

Regulatory Comments

From: John Cooke <JohnC@missionfed.com>
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Cc: John Cooke
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Attachments: NCUA Proposed MBL Rule - 2015.pdf

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NCUA Proposed MBL Rule

The NCUA Board approved a proposed member business loan (MBL) rule at the agency's June open Board meeting. The proposed rule will have a 60-day comment period with comments due to NCUA by August 31, 2015.

The proposed rule would completely overhaul NCUA's MBL regulation. Almost all requirements not in the Federal Credit Union Act would be removed. The proposal would create a category of "commercial" loans for safety and soundness purposes and utilizes the category of MBLs for compliance with the Act's limitations on member business lending. For example, the Act does not categorize any nonmember participations as MBLs and neither does the proposed rule. However, business loan participations are considered commercial loans for the purposes of safety and soundness.

The rule would remove all of the specific requirements that currently require waivers, including the personal guarantee requirement. It would also exempt some CUs with less than \$250 million in assets from the board of director and management responsibility requirements and commercial loan policy requirements. The proposal does have an 18-month implementation period.

Commercial Loans

The proposed rule would create a category of "commercial" loans that is not part of the current MBL rule. According to NCUA "MBLs are defined by the FCU Act and the current MBL rule, but commercial loans are not. As a result, the safety and soundness risk management requirements contained in the MBL rule have not always been consistently applied to commercial loans that are not MBLs." Some MBLs will not be considered commercial loans and thus will not be considered for safety and soundness purposes. For example:

- A Loan fully secured by a 1- to 4-family residential property (borrower's primary residence) will not be considered a commercial loan or MBL.
- A Loan fully secured by a 1- to 4-family residential property (not the borrower's primary residence) will be considered an MBL because of the Act's requirement, but not a commercial loan.
- Member business loan secured by a vehicle manufactured for household use over \$50,000 will be considered an MBL but not a commercial loan.
- A nonmember business participation is a commercial loan but not an MBL.

It appears that NCUA is attempting to separate the concepts of MBL for statutory purposes (i.e. lending cap) and what would normally be considered a commercial loan for safety and soundness purposes. This is most evidenced by the treatment of non-owner occupied 1- to 4- family residences that are statutorily required to be MBLs but would not be considered commercial loans.

Board of Directors and Management Responsibilities (§ 723.3)

Prior to engaging in commercial lending, a CU must address the following board responsibilities and operational requirements:

- Approve a commercial loan policy that complies with § 723.4 (see next section).
- Ensure the CU appropriately staffs its commercial lending program in compliance with § 723.3(b).

- Understand and remain informed, through periodic briefings from responsible staff and other methods, about the nature and level of risk in the credit union's commercial loan portfolio, including its potential impact on a CU's earnings and net worth.

The proposed rule would eliminate the 2-year experience requirement, but still requires that a CU have experience. Specifically the rule would require:

- *Senior executive officers.* A federally insured credit union's senior executive officers overseeing the commercial lending function must understand the credit union's commercial lending activities. At a minimum, senior executive officers must have a comprehensive understanding of the role of commercial lending in the federally insured credit union's overall business model and establish risk management processes and controls necessary to safely conduct commercial lending.
- *Qualified lending personnel.* A federally insured credit union must employ qualified staff with experience in the following areas:
 - Underwriting and processing for the type(s) of commercial lending in which the credit union is engaged;
 - Overseeing and evaluating the performance of a commercial loan portfolio, including rating and quantifying risk through a credit risk rating system; and
 - Conducting collection and loss mitigation activities for the type(s) of commercial lending in which the federally insured credit union is engaged.

Training of CU staff and third parties can be used to meet these requirements.

Commercial Loan Policy (§ 723.4)

The commercial loan policy requirement in proposed § 723.4 is comparable to the MBL policy requirements in § 723.6 of the current rule and sets out minimum expectations for risk assessment of the commercial borrower and for active risk management of the commercial loan portfolio. Prior to engaging in commercial lending, a CU must adopt and implement a comprehensive written commercial loan policy and establish procedures for commercial lending. The board approved policy must ensure the CU's commercial lending activities are performed in a safe and sound manner by providing for ongoing control, measurement, and management of the CU's commercial lending activities.

Again, his requirement is similar the requirements already in place for CUs that make MBLs. However, it is likely to be more detailed as NCUA will require CUs to have planning in place as to how the will address limitations that were once part of the regulation.

Waivers Eliminated

The current MBL rule allows CUs the ability to obtain waivers from many of the regulatory requirements. The proposed rule would eliminate these requirements and thus eliminates the need for waivers. The following requirements would be removed:

- Personal guarantee requirement
- Aggregate construction & development (C&D) loan limit
- Minimum borrower's equity for C&D loans
- LTV requirement
- Maximum unsecured MBL to one member or group of associated members
- Maximum aggregate unsecured MBL loan limit
- Maximum aggregate net MBL to one member or group of associated members

§ 723.5(b) would require that a CU that does not require the full and unconditional personal guarantee from the principal(s) of the borrower who has a controlling interest in the borrower must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk.

Because these requirements are eliminated, NCUA will require that a CU to develop and establish its risk tolerances at both the relationship and overall portfolio levels so that risks undertaken are consistent with prudential standards and are within the managerial and financial capability of the CU to accommodate. According to NCUA the "removal of the prescriptive requirements from the rule does not relieve the CU from setting appropriate limits as part of its overall commercial lending program. In fact, the Board believes these internal constraints are necessary risk mitigation practices and expects CUs to establish prudent limits in their policies appropriate for the CU's risk tolerance and management capability."

NCUA will incorporate expectations regarding risk management practices, such as LTV ratios and portfolio concentration limits, into supervisory guidance issued with any final rule adopted by the Board.

Loan Participations

The current rule requires a CU to obtain a waiver if its combination of MBLs and nonmember business loan participations cause it to exceed the MBL cap. The proposed rule eliminates this waiver requirement allowing CUs to purchase nonmember participations with no impact on the MBL cap. Member participations sold to other CUs will not count against the MBL cap. Only the interest in member participation held at a CU will count against the MBL cap.

This does not eliminate the cap but could allow creative CUs through buying and selling participations the ability to hold a much higher level of "commercial loans" than allowed by the MBL statutory cap.

Construction and Development Loans (§ 723.6)

The proposed rule would impose specific requirements for construction and development loans. The proposed rule would require that a commercial loan policy include adequate provisions by which the collateral value associated with the project is properly determined and established. For a construction or development loan, collateral value is the lesser of the project's cost to complete or its prospective market value.

MBL Cap Calculation

The current rule does not allow most CUs to exceed the lesser of 1.75 times the CU's net worth or 12.25 percent of the CU's total assets. The proposal would set the MBL limit as 1.75 times the applicable net worth requirement for a CU to be categorized as well-capitalized and elimination the 12.25 percent calculation. This could result in a modest increase in the MBL cap for some CUs, but should not negatively impact any CUs.

Exemption for Credit Unions With Less than \$250 million In Assets

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 or participating out commercial loans would be exempt from:

- Board of directors and management responsibilities (§ 723.3)
- Commercial loan policy requirements (§ 723.4)

Definitions

The proposed rule modifies the current rule's definitions of the following terms:

- Associated borrower;
- Loan-to-value ratio; and
- Net worth.

The proposed rule includes new definitions for the following terms:

- Commercial Loan;
- Common enterprise;
- Controlling interest;
- Credit risk rating system;
- Direct benefit;
- Loan secured by a 1- to 4- family residential property;
- Loan secured by a vehicle manufactured for household use;
- Readily marketable collateral;
- Residential property.

EXISTING DEFINITIONS

❖ *Associated Borrower, Common Enterprise, Control, and, Direct Benefit:*

The definitions of *Associated Borrower, Common Enterprise, Control, and, Direct Benefit* are all intertwined and are being revised to bring the definitions in line with other banking regulatory standards (See 12 CFR 32.5). The effect of this change should be to reduce how far the current term "Associated Member" extends under the current rule. A corresponding change is also made to the 701.22 affecting loan participations.

❖ *Loan-to-value ratio:*

This definition is revised to clarify that junior debt from other lenders in calculating loan-to-value ratios **do not** need to be included in calculating loan-to-value ratios. The comments to the proposed rule note that a CU should continue to evaluate the impact on the borrower's cash flow all outstanding debt owed by the borrower in determining the borrower's ability to repay the loan and should limit the amount of subordinate financing the borrower may obtain and require an equity investment by the borrower that is commensurate to the risk.

The rule further clarifies that the denominator of the LTV ratio is the market value for collateral held longer than 12 months, and the lesser of the purchase price and the market value for collateral held 12 months. Market value is defined in part 722. NCUA expects CUs to use prudent and appropriate valuation for other assets.

The rule specifies that a commercial loan policy must contain the methods to be used in collateral evaluation for all types of collateral authorized, including loan-to-value ratio limits; however, the limits are left to the discretion of the CU via policy. Current regulation contains a limit of 80% (with certain exceptions).

❖ *Net Worth:*

The proposed definition of “net worth” provides a cross reference to NCUA’s PCA and risk-based capital rules in part 702.

NEW DEFINITIONS

❖ *Commercial Loan:*

The rule proposes a new definition of Commercial loan to distinguish between the commercial lending activities in which a CU may engage, and the statutorily defined MBL which are subject to the MBL cap. All commercial loans, whether MBL or not, are subject to the safety and soundness requirements of the proposed rule (unless otherwise exempt).

“Commercial loans” are defined as any credit extended to a borrower for commercial, industrial, agricultural, and professional purposes except:

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 CUSO;
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 dully secured by shares in the credit union making the extension of credit or deposits in other financial institutions; and
7. Any loan to a borrower or an associated borrower, the aggregate of which is equal to less than \$50,000.

❖ *Credit Risk Rating System:*

“Credit Risk Rating System” is a formal process to identify and measure risk through the assignment of risk ratings, or credit risk score, or credit risk grades. It is determined through an evaluation of quantitative factors based on financial performance and qualitative factors based on management, operational, market, and business environmental factors.

❖ *Loan secured by a 1- to 4- family residential property:*

Means any loan secured wholly or substantively by a lien on a 1- to 4- family residential property for which the lien is central to the extension of credit. This definition is intended to clarify that loans secured by a 1- to 4- family residential property are not commercial loans for the purposes of the rule.

❖ *Loan secured by a Vehicle Manufactured for Household Use:*

Means new and used passenger cars and other vehicles such as a minivan, sport-utility vehicle, pickup truck, and similar light truck or heavy duty truck generally manufactured for personal, family, or household use and not used as a fleet vehicle or to carry far-paying passengers. “Fleet” means five or more vehicles that are centrally controlled and used for a business purpose.

❖ *Readily Marketable Collateral:*

Means a financial instrument or bullion that is salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations based upon actual transactions on an auction or similarly available daily bid and ask price market.

❖ *Residential Property:*

Means a house, condominium, cooperative unit, manufactured home, and unimproved land zoned for 1- to 4- family residential use. This definition is added to clarify that loans secured by a 1- to 4- family residential property are excluded from the definition of commercial loan. (Note: loans secured by a 1- to 4- family residential property not the borrower's primary residence are MBL's. Loans secured by a 1- to 4- family residential property that is the borrower's primary residence are neither commercial loans nor MBLs.)

State Regulation of MBLs

Currently 7 states operate with NCUA Board-approved MBL rules: Connecticut, Illinois, Maryland, Oregon, Texas, Washington, and Wisconsin. The NCUA is seeking comment on 3 options to transition these regulatory schemes:

OPTION A – Allow State Supervisory Authorities (SSAs) that currently have a state MBL rule to preserve the rules in their current format. State-chartered CUs operating under those rules would continue to comply with the provisions under the state, however, no other state would be permitted to submit a rule for NCUA consideration and approval.

OPTION B - Require SSAs to make conforming amendments to their rules and resubmit them to NCUA for an updated approval. The new MBL rule would need to reflect the same principles and incorporate the guidance but could be more restrictive if the state so chooses.

OPTION C – Combines aspects of Option A and Option B. Permits SSAs to preserve their rules in their current format, thus permitting State-Chartered CUs in that state to continue to operate in compliance with the applicable state rule. However, rather than prohibiting other SSAs from submitting their rules for consideration and approval, Option C permits SSAs to submit such rules so long as they conform with language similar to the beginning of the current §723.20(a).

Negative Impact

NCUA states that the proposed rule will require the agency to train staff to and issue guidance for staff to use. There could be some negative impacts to CUs from costs and more complex examinations.

- NCUA would conduct specialized training for examiners at a one-time cost of about \$1.9 million before implementing the rule.
- NCUA also would provide supervisory guidance for CUs, which could look like current requirements.
- Examination of commercial loans and lending practices will likely be more thorough as CUs will have much more flexibility in setting limits and operating a business lending program without specific requirement.

Questions for Consideration

1. Do you believe that the switch from a prescriptive rule to a principle-based rule will provide you more flexibility in making business loans? Why or Why not?
2. Will the adjustments in the calculations of loans that count for the MBL statutory cap assist your credit union in making more MBLs?
3. Does the proposed rule provide you with sufficient clarity to know what will be required in your policies/procedures? How will the proposed rule affect your current lending practices/policies?
4. Are you comfortable that your examiner will be able to examine your portfolio and policies utilizing a principle-based rule?
5. Does the removal of the waiver process benefit your MBL program?
6. Does the distinction between commercial loans and member business loans benefit your MBL program?
7. Will your credit union need to create a credit risk rating system or credit grading system in order to comply with the proposed rule?