



# Supervisory Letter



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## **Evaluating Credit Union Requests for Waivers of Provisions in NCUA Rules and Regulations Part 723, Member Business Loans (MBLs)**

### **I. Introduction.**

NCUA provides flexibility in applying regulatory standards where appropriate within prudential guidelines. Waiver provisions are one way that NCUA can provide flexibility to capable and healthy credit unions for unique circumstances. Hence, credit unions have the right to request waivers from certain parts of NCUA's Rules and Regulations. There are two overall categories for such waivers: (1) an individual transaction waiver (waivers for an individual or specific list of loans), and (2) a blanket waiver of a specific regulatory requirement.

Part 723 of NCUA's Rules and Regulations provides a framework of minimum standards and requirements to ensure credit unions make safe and sound member business loans. Sound lending practices benefit both the credit union and the member/borrower. Through sound business lending, the credit union reduces risk to its capital and its member benefits by receiving a loan tailored to their specific circumstances, needs, and financial ability. This guidance is intended to clarify the MBL waiver provisions in Part 723 of NCUA's Rules and Regulations and explain certain criteria and action steps that NCUA follows when evaluating a waiver request from a credit union.

### **II. Background on MBL Waivers.**

MBL waiver provisions are outlined in sections 723.10 through 723.13 of NCUA's Rules and Regulations.<sup>1</sup> A summary table of MBL related waiver provisions is in Exhibit 1 below.

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<sup>1</sup> See chapter 6 of the National Supervisory Policy Manual (NSPM) for additional information on MBL related waivers.

### Exhibit 1

Rules and Regulation Section	Description of MBL Waiver Provision	Decision Timeframe <sup>2</sup>
§722.3 Appraisal Requirements <sup>3</sup>	Waiver of the appraisal requirement for a category of loans meeting the definition of member business loan may be granted by the Regional Director.	45 days
§723.3(a) Aggregate Construction and Development Loan Limits	Waiver to exceed aggregate Construction and Development loan limit of 15% of net worth.	45 days
§723.3(b) Minimum Borrower Equity Requirements for Construction and Development Loans	Waiver of the 25% equity interest in the project financed.	45 days
§723.7(a) LTV Ratio Requirements for MBLs	Waiver to exceed 80% loan-to-value (LTV). If a credit union intends to make a loan with an LTV in excess 80% and does not have private mortgage insurance (PMI) or the other guarantees listed in the regulation, the credit union must apply for a waiver. However, if a credit union has PMI or some other guarantee, per the regulation, they can extend a loan up to 95% LTV without a waiver. If a credit union wants to exceed 95% LTV, it must apply for a waiver.  (See section VII of this guidance for TDR's)	45 days
§723.7(b) Requirement for Personal Liability and Guarantee	Waiver of the personal liability and guarantee requirement for MBLs.	45 days
§723.7(c)(2) Maximum Unsecured MBL to One Member or Group of Associated Members	Waiver to exceed aggregate unsecured MBL limit of the unsecured outstanding member business loans to any one member or group of associated members of the lesser of \$100,000 or 2.5% of net worth.	45 days
§723.7(c)(3) Maximum Aggregate Unsecured MBL Loan Limit	Waiver to exceed the aggregate amount of all unsecured outstanding MBLs of 10% of net worth.	45 days
§723.8 Maximum Aggregate Net MBL to Any One Member or Group of Associated Members	Waiver for a higher amount, the aggregate amount of net member business loan balances to any one member or group of associated members must not exceed the greater of 15% of the credit union's net worth or \$100,000.	45 days

### III. When can a Credit Union Request a MBL Waiver?

<sup>2</sup> The NCUA decision time frame begins when a complete waiver request is received from an FCU and, for an FISCU when received with a recommendation from the state supervisory authority (SSA).

<sup>3</sup> The waiver for this requirement is outlined in Sections 722.3(a)(9) and 723.10(a) of the Rules and Regulations. The approval timeframe is outlined in section 723.12(d)

A qualifying credit union, as defined in section V below, may submit a waiver request at any time. Credit unions can request a “one- time” waiver for a specific loan or list of loans or a “blanket” waiver of a specific regulatory requirement(s).

**1. One-time waiver.** The one-time individual loan waiver is designed to meet a specific need of an individual or small set of borrowers, or a temporary exigent event (e.g., a natural disaster affecting a service area).

**2. Blanket waiver.** Until expiration or revocation,<sup>4</sup> a blanket waiver gives the credit union authority to conduct lending activities without having to comply with a specific provision(s) of the regulation.<sup>5</sup> Healthy, well-run credit unions with risk focused member business lending programs may apply for blanket waivers to meet an anticipated program need. Such waivers are obtained in advance of a pending loan or situation specific event to facilitate timely processing of loan applications. The blanket waiver is available to credit unions with a common need across multiple borrowers in the portfolio. Such need is usually due to economic changes to local markets or the borrower’s industry that have impacted the borrowers’ ability to meet all of the Part 723 requirements.

For the waiver process to work effectively, a credit union should identify or anticipate a need for a waiver early enough to reduce or eliminate delays in the loan approval process, taking into account NCUA’s processing time for waivers (see Exhibit 1). A credit union should have in place the necessary tracking system to identify upcoming loan maintenance (loan maturities) and address those issues well in advance to be sure the credit decision and other necessary risk assessment can be completed in a timely fashion with minimal impact on the member.

#### **IV. How does a Credit Union Request a MBL Waiver?**

To obtain a waiver, a federal credit union must submit a request to the assigned Regional Director.<sup>6</sup> A state chartered federally insured credit union must submit the request to its state supervisory authority(SSA). If the SSA approves the request, the state regulator will forward the request to the corresponding NCUA Director<sup>7</sup>. A waiver is not effective until it is approved by NCUA.<sup>8</sup>

The waiver request must contain the following:

- (a) A copy of the business lending policy;

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<sup>4</sup> NCUA’s policy is to reevaluate all blanket waivers at least every 3 years. In most cases the credit union waiver process is reviewed at each exam contact. Waivers can be revoked at any time if it is determined there is a safety and soundness concern or a lack of compliance by the credit union.

<sup>5</sup> Subject to any conditions of the waiver approval.

<sup>6</sup> The Director of the Office of National Examination and Supervision (ONES) in the case of credit unions assigned to this office.

<sup>7</sup> Concurrence and approval of the NCUA Regional Director is not required for waivers submitted and approved by an SSA that administers a state member business loan rule approved by NCUA under section 723.20(a)(b).

<sup>8</sup> It is recommended the FISCO provide advance notice to the NCUA region that it has submitted a waiver request to the SSA.

- (b) The higher limit sought (if applicable);
- (c) An explanation of the need to raise the limit (if applicable);
- (d) Documentation supporting the ability to manage this activity; and
- (e) An analysis of the credit union's prior experience making member business loans, including at a minimum:
  - (1) The history of loan losses and loan delinquency;
  - (2) Volume and cyclical or seasonal patterns;
  - (3) Diversification;
  - (4) Concentrations of credit to one borrower or group of associated borrowers in excess of 15% of net worth;
  - (5) Underwriting standards and practices;
  - (6) Types of loans grouped by purpose and collateral; and
  - (7) The qualifications of personnel responsible for underwriting and administering member business loans.

Once the waiver application has been submitted, NCUA will:

- Review the completeness of the information submitted.
- Notify the credit union when the credit union waiver request is deemed complete.
- Notify the credit union of the action taken within the corresponding timeframe (see Exhibit 1) after receiving a complete request.
- Evaluate the level of risk to the credit union and the merits of the credit union as outlined below.

## **V. What does NCUA Evaluate for Waivers?**

Granting a waiver typically increases the risk associated with the lending involved. Therefore, waivers are only granted to credit unions with the financial capacity, management capability, and MBL experience to adequately absorb and manage the risk. Whether it is for a one-time or blanket waiver, the credit union must proactively manage the MBL portfolio. Proactive management begins with individual loan relationships and involves regular site visits and analysis of current financial information.

When considering whether to approve a waiver request, NCUA evaluates initially and periodically thereafter the level of credit risk to the credit union and the credit union's historical

CAMEL composite and component ratings. A credit union that seeks a waiver should exhibit financial strength and consistent operating performance that includes:<sup>9</sup>

- Well capitalized per Part 702 (Prompt Corrective Action) of NCUA’s Rules and Regulations.
- Composite CAMEL code rating and Management and Asset Quality component ratings are 1 or 2 for the last two consecutive exams.
- Positive trends in earnings.
- No material deficiencies<sup>10</sup> noted in the MBL lending program for the last two consecutive examinations.
- The credit union’s MBL lending program has been in place for at least 5 years, with a well-established and proven credit risk rating and monitoring system to support its MBL program. A well-administered credit risk rating and monitoring system focuses both on the financial capacity of the borrower at loan origination and includes ongoing loan administration practices that actively monitor emerging risk of each borrower and the overall portfolio.
- A strong risk management process. The credit union needs to maintain a risk management process that consistently and thoroughly evaluates the risk connected to the individual borrower as well as the aggregate risk of the MBL portfolio.
- Appropriate financial reporting processes exist around the lending function including impairment measurement consistent with GAAP, accurate regulatory risk grading and timely charge-off of uncollectable amounts.

One-time waivers for a soundly underwritten specific loan(s) are limited to cases where a unique set of circumstances cause the creditworthy borrower to fall outside of compliance with a regulatory provision(s). The credit union “being able to grant a loan to a special member”, or “risking losing loans to a competitor,” are not adequate reasons to justify a regulatory waiver. Before requesting a one-time waiver for an individual loan or a specific list of loans a credit union should evaluate the risks associated with the borrower by performing the following due diligence prior to requesting the waiver:<sup>11</sup>

- Borrower analysis that includes a satisfactory borrower payment history and review and explanation of the financial trends of the borrower based on a minimum of the last three fiscal year-end financial statements and most recent quarterly statement. The analysis

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<sup>9</sup> The Regional Director can, on a case by case basis, allow exceptions to these criteria when supported by reasonable rationale and the credit union meets the majority of these requirements.

<sup>10</sup> Examples of material deficiencies would be incomplete risk assessment, poor loan administration, lack of detail global risk assessment, lack of or inadequate application of risk rating and monitoring systems.

<sup>11</sup> At the subsequent exam contact, after the waiver approval, the examiners will evaluate the credit unions adherence with the due diligence requirements outlined in this section. The level of documented compliance will be considered for future waiver requests.

focuses on income and expense trends, debt service ability, balance sheet changes and the impact of those changes on debt service ability. The trends should be positive and the loan risk grade should be at least a pass/acceptable.

- **Borrower prepared** projection when historic performance does not support projected debt payments. The projection must be supported by reasonable rationale and at least include a projected balance sheet and income and expense statement.
- A global analysis of the guarantor(s) which evaluates the other sources of income or losses affecting the guarantor(s) along with a documented review of the composition of the guarantor's assets and liabilities.<sup>12</sup> The credit union must perform reasonable due diligence to determine if the related interests of the principal(s) will have a negative impact or place an undue burden on the borrower. When the personal guarantee requirement has been waived, the credit union should conduct as full a financial assessment of the principal as possible. This will include an understanding of the principal's previous experience, other ventures and economic influences on those ventures.<sup>13</sup>
- Collateral valuations by the appropriate method as required in Part 722 of NCUA's Regulations (also see Letter to Credit Unions 10-CU-23).
- Other appropriate risk assessment including a full understanding of the current market conditions and competitive analysis of the borrower's operating environment and competition. At the borrower level, the credit union should demonstrate its understanding of the risks associated with the waiver for that particular borrower. The credit union should recognize any material increases in risk and be able to justify the additional exposure in terms of its capacity to absorb (its capital) and its risk management processes (its expertise).

The following conditions should be evident in credit unions that seek a blanket waiver. Credit unions should demonstrate they:

- Perform due diligence regarding the borrower's creditworthiness in accordance with standards outlined above.
- Adhere to a policy that outlines financial and credit risk management requirements for any borrower granted a waiver. Credit documentation which should include justification (risk mitigation) for the waived provision.
- Maintain a process for identifying and monitoring risk of the borrower and specify process requirements in their MBL loan policy.

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<sup>12</sup> Under section 723.7 of NCUA Rules and Regulations, the principals of the borrowing organization (except certain not for profit organizations) must provide their personal liability and guarantee. Thus, most credit union MBLs have a guarantor(s).

<sup>13</sup> Where the principal is not guaranteeing the borrowing entity's obligation, there can be limits on the amount of personal information the credit union is entitled to receive. However, the credit union should make a best effort to identify any potential risk to the proposed financing resulting from the principal's other interests.

- Establish and monitor concentration limits for all loans with waivers. Waiver reporting should capture total waivers granted and include concentrations by type.
- Implement a system to track the performance of loans with waivers and capture, at a minimum, trends in delinquency, financial condition of the borrower, and collateral values.

## **VI. Obtaining Waivers for Loan Participations.**

Some credit unions are actively involved in selling and purchasing shared interests in Member Business Loans through loan participations. Participations can be an effective means to diversify risk and enhance earnings. Participated loans often involve a borrower that needs and qualifies for a waiver. Waivers for participated loans are generally requested on a one-time individual loan basis to accommodate a specific borrower's unique circumstance. Obtaining a waiver for a participated loan adds complexity because of multiple participants that are often located throughout different states and NCUA regions. Each credit union participating in the loan is required to obtain separate approval for the waiver from their assigned region resulting in multiple independent reviews. The regional review consists of evaluating two components; the merits of the borrower and the merits of the participating credit unions. To streamline the process, the responsibilities can be separated as follows:

1. At the borrower level, the originating lender can obtain approval based on the merits of the borrower and an assessment of the originating lender's risk management practices and process from their respective NCUA regional office. To eliminate a duplication of efforts, the approval for the borrower and originating lender's qualifications by the respective NCUA region will be shared, deemed sufficient and accepted by all other NCUA regional offices that have credit unions participating in the loan. The assigned region is responsible for determining the adequacy of the originating lender's due diligence and risk assessment of the borrower. Specifically, the region will evaluate the originating lender's MBL program and practices in complying with the borrower evaluation process (outlined above) and risk monitoring requirements as specified in this guidance.
2. The purchasing credit union will obtain individual approval to participate in loans with approved waivers from its assigned regional office. The assigned regional office will evaluate, based on the merits of the purchasing credit union, its compliance with the criteria outlined in section V of this guidance for the qualification of a credit union to participate in loans with waivers. Credit unions that do not meet the specified criteria do not qualify for waiver approval.

As with all waivers, a proactive assessment of waiver needs will improve efficiency in the process. Qualifying credit unions that plan to actively pursue interests in participated loans where specific waivers are necessary may wish to seek blanket waiver authority in order to better expedite the process.

## VII. Waivers to Section 723.7(a) – Loan to Value (LTV) Restrictions.

This section provides specific clarifications regarding waiver requests relating to loan-to-value restrictions.

LTV requirements have long been credit worthiness criteria for sound lending and a part of the supervisory framework. An LTV limit serves to ensure a reasonable investment or equity stake by the borrower and principals. This establishes an appropriate sharing of risk and provides an adequate margin in the event of a default and the loan has to be satisfied by the liquidation of the collateral. Importantly, the margin provided by the equity protects the credit union from adverse market conditions that could negatively affect the collateral values at a time when liquidation of the collateral asset may be necessary to satisfy loan repayment.

The regulation for LTVs requires the following:

- The maximum loan-to-value ratio for all liens must not exceed 80% unless the value in excess of 80% is covered through private mortgage insurance or equivalent type of insurance, or insured, guaranteed, or subject to advance commitment to purchase by an agency of the federal government, an agency of a state or any of its political subdivisions, but in no case may the ratio exceed 95%.
- The LTV is calculated as all liens from all sources. All sources include debt from other institutional lenders, private sources, and from the principals. A loan to the borrowing entity from the principals can be considered equity when the loan is fully subordinated to the senior debt.<sup>14</sup>

LTV waivers are often sought when a loan is renewed at the scheduled balloon maturity date or a loan is rewritten prior to the maturity because the value of the underlying collateral value has materially deteriorated from the time the loan was originated.<sup>15</sup>

Higher LTV values at renewal are often a symptom of deteriorating market conditions or the financial condition of the borrower, especially in the case of income property as the value is determined based on the property's ability to generate income.

Renewals at balloon maturity or rewrites of loans are events that require the credit union to update its risk analysis to determine the borrower's current financial condition and collateral

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<sup>14</sup> Principals may invest in the borrower either directly through paid in capital or by lending the funds to the borrower. Investment through loans can be considered equity and excluded from the LTV calculation when it is provided by the principals or an entity with mirror ownership to the borrower in a credit vehicle that is fully subordinated to the senior debt. In this case "fully subordinated" means debt that does not require and prohibits any payments of interest, principal and other transfer of funds, including through debt acceleration in the event of default, to the subordinate lender until the senior debt holder is paid in full.

<sup>15</sup> In MBL lending a balloon maturity is a common risk mitigation practice to give the credit union an opportunity to reevaluate credit and interest rate risk. Because of the dynamics affecting business borrowers, it is essential for the lender to have the ability to renegotiate the transaction and mitigate any increased risk that has developed since the inception of the loan.



status. Lending actions that meet the definition of a new loan under GAAP<sup>16</sup> are subject to the regulatory LTV limit and require an MBL waiver when the collateral no longer complies with the LTV requirements of Part 723. However, a loan related action (like a modification or certain types of refinancing of an existing loan) where the action does not meet the definition of a “new loan” under GAAP does **not** require the credit union to seek a waiver from NCUA. For example, lending actions that would require the loan to be reported as a troubled debt restructuring (TDR)<sup>17</sup> are **not** deemed new extensions of credit and therefore do not require the credit union to seek a waiver from NCUA of the regulatory LTV limit.

For all non-conforming LTV situations, at least the following additional steps should be performed by the credit union before NCUA will grant a waiver:

- Identify why the collateral value has changed. For income producing property in particular, the credit union should determine the repayment ability of the borrower and guarantors as a change in revenue and net operating income will have a direct impact on the collateral value. If the loan can be supported from other sources of income, the credit union should renegotiate the transaction to commit those sources through secured guarantees or additional collateral. The secured guarantees or additional collateral in combination with the existing collateral may then be sufficient to comply with the LTV requirement without a waiver.
- Measure impairment in accordance with generally accepted accounting principles (GAAP) and existing supervisory guidance. Credit unions should follow the 2006 *Interagency Allowance for Loan and Lease Loss Policy* supervisory guidance transmitted by Accounting Bulletin 06-1 (December 2006). To the extent an impaired loan evaluated individually is determined to be collateral dependent; the agencies require impairment to be measured using the fair value of collateral method. As defined in GAAP, a loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral. In general, any portion of the recorded investment in a collateral-dependent loan (including any capitalized accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible, and is therefore deemed a confirmed loss, should be promptly charged off against the ALLL. If the adjusted recorded investment in the

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<sup>16</sup> See FASB ASC 310-20-35. A “new loan” must generally meet all the following requirements: 1) it does not qualify for financial reporting as a TDR; 2) the terms of the restructured loan other than a TDR are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, i.e., the new loan's effective yield is at least equal to the effective yield for such loans; and 3) restructurings of the original debt instrument are more than minor, i.e., if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument.

<sup>17</sup> In relation to TDRs see revised Part 741 of the NCUA Rules and Regulations including the addition of new Appendix C, Interpretive Ruling and Policy Statement on Loan Workouts and Nonaccrual Policy, and Regulatory Reporting of Troubled Debt Restructured Loans.

loan <sup>18</sup>(i.e., after charge-off), is compliant with the LTV requirement of 80%, then a waiver is not necessary.<sup>19</sup>

In adverse economic environments, there may be situations where the income and cash flows from the borrower and guarantor(s) are sufficient to meet obligations and debt payments for a reasonable period. However, due to the lack of market activity, the appraiser has negatively adjusted the appraised value. A waiver may be warranted in this situation provided the borrower's financial condition has not materially deteriorated and the borrower has a satisfactory repayment history. In cases where the guarantor's resources are required to support the borrower, such resources need to be directly pledged to the loan as additional collateral or to secure the personal guarantee.

### **VIII. Waivers to Section 723.7(b) – Personal Liability and Guarantee Requirements.**

Personal guarantees provide an additional form of credit enhancement for a business loan. In small business, investor real estate and privately held entity lending, it is standard practice for the principal to assume the majority of the risk by personally guaranteeing the loan. The business owner will benefit the most from the success of the business operation; therefore it is appropriate for the principal to shoulder the bulk of the risk by personally guaranteeing the loan.

A personal guarantee by the principal offers additional financial support to back the loan, but more importantly solidifies the long-term commitment by the principal to the success of the business operation (borrower). Without the personal commitment, reinforced by the guarantee, the principal's economic incentive and willingness to work through adversity is diminished. A firm commitment by the principal is vital to preserving the value of the borrower's business, either by improving operations or most likely by preserving asset values in liquidation. The guarantor's economic incentive is to manage the business successfully and retain value, which will ultimately lessen any deficiency they would be obligated to pay.

Part 723.7(2)(b) requires "*Principals, other than a not for profit organization as defined by the Internal Revenue Service Code (26 U.S.C.501) or those where the Regional Director grants a waiver, must provide their personal liability and guarantee.*" The requirement that principals provide a guarantee means the guarantee of one or more natural persons who have a majority ownership interest in the business organization (borrower) receiving the loan. For a corporation, this will be one or more shareholders having a majority ownership of the corporation. Natural person partners having a majority ownership interest in a partnership must each guarantee the full amount of a loan to a partnership.

The most effective guarantee will be from the principals who have control of the borrower's operation. This is because they will have the authority to manage operations and an economic incentive to maximize borrower value and retain assets in the borrowing entity. A controlling

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<sup>18</sup> Recorded investment in the loan" means the face amount of the loan increased or decreased by applicable accrued interest and unamortized premium, discount, finance charges, or acquisition costs and may also reflect a previous charge-off, i.e., direct write-down of the investment in the loan to a new basis.

<sup>19</sup> That is, the collateral risk has been recognized either through reserves, the allowance for loan and lease losses, or charge off and the value of the loan is accurately reflected in the credit union's capital position and financial reports.

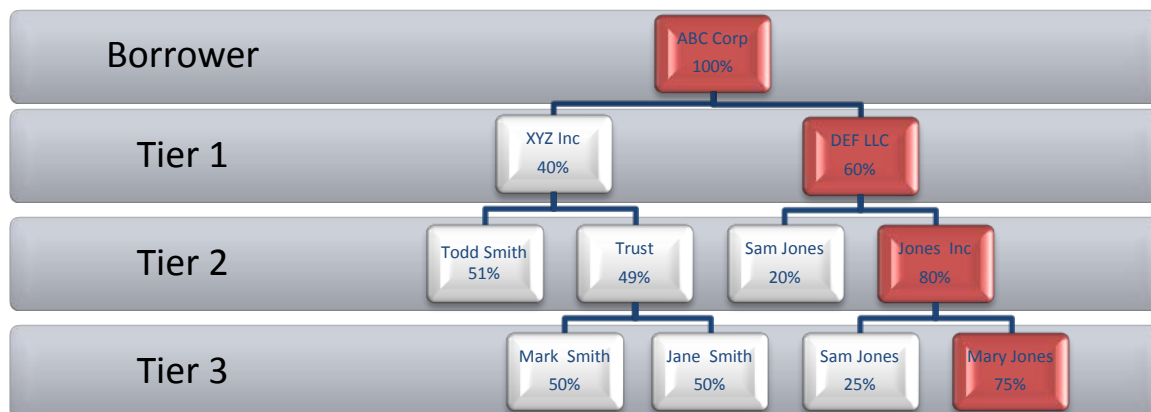
interest generally rests with a majority of shareholders. However, there are situations where the controlling interest can be with owners that do not hold a majority ownership. This occurs when an owner controls the voting rights of another owner. For example, it is a common practice in family owned businesses, as part of estate planning, to transfer ownership from one generation to the succeeding generation with the transferring owner retaining control of the business. The ownership interest is passed without the voting rights, which are retained by the transferring owner. In these circumstances, it is possible for the majority ownership to not have a controlling interest. For situations where control of the business is not with a majority of the owners, the credit union should require the guarantee of the principal(s) with the controlling interest along with requiring the guarantee of the majority owners.

There is no limitation to the guarantee in rule; thus, the full, joint and several personal guarantees are required from all of the principals in the borrowing entity.<sup>20</sup> Any partial or limited guarantee or a guarantee that does not include a controlling interest requires a waiver from the NCUA. The guarantors either individually or in aggregate should have sufficient financial resources at risk to solidify the commitment to the success of the borrower and loan repayment.

The matter of assessing business ownership can be complicated by complex ownership structures. Ownership structures can involve multiple privately held entities<sup>21</sup> and/or combinations of individuals and other entities. It is helpful to review an example of a complex structure to understand how a lender can evaluate and assign ownership amounts.

Below is an example of how to analyze the ownership structure of a complex business arrangement to identify the appropriate guarantors. The first step is to map out the respective individuals and entities that have an ownership affiliation with the borrower (ABC Corp).

**Exhibit 2**



<sup>20</sup> The guarantor is to provide a “payment guarantee” which requires the guarantor(s) to fulfill the payment obligations of the debtor either through scheduled payments or under terms of default when the repayment of the debt is accelerated. “Full” means the entire amount of the borrower’s indebtedness, past, present and future, to the lender of the borrower. The joint and several provisions allow the lender to pursue one or all guarantors for the full amount of the indebtedness, at the lender’s discretion, until the debts are satisfied.

<sup>21</sup> Privately held entities take many forms. They can be incorporated, trusts, limited liability companies and/or different types of partnerships. It is the lenders responsibility to understand the ownership structure and the appropriate method and process for obligating the borrower and guarantors and perfecting the collateral interest. Any financial support (cash flow or assets) not generated from the borrowers operations, used to qualify the loan for approval should be committed to the loan as either a guarantor or as additional collateral.

The next step is to calculate through the ownership chain the actual ownership percentage of each natural person associated with the borrower. The personal interest is calculated by working down from the borrower to the individual owner through the ownership chain as illustrated in the table below.

### Exhibit 3

Natural Person	Connection	ABC Corp		1st Tier		2nd Tier		3rd Tier			ABC Corp. Ownership
Todd Smith	XYZ to ABC	100%	X	40%	X	51%			=		20.4%
Jane Smith	Trust to XYZ to ABC	100%	X	40%	X	49%	X	50%	=		9.8%
Mark Smith	Trust to XYZ to ABC	100%	X	40%	X	49%	X	50%	=		9.8%
Sam Jones	DEF to ABC	100%	X	60%	X	20%			=	12%	
Sam Jones	Jones Inc. to DEF to ABC	100%	X	60%	X	80%	X	25%	=	12%	
Total Sam Jones									=		24.0%
Mary Jones	Jones Inc. to DEF to ABC	100%	X	60%	X	80%	X	75%	=		36.0%
Total ABC Corp Ownership											100.0%

In this example there are several combinations of principals that could guarantee the ABC Corp relationship to achieve a majority ownership interest (more than 50%). For example, Sam Jones and Mary Jones with 24.0% and 36.0% respectively would have a combined ownership interest of 60%. Alternatively, one would assume that because of the majority ownership, that includes Todd Smith, Mark Smith, and Sam Jones with 20.4%, 9.8%, and 24.0% respectively (54.2% total), that they would have the controlling interest. However this combination of individuals does not include the one individual who actually possess control, which is Mary Jones.

As the ownership boxes highlighted in red in exhibit 2 illustrate, Mary Jones has ultimate control of the borrower as she maintains a controlling interest of over 50% in each entity in the ownership chain from her personal ownership up the chain to ABC Corp. Therefore, when obtaining the personal guarantee of the principals in complicated ownership arrangements, the credit union should perform sufficient due diligence to determine the natural persons with actual controlling authority and require those individuals to guarantee along with or as part of the majority ownership.

In this example, due to the complex nature of the ownership structure combined with the possibility of movement (transfer) of assets and funds from the borrower to other entities in the ownership chain the credit union should require the guarantee of all entities involved in order to maintain its rights and provide a path to any funds or assets removed from the borrower. It may be necessary to map out these kinds of ownership relationships in order to make a sound determination about the appropriateness of guarantees.

NCUA expects credit unions to practice appropriate risk assessment and monitoring. The following factors must be evident for all loans where the credit union uses a waiver from NCUA of the personal guarantee requirement:

- The borrower is creditworthy.
- Superior debt service coverage exists.
- The borrower's income and profit trends are positive.
- The borrower has a strong balance sheet with a conservative debt-to-worth ratio.
- The loan is supported by marketable collateral.

- There exists a low LTV ratio.
- The credit union has a long-term relationship (at least 5 years) with the borrower and current principals.

When a personal guarantee is waived, the credit union must increase its monitoring efforts to identify emerging risks timely. Monitoring steps must include at a minimum:

- Establishing and requiring compliance with appropriate and well defined financial covenants that measure and monitor changes in the key aspects of the borrower's financial condition.
- Regular financial reporting by the borrower which includes a year-end financial statement prepared in accordance with GAAP, an annual tax return, and quarterly management-prepared financial statements (balance sheet and income expense statement). The lender should reserve the right to increase the frequency of the financial reporting when necessary.
- A loan agreement that documents the requirements outlined above and gives the lender the ability to take immediate and appropriate action if the borrower fails to comply or the borrower's financial condition deteriorates.
- At least annual site visits of the borrower.

Early detection of problems reduces the risk to the credit union and assists the borrower in managing their business.

## **IX. Associated Borrower**

Section 723.8 "*How much may one member or a group of associated members borrow?*" limits the aggregate amount of net member business loan balances to any one member or group of associated members to not exceed the greater of:

- (a) 15% of the credit union's net worth; or
- (b) \$100,000.

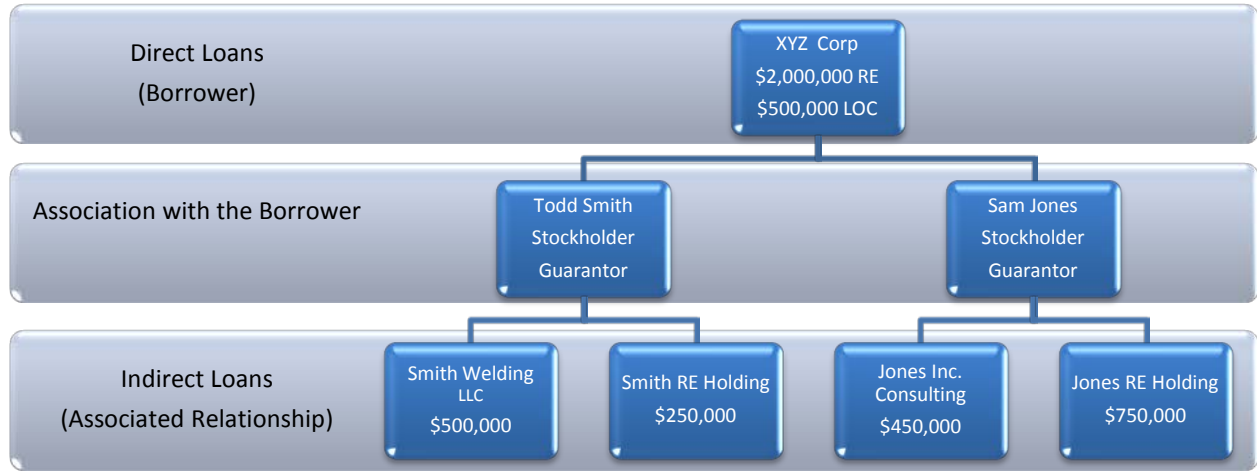
Section 723.21 defines an associated member as any member with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower.

A pecuniary interest for purposes of part 723.8 is any connection through guaranties, co-signs, and other influences on the management, control or operations of the borrower, such as other owners, investors, major stockholders, affiliates and management.

The credit union should identify these relationships and include in the loan approval document a summary and aggregation of all loans and commitments outstanding to the borrower and associate members. Disclosing the aggregate associated relationship will ensure the approving authority is fully informed and the relationship is in compliance with the concentrations limits set forth in section 723.8. The summary should detail the MBL loans directly related to the borrower, both existing and proposed, and those loans indirectly to the borrower from the associated members.

The following is an example of the type of associated relationship encountered by credit unions.

**Exhibit 4**



In this example, the total associated borrower relationship is calculated as follows:

**Exhibit 5**

<b><u>Direct Financing</u></b>	<b>(Borrower)</b>	\$2,000,000	RE Loan	
		\$500,000	LOC	
<hr/>				
<b>Total XYZ Corp</b>				<b>\$2,500,000</b>
<b><u>Indirect Financing</u></b>	<b>(Guarantors)</b>			
Smith Welding		\$500,000		
Smith Apartments		\$250,000		
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<b>Total Todd Smith</b>				<b>\$750,000</b>
Jones Consulting		\$450,000		
Jones RE Holdings		\$750,000		
<hr/>				
<b>Total Sam Jones</b>				<b>\$1,200,000</b>
<hr/>				
<b>Total Associated Borrower</b>				<b>\$4,450,000</b>

The total associated relationship is \$4,450,000 with direct debt to the borrower (XYZ Corp) of \$2,500,000 and indirect debt to the guarantors and stockholders of \$750,000 for Todd Smith and \$1,200,000 from Sam Jones. It is important to understand, once an associate member relationship is established, all future calculations when determining compliance with section 723.8, for the associate members (guarantors in this example) individually and for the borrower requires the inclusion of all the associated member and borrower debt with the credit union. This is because any change in the associated member’s debt with the lender changes the associated debt relationship for this borrower. Including all associated member debt in the calculation ensures this transaction and the borrower remain compliant with the regulatory requirements.

When calculating the total associated debt for a relationship, all MBL's provided by the lender to the borrower and principals should be included in the associated borrower calculation.

## **IX. Conclusion.**

Rules and regulations are in place to maintain a stable and healthy credit union system. Credit unions operate in dynamic environments that require a certain level of flexibility to meet member needs. Well-run and well-capitalized credit unions can use one-time and blanket waivers to have the flexibility to meet member needs when specific circumstances and compensating risk mitigants otherwise allow for safe and sound lending.