Proposed Rule Summary

Prepared by NASCUS Legislative & Regulatory Affairs Department
June, 2015

NCUA 12 CFR Part 723 Member Business Lending

NCUA has published proposed changes to its Member Business Lending (MBL) rule, Part 723. The proposed changes mark a potentially dramatic change in NCUA's approach to regulating member business lending. The proposed changes come as the credit union system's MBL portfolio has grown from $4 billion in 2000 to $51 billion in 2015 (a 1275% increase).

NCUA characterizes its proposed rule as moving to "principle" based regulation as opposed to the existing MBL rule containing thresholds and waivers that NCUA characterizes as "prescriptive." The proposed rule would eliminate most of the existing regulatory thresholds and limits in Part 723, replacing those provisions with expanded requirements for policies, procedures, and oversight by credit union management and credit union directors.

With respect to the 7 existing NCUA approved state specific rules, NCUA offers three alternatives as to how to treat those rules going forward, and seeks feedback on which approach (or suggestions for an alternate approach) should be adopted for the final rule.

Other changes proposed by NCUA include:

- Removing loan-to-value limits
- Clarifying that non-member MBL loan participations do not count toward the cap
- Creating a definition for commercial loans
- Lifting aggregate limits on construction and development lending
- Eliminating minimum borrower equity on construction and development lending
- Allowing credit unions to determine the necessity of personal guarantees
- Creates exemption from ***commercial lending requirements*** (note not MBL requirements) for some credit unions with less than $250m in assets

NCUA will follow publication of a final rule with extensive guidance, and a comprehensive examiner re-training program. NCUA also proposes delaying implementation of a final commercial lending rule for 18 months from publication of a final rule in the *Federal Register*.

Comments are due to NCUA on or before August 31, 2015. You may read the proposed rule in full here.

Summary

NCUA's current MBL rule does not distinguish between commercial loans and MBLs. MBLs are defined by the FCU Act and the current MBL rule, but commercial loans are not. In other words, NCUA's rules for non-consumer (business/commercial) lending addressed only those loans that were statutorily defined as MBLs. 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.

NCUA's proposed rule would significantly alter the way NCUA regulates MBLs and commercial lending. The proposed rule distinguishes between the specific category of statutorily defined MBLs and the universe of commercial loans that a credit union may extend to a borrower for commercial, industrial, agricultural, and professional purposes. The proposal eliminates numerous thresholds and waiver provisions and replaces them with increased emphasis on policies, procedures and management and credit union board oversight. In addition, NCUA will, when finalizing the new MBL rule, publish extensive guidance to direct supervisory oversight of credit union MBL programs and activities.

Statistics

In its preamble, NCUA provides a statistical overview of credit union business lending, noting the average MBL balance is $217K and that overall credit union MBL portfolios have grown 14% annually for the past 10 years. At the same time, outstanding MBLs as a percentage of total assets grew from 1.9% to 4.3% and as a percentage of total loans from 3% to 6.8%.

In addition, credit union business lending has increased across asset categories:

Credit Union Assets	2004 % of CU's Offering MBLs	2014 % of CU's Offering MBLs	2014 Total % of CU System's MBLs Held
Less than $100m	13%	21%	4%
Between $100m and $500m	53%	77%	20%
Greater than $500m	72%	93%	76%

NCUA also notes that the performance of credit unions' business lending has improved. In 2014, the delinquency and charge-off rates of business loans continued a trend of decreasing, dropping to 85bps and 28bps respectively, from 406bps and 81bps in 2010. Other statistics cited by NCUA include:

- 98% of CUs with MBLs at end of 2014 were well capitalized
- 81% of CUs with MBL at end of 2014 had overall CAMEL Rating of 1 or 2 (compared with 67% of those CUs without MBL)

NCUA does acknowledge that MBL has caused some credit union failures. Poorly run MBL programs contributed to the failure of 5 credit unions since 2010, accounting for roughly $141m in losses to the NCUSIF (25% of all NCUSUF losses in the past 5 years).

NCUA notes that waivers where originally intended as case-by-case exceptions to the MBL rule, but have increasingly become the "norm." There are currently over 1,000 active MBL-related waivers, with 115 waivers granted in 2014 alone.

Proposed §723.1 – Purpose and Scope

Proposed §723.1 states the rules 2 broad objectives: to establish policy and program responsibilities that a credit union must adopt and implement as part of a safe and sound

commercial lending program and to incorporates the statutory constraints in § 107A of the FCU Act, which limits the aggregate amount of MBLs that a credit union may make. In so doing, the new rule distinguishes between the prudent risk management required for all loans for commercial, industrial, agricultural, and professional purposes and the statutory limitations affecting MBLs.

Proposed §723.1 also describes which credit unions and loans are covered by Part 723, and which other regulations apply to commercial loans. The rule does not apply to:
(1) loans made by corporate credit unions
(2) loans made by one FICU to another FICU
(3) loans made by a FICU to a CUSO
(4) loans fully secured by a lien on a 1-4 family residential property that is the borrower's primary residence
(5) any loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions
(6) any loan(s) to a borrower or an associated borrower, the aggregate balance of which is equal to less than $50,000.

NASCUS note: *The proposed rule seems to narrow one of the exceptions to Part 723. Under current §723.1(c), loans to other "credit unions" are exempted. However, as noted above, proposed §723.1(b)(2) the exception applies to loans to "federally insured credit unions," seemingly leaving loans to privately insured credit unions as subject to all of the rules.*

Proposed §723.1(c)(2) expands the exception for loans made pursuant to a government loan program. Pursuant to current Part 723, a credit union making a commercial loan through an SBA program that has requirements less restrictive than NCUA's rule may follow the SBA loan requirements. The proposed rule expands that exception to any government loan program that guarantees repayment, insures repayment, or provides an advance commitment to purchase the loan.

Under the proposed rule, credit unions with assets less than $250 million **and** total commercial loans less than 15% of net worth that are not regularly originating and selling or participating out commercial loans will be exempted from the proposed rule's commercial loan program requirements.

Proposed §723.2 – Definitions
The proposed rule moves the definitions from current to §723.21 to proposed §723.2, adds new definitions and amends others.

1) Amended definitions

- *Associated borrower* - The proposed rule replaces the definition of "associated member" with the term "associated borrower," which would be defined as '"any other person or entity with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower. This means any person or entity named as a borrower or debtor in a loan or extension of credit, or any other person or entity, such as a drawer, endorser, or guarantor, engaged in a common enterprise with the borrower, or

deriving a direct benefit from the loan to the borrower." The associated borrower definition in NCUA's loan participation rule would also be amended in a parallel manner.

- *Loan-to-value ratio (LTV)* - The LTV definition would be amended to exclude junior liens from the aggregation of unfunded commitments secured by the collateral. In addition, the proposed definition 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 or less. Market value is defined in NCUA's § 722 for real estate. For other assets, the credit unions should use prudent and appropriate valuation methods.

- *Net worth* - The proposed rule will cross reference definition of "net worth" provides a cross reference to NCUA's § 702 PCA rules to incorporate a more full definition on "net worth."

2) New Definitions

- *Commercial loan* - Defined as any credit extended to a borrower for commercial, industrial, agricultural, and professional purposes. The proposal would provide the following exceptions:
  (1) loans made by a corporate credit union
  (2) loans made by a FICU to another FICU (note PISCUs excluded from this exception)
  (3) loans made by a federally insured credit union to a CUSO
  (4) loans secured by a 1-4 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 fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions
  (7) any loan(s) to a borrower or an associated borrower, the aggregate balance of which is equal to less than $50,000

Under the proposed rule, loans for the purchase of fleet vehicles or to purchase a vehicle to carry fare-paying passengers are commercial loans, as are loans to a vehicle dealership or seller to replenish its regular inventory of vehicles for sale.

Member business loans are defined in proposed §723.8.

- *Common enterprise* - Under the proposed rule, a "common enterprise" exists when:
  1) the expected source of repayment for each loan or extension of credit is the same for each borrower and no individual borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid
  2) the loans are extensions of credit made to borrowers who are related directly or indirectly through common control (including where one borrower is directly or indirectly controlled by another borrower) and substantial financial interdependence exists between or among the borrowers

3) the separate borrowers obtain loans or extensions of credit to acquire a business enterprise of which those borrowers will own more than 50% of the voting securities or voting interests

The rule defines financial interdependence as 50% or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with another borrower.

- *Control* - another element of the proposed definition of "associated borrower," control exists when a person or entity directly or indirectly, or acting through or together with one or more persons or entities:
  1) owns, controls, or has the power to vote 25% or more of any class of voting securities of another person or entity
  2) controls, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person or entity
  3) has the power to exercise a controlling influence over the management or policies of another person or entity

- *Credit risk rating system* – the proposed rule introduces a formal process to identify and measure risk through the assignment of risk ratings. The risk ratings must be supported by comprehensive analysis and must be able to differentiate the level of credit risk associated with each borrower, incorporating both quantitative and qualitative risk factors:
  1) Quantitative risk factors may include the borrower's financial condition, size, collateral, and guarantees
  2) Qualitative risk factors may include, but are not limited to, the ability and integrity of the borrower's management, operation, and changes in the economy and industry

- *Direct benefit* - the proceeds of a loan or extension of credit to a borrower, or assets purchased with those proceeds, that are transferred to another person or entity, other than in a bona fide arm's length transaction where the proceeds are used to acquire property, goods, or services.

- *Loan secured by a 1-4 family residential property* - any loan secured wholly or substantively by a lien on a 1- 4 family residential property for which the lien is central to the extension of credit. The proposed definition is intended to clarify that these loans 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 minivans, sport-utility vehicles, pickup trucks, and similar light trucks or heavy duty trucks generally manufactured for personal, family, or household use and not used as fleet vehicles or to carry fare-paying passengers.

- *Readily marketable collateral* - 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* - defined as a house, condominium, cooperative unit, manufactured home, and unimproved land zoned for 1- to 4- family residential use.

3) Other definitions contained in the rule

The proposed rule moves several existing definitions into other parts of the rule to align with their subject matter. Discussed in more detail below where those specific provisions are summarized, these additional definitions include "construction and development loan" and "net member business loan balance."

Proposed §723.3 – Board of directors and management responsibilities

Proposed §723.3 establishes NCUA's expectations for the board and directors' oversight of the credit union's commercial loan program.

- Board of directors – under the proposed rule, the credit union's board of directors are required to approve the credit union's commercial loan policy. The board must review the policy at least annually, or more often as necessitated by changes in the credit union's structure or commercial lending portfolio. The approved policy must comport with requirements established by proposed §723.4.

- Required expertise and experience - The board is responsible for ensuring the credit union's commercial lending program is appropriately staffed. The proposed rule replaces the existing 2-year experience requirement with the following requirements:
  1) The credit unions senior executives overseeing the commercial lending program must understand the credit union's lending activities. Senior executive officers must have a comprehensive understanding of the role of commercial lending in the credit union's overall business model and must understand, and establish, adequate processes and controls for the program.
  2) The credit union must employ qualified staff with expertise in underwriting processing the types of commercial lending in which the credit union is engaged; overseeing and evaluating the performance of a commercial loan portfolio including the use of a credit risk rating system to quantify risk; and the collection and loss mitigation activities for the type of commercial lensing in which the credit union is engaged.

- Options for meeting the experience requirement – Under the proposed rule, a credit union may meet the expertise and experience requirement by conducting internal training to develop the expertise, by hiring qualified individuals, or by use of a third party. The proposed rule establishes the following conditions on use of a third party:
  1) the third party has no affiliation or contractual relationship with the borrower or any associated borrower
  2) the decision to grant a loan must reside with the credit union
  3) "qualified" credit union staff exercises ongoing oversight of the third party
  4) the third party relationship must comply with proposed §723.7 (ineligible borrowers, equity arrangements, conflict of interest)

Proposed §723.4 – Commercial loan policy

Proposed §723.4 is comparable to existing §723.6, setting out the expectations and policy requirements for credit unions offering commercial loans. The proposed rule requires a commercial loan policy address the following:

- types of commercial loans permitted
- trade area
- maximum amount of assets, in relation to net worth, that the credit union will lend to any one borrower or group of associated borrowers, in aggregate, across all categories, including secured, unsecured, and unguaranteed loans **Note:** the proposed rule **requires** credit unions to include a cap in their policies limiting commercial loans to one borrower, or group of associated borrowers to an aggregate amount not to exceed 15% of the credit union's net worth, or $100k (whichever is greater). Credit unions may exceed the 15% net worth cap by an additional 10% of net worth if the amount over the 15% cap is fully secured at all times with a perfected security interest by readily marketable collateral as defined in proposed §723.2.
- the qualifications and experience requirements of personnel involved in the administration of the commercial loan program
- the loan approval process, including levels of approval authority commensurate with the loans complexity and risk to the credit union
- underwriting standards, which must include the scope of financial analysis necessary to evaluate the borrower and borrower's ability to repay, due diligence of the principles and any impact principles might have on borrower's ability to meet repayment terms, requirements for borrower projections when historic performance does not support repayment projections, requirements for financial statements sufficient to support accurate analysis and risk assessment, guidelines for evaluating collateral, including loan-to-value limits and means to secure collateral, and all other appropriate risk assessments such as analysis of current market conditions
- formal risk management processes commensurate with the scope of commercial lending activities, including (as appropriate) the use of covenants, the frequency of borrower financial reporting, and periodic loan reviews
- the use of a credit risk rating system **Note:** the preamble to the proposed rule requires credit unions to incorporate NCUA Accounting Bulletin No. 06, Attachment 1, Loan Review Systems or any NCUA updates to that guidance in their policies.
- a process to identify, report and monitor loans approved as exceptions to the general policies

Proposed §723.5 Collateral and security

The proposed rule eliminates the current prescriptive limits and requirements related to collateral and replaces it with the following general requirements:

- credit unions must require collateral commensurate with the level of risk associated with the loan, sufficient to ensure adequate loan balance protection and risk sharing with borrower and principles
- unsecured commercial loans must contain documentation in the loan file that mitigating factors sufficiently offset the risk
- a loan made to a borrower **without a personal guarantee** of the principal(s) must contain in the loan file documentation that mitigating factors sufficiently offset the risk

In the preamble to the proposed rule, NCUA notes that credit unions will be expected to consider other factors related to collateral, such as the marketability, age, condition, and alternative uses of the collateral. NCUA also notes that loan-to-value limits in the credit union's policy should account for age, condition and use of the collateral.

NCUA also expands upon its expectations for personal guarantees in the preamble, emphasizing that a credit union's decision to waive the personal guarantee for the repayment of the loan may only be done with appropriate corresponding underwriting parameters and portfolio safeguards. NCUA also states in the preamble that the credit union's policy should set limits on these types of loans as well as establish monitoring and reporting procedures.

Proposed §723.6 – Construction and Development Loans

Proposed §723.6 defines a construction and development loan as any financing arrangement to enable the borrower to acquire property or rights to property, including land or structures, with the intent to construct or renovate an income producing property, such as residential housing for rental or sale, or a commercial building, such as may be used for commercial, agricultural, industrial, or other similar purposes. It also means a financing arrangement for the construction, major expansion or renovation of the preceding property types. A loan to finance the maintenance, repairs, or improvements to an existing income producing property that does not change its use or materially impact the property is not a construction or development loan.

The proposed rule establishes the collateral value of a construction or development loan as the lesser of the project's cost to complete or its prospective market value.

- Cost to complete – the proposed rule defines the cost to complete as the sum of all qualifying costs necessary to complete a construction project and documented in an approved construction budget. The "qualifying costs" would include on/off-site improvements, building construction, and other reasonable and customary costs such as general contractor's fees, bonding, and contractor insurance. Qualifying costs also include the value of the land (determined as the lesser of appraised market value or purchase price for land held less than 12 months, or the appraised market value for land held longer than 12 months). Other generally accepted construction costs may also be included. Project costs for related parties, such as developer fees, leasing expenses, brokerage commissions, and management fees, may be included only if reasonable in comparison to the cost of similar services from a third party. Qualifying costs ***do not include*** interest or preferred returns payable to equity partners or subordinated debt holders, the developer's general corporate overhead, and selling costs to be funded out of sales proceeds such as brokerage commissions and other closing costs. **Note:** NCUA states in the preamble to the proposed rule that the proposal's description of qualifying costs will supersede two previously issued NCUA legal opinion letters, OGC Op. 01-0422 (June 7, 2001) and OGC Op. 05-0243 (May 25, 2005).

- Prospective market value - the prospective market value is the market value opinion determined by an independent appraiser in compliance with the Uniform Standards of Professional Appraisal Practice (Statement 4). Depending on whether the property is held

for commercial use or for income producing use, one of two valuation methods may be sued. The prospective market value "as-completed" reflects the property's market value as of the time that development is to be completed and begin commercial use. The prospective market value "as-stabilized" reflects the property's market value as of the time an income producing property is projected to achieve stabilized occupancy.

The proposed rule also requires credit union engaged in construction and development to include additional elements in the required commercial lending policy:

- qualified credit union personnel must review and approve a line item construction budget prior to closing the loan Note: the proposed rule uses the phrase approval of "any line item construction budget" but the preamble indicates a line item budget is required
- a credit union approved requisition and loan disbursement process must be established
- requirement that funds are dispersed only after on-site inspections performed a qualified individual representing the credit union, with the inspection documented in a written report certifying that the work requisitioned for payment has been completed and the remaining funds to be disbursed are sufficient to complete the project
- each loan disbursement subject to confirmation that no intervening liens have been filed

Proposed §723.7 – Prohibited activities

The prohibitions of existing §723.2 have been moved to proposed §723.7. The proposed section also contains a modified version of existing §723.5(b) provisions regarding conflict of interest.

- The prohibition against making commercial loans to insiders and compensated directors (in some cases) is expanded in the proposed rule. Under the existing MBL, the prohibition applies specifically to the CEO, assistant CEO, and CFO. Under the proposed rule the prohibition applies to any senior management employee "including the CEO, assistant CEO, and CFO." The prohibition regarding compensated directors unless they recuse themselves from the decision at the board level is unchanged.
- The prohibition with regard to joint ventures and equity agreements is unchanged.
- The conflict of interest provision of the existing MBL rule is incorporated into the proposed rule, including the prohibition against the third party used to satisfy the expertise requirements having a participation interest in the loan or any interest in collateral securing a loan being evaluated by the third party. The proposed rule adds an explicit prohibition against the third party receiving compensation contingent on the closing of a loan, with the following exceptions:
  1) The third party may provide services related to the loan such as loan servicing
  2) The third party may purchase a participation interest in a loan it evaluates for a credit union
  3) A CUSO need not be independent from the transaction provided the credit union has a controlling financial interest in the CUSO

Proposed §723.8 – Aggregate member business loan limit; exclusions and exceptions

Proposed §723.8 sets out the statutory aggregate limits of Section 107A of the FCU Act. The proposed rule states the statutory limit as 1.75 times the actual net worth of the credit union, or 1.75 times the minimum net worth required by PCA to be well capitalized. The proposed rule

drops the reference to 12.25% of assets. **Note:** if a higher risk based capital requirement is promulgated, then the credit union MBL cap would actually increase.

Proposed §723.8 also clarifies the distinction between commercial loans subject to the safety and soundness provisions and MBLs subject to the statutory limit. Two types of MBLs (and counted toward the 1.75 times net worth cap, if loans greater than $50k) are expressly excluded from the proposed commercial loan definition:

1) loans secured by a 1-4 family residential property
2) loans secured by a vehicle manufactured for household use

The proposal defines several types of business loans as commercial loans that are not defined as MBLs for purposes of the statutory MBL limit:

1) loans in which a state or federal agency fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full
2) non-member commercial loans or non-member participation interests in a commercial loan made by another lender, provided the federally insured credit union acquired the non-member loans and participation interests in compliance with all relevant laws and regulations and it is not, in conjunction with one or more other credit unions, trading member business loans to circumvent the aggregate limit

The proposed rule also identifies those credit unions that are exempted from the aggregate MBL loan limit by statute:

- credit unions with a LICU designation
- credit unions that participate in the Community Development Financial Institutions program
- credit unions chartered for the purpose of making commercial loans
- credit unions that had a history of primarily making MBLs as of the date of enactment of the Credit Union Membership Access Act of 1998 (CUMAA)

Under the proposed rule, calculation of net member business loan balance is the same as existing Part 723: calculate the outstanding loan balance plus any unfunded commitments, reduced by any portion of the loan that is secured by shares in the credit union, or by shares or deposits in other financial institutions, or by a lien on the member's primary residence, or insured or guaranteed by any agency of the federal government, a state or any political subdivision of such state, or subject to an advance commitment to purchase by any agency of the federal government, a state or any political subdivision of such state, or sold as a participation interest without recourse and qualifying for true sales accounting under generally accepted accounting principles.

Proposed §723.9 – Transitional Provisions

Proposed §723.9 deals with waivers and enforcement restraints that might be in effect at the time a final rule is promulgated. Under the proposal, any waiver previously issued by NCUA concerning any aspect of the current rule becomes moot upon the final rule's effective date, except waivers that were granted for a single borrower or borrowing relationship to exceed the limits set forth in existing §723.8, or for federally insured state chartered credit unions in states that have grandfathered rules where NCUA is required to concur with a waiver to the state's rule.

Waivers granted to credit unions for single borrowing relationships will remain in effect until the aggregate balance of the loans outstanding associated with the relationship are reduced and in compliance with the requirements of proposed §723.4(c).

Under the proposed rule, any enforcement actions or other constraints imposed on a credit union in connection with its commercial lending program, would remain in effect after the publication of a final rule.

Proposed Changes to §701.22 Loan Participations

The proposed rule would make several changes to NCUA's loan participation rule to conform to the proposed MBL/commercial loan changes. The proposed MBL/commercial loan definition of associated borrower replaces existing §701.22's definition of associated borrower. NCUA also proposes adding new definitions to the loan participation rule for:

- common enterprise – the expected source of repayment for each loan is the same for each borrower
- control – a person or entity, directly or indirectly, owns, controls, or has the power to vote 25% of shares, or control the board or management
- direct benefit – the proceeds of a loan or assets purchased with those proceeds, that are transferred to another person in other than an arms-length transaction

Proposed Changes to Part 741.203 Minimum loan policy requirements

The proposed rule reflects a change to Part 741.203 which deletes the reference to state specific MBL rules and exception for FISCUs in those states. NCUA specifically seeks comment on whether to eliminate state specific rules, grandfather state specific rules, or allow new state specific rules going forward.

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