluation of the final rule.

By publishing the draft guidance with the final rule, state and federal examiners and federally insured credit unions will be able to evaluate the full meaning of NCUA's final MBL/commercial lending rule. In addition to being able to commence an adjustment to the new regulatory framework during the 18 month period, credit unions will be able to provide feedback to state and federal regulators on the proposed guidance to ensure a vetted supervisory framework is in place come the delayed effective date.

We commend NCUA's efforts to revising member business lending/commercial lending rules for federally insured credit unions. In particular, NCUA cooperation and consultation with state regulators, as directed by statute, facilitated productive dialogue throughout the process. As NASCUS' comments on the proposed rule should make clear, while NCUA and state regulators may have differing ideas on some of the details of commercial lending regulation, they share the overall consensus on the need for thoughtful risk mitigation by credit unions and prudent supervision by regulators. We would be pleased to discuss these comments in detail at NCUA's convenience. We believe by incorporating our modest recommendations, NCUA can promulgate a final MBL/commercial lending rule that protects the share insurance fund, provides credit unions needed operational flexibility to serve their members and communities, and serves the supervisory goals of both state and federal regulators.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
General Counsel

Prudential Commercial Real Estate Loan Workouts," Federal Financial Institutions Examination Council (October 30, 2009); http://online.wsj.com/public/resources/documents/bcreg.pdf.

[19] 12 C.F.R. Appendix A to Part 365.

[20] Available at https://www.fdic.gov/regulations/examinations/supervisory/insights/siwin06/examiners_desk.html (December 14, 2006).