FEDERAL REGISTER

Vol. 80 Wednesday,
No. 126 July 1, 2015

Part V

National Credit Union Administration

12 CFR Parts 701, 723, and 741
Member Business Loans; Commercial Lending; Proposed Rule

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 701, 723, and 741

RIN 3133–AE37

Member Business Loans; Commercial Lending

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed rule.

SUMMARY: As part of NCUA's Regulatory Modernization Initiative, the NCUA Board (Board) proposes to amend its member business loans (MBL) rule to provide federally insured credit unions with greater flexibility and individual autonomy in safely and soundly providing commercial and business loans to serve their members. The proposed amendments would modernize the regulatory requirements that govern credit union commercial lending activities by replacing the current rule's prescriptive requirements and limitations—such as collateral and security requirements, equity requirements, and loan limits—with a broad principles-based regulatory approach. As such, the amendments would also eliminate the current MBL waiver process, which is unnecessary under a principles-based rule. The Board emphasizes that the proposed rule represents a change in regulatory approach and supervisory expectations for safe and sound lending would change accordingly. With adoption of a final rule, NCUA would publish updated supervisory guidance to examiners, which would be shared with credit unions, to provide more extensive discussion of expectations in relation to the revised rule.

DATES: Comments must be received on or before August 31, 2015.

ADDRESSES: You may submit comments by any of the following methods (Please send comments by one method only):

- *Federal eRulemaking Portal: http://www.regulations.gov.* Follow the instructions for submitting comments.
- *NCUA Web site: http://www.ncua.gov/RegulationsOpinionsLaws/proposed_regs/proposed_regs.html.* Follow the instructions for submitting comments.
- *Email:* Address to *regcomments@ncua.gov.* Include ''[Your name]—Comments on Proposed Rulemaking for Part 723'' in the email subject line.
- *Fax:* (703) 518–6319. Use the subject line described above for email.
- *Mail:* Address to Gerard S. Poliquin, Secretary of the Board, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428.
- *Hand Delivery/Courier:* Same as mail address.

FOR FURTHER INFORMATION CONTACT: Vincent Vieten, Member Business Loan Program Officer, or Lin Li, Credit Risk Program Officer, Office of Examination and Insurance, at the above address or telephone (703) 518–6360 or Pamela Yu, Senior Staff Attorney, Office of General Counsel, at the above address or telephone (703) 518–6540.

SUPPLEMENTARY INFORMATION:

I. Background

Part 723 of NCUA's regulations defines MBLs, establishes minimum standards for making MBLs, and implements various statutory limits pursuant to Section 107A of the Federal Credit Union Act (FCU Act).[1] Under the current rule, an MBL is any loan, line of credit, or letter of credit, where the proceeds will be used for a commercial, corporate, other business investment property or venture, or agricultural purpose.[2] There are several exceptions to this general definition.[3]

The current rule, however, 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. 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.

A. Intent and Purpose

In 2011, Chairman Matz announced NCUA's Regulatory Modernization Initiative, consistent with President Obama's Executive Order 13579. NCUA remains committed to regulatory modernization, including modifying, streamlining, refining, or repealing outdated regulations. In addition to making regulatory changes as the need arises, the Board has a policy of continually reviewing NCUA's regulations to ''update, clarify and simplify existing regulations and eliminate redundant and unnecessary provisions.'' [4] To carry out this policy, NCUA identifies one-third of its existing regulations for review each year and provides notice of this review so the public may comment. In 2013, NCUA reviewed its MBL rule as part of this process. Public comments on the rule included general requests for regulatory relief and more flexibility in the MBL rule. Specific requests for relief focused on provisions regarding the loan-to-value (LTV) ratio requirement, the personal guarantee requirement, vehicle lending, and construction and development lending. Commenters also requested changes to streamline the waiver process. Other commenters broadly called for NCUA to eliminate from the MBL rule any prescriptive requirements that are not specifically required by the FCU Act.

Credit unions are an important source of credit for small businesses, as reflected in the average member business loan balance of $217,000, and they continued to lend during the 2008–2009 recession. Over the last ten years, credit unions' business loan portfolios have experienced significant growth.[5] Total business loans including unfunded commitments at federally insured credit unions grew from $13.4 billion in 2004 to $51.7 billion in 2014, an annualized growth rate of 14 percent. Business loans have also become a larger share of credit unions' loans and assets. During the same time period, business loans outstanding as a percentage of total assets grew from 1.9 percent to 4.3 percent, and business loans as a percentage of total loans grew from 3.0 percent to 6.8 percent. The percentage of credit unions offering business loans also increased significantly. Once an ancillary product offered by a small number of credit

[1] 12 U.S.C. 1757a.

[2] 12 CFR 723.1(a).

[3] Under the current rule, the following are not member business loans: (1) A loan fully secured by a lien on a 1 to 4 family dwelling that is the member's primary residence; (2) A loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions; (3) Loan(s) to a member or an associated member which, when the net member business loan balances are added together, are equal to less than $50,000; (4) A loan where a federal or state agency (or its political subdivision) fully insures repayment, or fully guarantees repayment, or provides an advance commitment to purchase in full; or (5) A loan granted by a corporate credit union to another credit union. 12 CFR 723.1(b).

[4] NCUA Interpretive Ruling and Policy Statement (IRPS) 87–2, Developing and Reviewing Government Regulations, (Sept. 18, 1987), as amended by IRPS 03–2 (May 29, 2003) and 13–1 (Jan. 18, 2013).

[5] Unless otherwise specified, all call report based data is as of December 31, 2014, and other data (such as CAMEL ratings) is as of February 24, 2015.

unions, business lending is now becoming a core service offered by many credit unions as they strive to meet the expanding needs of their small business members.

PERCENT OF CREDIT UNIONS THAT OFFER BUSINESS LOANS

Credit unions with total assets	2004	2014
Below $100 million	13	21
Between $100 and $500 million	53	77
Greater than $500 million	72	93
Total Throughout Industry	19	36

The majority of business loans are held by larger credit unions.

Credit unions with total assets	2014	
	Total business loans (in millions)	Percent of total business loans
Below $100 million	1,855	4%
Between $100 and $500 million	10,571	20%
Greater than $500 million	39,316	76%
Total Throughout Industry	51,741	100%

As the economy has recovered from the recent recession, the performance of credit unions' business lending has improved. The delinquency and charge-off rates of business loans continue to decrease and revert to pre-recession levels. Delinquency and net charge-off rates in 2014 dropped to 85bps and 28bps respectively, from 406bps and 81bps in 2010. For credit unions that have business loans at the end of 2014, 98 percent are well-capitalized. In addition, a significant majority of the credit unions with business loans have strong CAMEL ratings. At the end of 2014, 81 percent of credit unions with business loans had an overall CAMEL rating of 1 or 2, compared to 69 percent for those without business loans. Generally, credit unions have conducted business lending safely and served their small business members' needs well. However, there have been instances where some credit unions have failed to adequately manage the risks of their business lending activities and this has led to their failure and, in some cases, losses to the National Credit Union Share Insurance Fund. Poorly managed business lending activities were a contributing factor in the failure of at least five credit unions since 2010. They account for roughly $141 million, or 25 percent of total share insurance fund losses over the last five years.

The Board recognizes that credit unions generally have conducted business lending safely, and that the supervision process has been largely successful in addressing most of those credit unions that did not perform as well. Accordingly, to modernize the MBL rule and provide reasonable regulatory relief to federally insured credit unions, the Board is proposing to alter its overall approach to regulating commercial lending, by shifting from a prescriptive rule to a principles-based rule. Specifically, the proposed rule eliminates detailed collateral criteria and portfolio limits and instead focuses on broad yet well-defined principles that clarify regulatory expectations for federally insured credit unions engaged in commercial lending activities. As discussed further below, the proposed rule also distinguishes between the broad commercial lending activities in which a credit union is authorized to engage, and the more narrowly defined category of MBLs subject to the statutory aggregate limits in the FCU Act. The proposed new approach will eliminate some unintended consequences of the prescriptive approach, such as causing credit unions to manage their lending practices to regulatory restrictions instead of focusing on sound risk management practices. The uniform regulatory prescriptions also inhibit credit unions from considering all relevant risk-mitigating factors in certain borrowing relationships. The current waiver process originally was intended to address case-by-case situations. However, navigating and administering that process requires significant time and resources from both credit unions and NCUA, and can lead to delays in acting on the borrower's application. There are currently over 1,000 active MBL-related waivers. In 2014 alone, NCUA approved 115 MBL waivers.

The industry has gained valuable experience as the level of commercial loan activity has increased and credit unions navigated a deep recession. The Board now believes the principles-based regulatory approach that is reflected in this proposal is preferable to the prescriptive approach in the current rule. Under the proposed approach, NCUA supervision will focus on the effectiveness of the credit union's risk management process, which will allow credit unions greater autonomy and flexibility to soundly administer, underwrite, and service commercial loans in a manner that is consistent with regulatory objectives and accepted risk management practices. The Board expects credit unions to perform the necessary risk assessments to ensure sound lending practices. Through sound business lending, credit unions are able to manage risk and benefit their members by offering financing tailored to members' specific circumstances, needs, and financial capacity. For the principles-based regulatory approach to be effective, it is essential there be a clear set of supervisory expectations. The Board understands that providing more flexibility to credit unions to manage their business lending risks must be predicated on the notion that credit unions will carefully adhere to sound practices. Moreover, the Board believes credit unions should be expressly guided by the principle that their business loans will be designed to meet the needs of the members while at the same time ensuring credit union capital is adequately protected from unnecessary risk. Credit unions that make business loans will best meet this standard by ensuring they have the right risk management processes and staff to maintain a comprehensive understanding of the member-borrower's business operations and financial capacity. These processes need to be ongoing for the life of the loans. Credit unions that maintain a strong risk management process in their commercial lending activities will be more successful transitioning from the current rule to the proposed approach. Credit unions with less sophisticated processes or a tendency to manage risk through strict adherence to regulatory restrictions may need to update staff experience and risk management methodologies to safely manage business loan portfolios in the future.

B. Key Changes to the Current MBL Rule

As mentioned above, the proposed rule would significantly alter NCUA's overall approach to regulating and supervising credit union commercial lending activities. The proposal modernizes the regulatory requirements that govern credit union commercial lending by eliminating the current rule's prescriptive underwriting criteria and waiver requirements in favor of a principles-based approach to regulating commercial loans.

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.[6] Prudent risk assessment is necessary for all commercial loans, and this proposal focuses on the principles and supervisory expectations for safe and sound commercial lending. The proposed rule also adopts a broader, more practical approach to ensuring that credit unions have the pertinent staff expertise and organizational discipline necessary to support a safe and sound commercial loan program. It also reinforces the broad principle that a credit union's board of directors is responsible for the credit union's commercial loan risk, and that the board must establish adequate controls and provide sound governance for the credit union's commercial lending program.

II. Summary of the Proposed Rule

A. Overview

The proposed rule would provide federally insured credit unions with greater flexibility and individual autonomy in safely and soundly making commercial and business loans to meet the needs of their membership. The proposed amendments modernize the regulatory requirements that govern credit union commercial lending activities by replacing the current rule's prescriptive requirements and limitations, such as collateral and security requirements, equity requirements, and loan limits, with broad principles to govern safe and sound commercial lending. The principles are predicated on NCUA's expectation that credit unions will maintain prudential risk management practices and sufficient capital commensurate with the risks associated with their commercial lending activities. The Board emphasizes that the proposed rule represents a change in regulatory approach and supervisory expectations will change accordingly. NCUA remains committed to rigorous and prudential supervision of credit union commercial lending activities. Oversight will focus on the effectiveness of the risk management process and the aggregate risk profile of the credit union's loan portfolio, as opposed to compliance with prescriptive measures. Responsible risk management and comprehensive due diligence remain crucial to safe and sound commercial lending, and it is expected that credit unions subscribe to these overarching principles in administering, underwriting, and servicing commercial loans.

[6] As discussed in further detail below, there are certain exceptions to the proposed definition of commercial loan.

The key provisions of the proposed rule are discussed in more detail below.

B. Key Provisions of the Proposed Rule

§ 723.1—Purpose and Scope

Section 723.1 of the proposed rule articulates and summarizes the rule's overall purpose. The Board intends for the rule to accomplish two broad objectives. First, it establishes policy and program responsibilities that a credit union must adopt and implement as part of a safe and sound commercial lending program. Second, it incorporates the statutory constraints in Section 107A of the FCU Act, which limits the aggregate amount of MBLs that a credit union may make to the lesser of 1.75 times the actual net worth of the credit union or 1.75 times the minimum net worth required under the FCU Act for a credit union to be well capitalized.[7]

The Board recognizes that commercial lending is complex and involves different risks than consumer lending. Managing those risks entails substantially greater effort and attention than merely applying a strict limit on the aggregate amount a credit union is allowed to invest in MBLs. Accordingly, the proposed rule distinguishes between the safety and soundness objectives generally applicable to all loans for commercial, industrial, agricultural, and professional purposes and the statutory limitations affecting MBLs. The proposed rule is intended to clarify that prudential risk management is required for all commercial loans.

Proposed § 723.1 also describes which credit unions and loans are covered by Part 723, and which other regulations apply to commercial loans. Part 723 applies to commercial and member business loans made by federal natural-person credit unions and state-chartered, federally insured natural-person credit unions. The rule does not apply to (1) loans made by corporate credit unions; (2) loans made by one federally insured credit union to another federally insured credit union; (3) loans made by a federally insured credit union to a credit union service organization (CUSO); (4) loans fully secured by a lien on a 1- to 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; and (6) any loan(s) to a borrower or an associated borrower, the aggregate balance of which is equal to less than $50,000.

[7] 12 U.S.C. 1757a(a).

Further, the proposed rule exempts from the requirements of proposed § 723.3 and § 723.4 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 (qualifying credit unions). Accordingly, qualifying credit unions, especially smaller institutions, which are only occasionally granting a loan(s) that meets the proposed commercial loan definition would be alleviated from the burden of having to develop a full commercial loan policy and commercial lending organizational infrastructure. The intent is to avoid the inclusion of credit unions that infrequently originate minimal amounts of loans that technically meet the proposed commercial loan definition, or that infrequently reduce their risk profile by selling or participating part of their loan portfolio. However, the Board notes that credit unions need to have a board approved loan policy covering their lending activity in general. Qualifying credit unions would merely need to make sure their existing loan policy provides for the types of commercial loans granted, including satisfying all the other applicable commercial lending requirements in the proposed rule.

The proposed 15 percent of net worth threshold is consistent with the longstanding single-obligor limit common in the credit union and banking industries. The Board regards 15 percent as a prudent level for exempting credit unions from proposed § 723.3 and § 723.4 and it coheres to standard industry practices. The proposed $250 million asset threshold is consistent with similar provisions the Board adopted in NCUA's derivatives[8] and liquidity and contingency funding plans[9] regulations. With regard to asset size, the Board is concerned that extending this exemption to credit unions over $250 million in assets could incentivize some credit unions, regardless of their capacity and member business loan needs, to unduly restrict the volume of business lending—a vital source of working capital and job creation—to avoid higher prudential standards.

The Board recognizes that credit unions under $250 million in assets have more limited staff and facility resources and are generally not engaged in business lending on a material scale. The proposed exemption acknowledges that small portfolio exposures coupled with a generally inactive business

[8] 12 CFR part 703.

[9] 12 CFR 741.12.

lending program do not warrant the adoption of the broader risk management standards included in the proposal. Conversely, the Board views credit unions that are holding business loans, and that are $250 million in assets or greater, as having sufficient size and capacity to incorporate these common prudential standards into their operations. The Board, however, invites comment on whether all credit unions maintaining only relatively small amounts of commercial loans should be exempt from proposed § 723.3 and § 723.4.

The other regulations applying to commercial loans, which are enumerated in proposed § 723.1(c), are substantively consistent with the current MBL rule, with minor changes for clarity.

§ 723.2—Definitions

For clarity and improvement, the proposed rule modifies the current rule's definitions of the following terms:

- Associated borrower
- Loan-to-value ratio
- Net worth

Additionally, the proposed rule includes new definitions for the following terms, which are not currently defined in the MBL rule:

- 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

Finally, to improve the readability of the rule, the proposal moves two definitions to more relevant sections of the proposed regulation:

- Construction and development loan
- Net member business loan balance

Each of the modified, new, and moved definitions is discussed in more detail below.

i. Modified Definitions

Associated borrower

The proposed rule replaces the current rule's definition of ''associated member'' with the term ''associated borrower,'' and updates the definition to be more consistent with the combination rules applicable to banks.[10] The proposed definition introduces the concepts of direct benefit, common enterprise, and control. This and each newly defined term, as discussed below, are also included in the definitions section of the proposed rule. Under the proposal, an ''associated borrower'' is ''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.''

As discussed below, for consistency, the associated borrower definition in NCUA's loan participation rule is proposed to be amended in a parallel manner.[11]

Loan-to-value ratio

The proposed rule modifies the current definition of ''loan-to-value ratio'' (LTV) to clarify how this ratio should be calculated. Specifically, in calculating an LTV ratio, a credit union must include in the numerator all outstanding loan balances plus any unfunded commitments secured by the collateral, including those from other lenders that are senior to the credit union's lien position. Outstanding exposures from other lenders that are subordinated to the credit union's lien position do not need to be included in the LTV calculation. However, the risk assessment performed by the credit union should evaluate the impact on the borrower's cash flow all outstanding debt owed by the borrower in determining the borrower's ability to sufficiently meet all obligations. In addition, the presence of subordinate financing can have an impact on actions taken by the credit union if it has to exercise its rights to the collateral. The credit union 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. This strengthens the credit union's position and also achieves a more meaningful risk sharing arrangement with its borrower.

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. The Board intends this clarification to ensure that credit unions have appropriate collateral protection in the event that the appraisal value is inflated or the borrower overpays for the purchased collateral. Market value is defined in part 722 of NCUA's regulations for real estate. For other assets, the Board expects credit unions to use prudent and appropriate valuation methods aligned with commercial lending practices that will result in a reliable and accurate collateral value.

Net worth

For consistency, the proposed definition of ''net worth'' provides a cross reference to NCUA's prompt corrective action and risk-based capital rules in part 702, which more fully address the methodology for determining a credit union's net worth.

ii. New Definitions

Commercial loan

The Board is proposing to add a new definition to distinguish between the commercial lending activities in which a credit union may engage, and the statutorily defined MBLs, which are subject to the aggregate MBL cap contained in the FCU Act.[12] The Board emphasizes that all commercial loans, whether MBLs or not, are subject to the safety and soundness requirements provided in § 723.3 through § 723.7 of the proposed rule, unless the credit union is exempt from some of these provisions as provided in proposed § 723.1. Only MBLs are subject to the statutory limits on the aggregate amount of MBLs that may be held by a credit union, per § 723.8 of the proposed rule.

The proposed rule generally defines a ''commercial loan'' as any credit a credit union extends to a borrower for commercial, industrial, agricultural, and professional purposes, with several exceptions. Specifically, the proposed definition expressly specifies that the following loans are not commercial loans: (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 credit union service organization; (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 fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions; and (7) any loan(s) to a borrower or an associated borrower, the aggregate balance of which is equal to less than $50,000.

Loans by corporate credit unions and loans to other insured credit unions are excluded from the definition because

[10] 12 CFR 32.5.

[11] 12 CFR 701.22(a).

[12] 12 U.S.C. 1757a.

these loans possess characteristics that are distinct from the types of commercial loans that the proposal's safety and soundness provisions are intended to address. Loans to CUSOs are excluded from the definition because loans to CUSOs, up to 1 percent of the paid-in and unimpaired capital and surplus of the credit union, are authorized and governed by a provision of the FCU Act not related to MBLs.[13]

Loans secured by a 1- to 4-family residential property, whether or not it is the borrower's primary residence (*i.e.,* owner or non-owner occupied), are excluded from the commercial loan definition. However, the Board notes that loans secured by non-owner occupied 1- to 4-family residential properties have risk characteristics that are more similar to commercial real estate loans than those of owner-occupied 1- to 4- family residential loans. Credit unions should have credit risk management policies and processes suitable for the risks specific to this type of lending. Underwriting standards and the complexity of risk analysis should increase as the number of properties financed for a borrower and associated borrowers increases. When a borrower finances multiple properties and the repayment of the loan is dependent on the successful operation of the multiple residential rental units, a comprehensive global cash-flow analysis of the borrower and principal is generally necessary to properly underwrite and administer the credit relationship. In such cases, credit unions should analyze and administer the relationship on a consolidated basis.

The proposed definition also excludes loans secured by a vehicle generally manufactured for personal, family, and household use. As discussed in more detail below, however, loans for the purchase of fleet vehicles or to carry fare-paying passengers are commercial loans. In addition, a loan to a vehicle dealership or seller to replenish its regular inventory of vehicles for sale (*i.e.,* a so-called ''floor plan loan'' or ''vehicle inventory loan'') is included in the definition of commercial loan.

The Board emphasizes that there are several distinctions between a commercial loan and a statutorily defined MBL, whether directly offered by the credit union or purchased as a loan participation. These distinctions are also discussed in more detail below, relative to proposed § 723.8, which addresses the statutory MBL limits.

There are a two types of commercial loans that are subject to the proposed rule's safety and soundness provisions, but are not MBLs and do not count toward the aggregate MBL limit. Any commercial, industrial, agricultural, or professional loan in which a federal or state agency (or its political subdivision) has committed to fully insure repayment, fully guarantee payment, or provide an advance commitment to purchase the loan in full is a commercial loan but not an MBL. Defining these as commercial loans is intended to ensure the credit union has the requisite expertise and risk management systems to meet the requirements to maintain the government guarantee or commitment to purchase. Also, any non-member loan or non-member participation interest in a commercial, industrial, agricultural, or professional loan is a commercial loan but generally not an MBL.[14] Although these loans are not MBLs because they are loans to non-members, they are still commercial loans and thus fall within the rule's definition and must follow the same risk management practices.

There are two types of loans that are not commercial loans subject to the proposed safety and soundness provisions but they are MBLs and thus, must be counted against the credit union's net member business loan balance. Specifically, loans secured by a 1- to 4-family residential property that is *not* the borrower's primary residence,[15] and loans secured by a vehicle manufactured for household use that will be used for a commercial purpose are generally not commercial loans, but they are MBLs.

Common enterprise

As discussed in greater detail above, the proposed definition of ''associated borrower'' includes any other person or entity with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower, including any person or entity engaged in a common enterprise with the borrower.

Under the proposed rule, a ''common enterprise'' exists and loans to separate borrowers will be aggregated 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; or (2) when 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; or (3) when separate borrowers obtain loans or extensions of credit to acquire a business enterprise of which those borrowers will own more than 50 percent of the voting securities or voting interests.

For purposes of the rule, substantial financial interdependence means 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with another borrower. Gross receipts and expenditures include gross revenues or expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments. In addition, an employer will not be treated as a source of repayment because of wages and salaries paid to an employee, unless the standards described above in (2) are met.

Control

As discussed above, ''control'' is another element of the proposed definition of ''associated borrower'' in the proposed rule. 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 percent 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; or (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 defines ''credit risk rating system'' as a formal process to identify and measure risk through the assignment of risk ratings. Assigning credit risk ratings, also referred to as credit risk grades, is the standard and accepted practice by commercial lenders and other regulators for establishing the level of risk associated with a commercial loan and the overall commercial loan portfolio. An effective credit risk rating system assigns risk ratings to commercial loans at inception. The ratings are reviewed and confirmed as frequently as necessary during the life of the loan to satisfy the credit union's risk monitoring and reporting policies. The risk ratings must

[13] *See* 12 U.S.C. 1757(5)(D).

[14] Proposed § 723.8(b)(4) stipulates, however, that for the exclusion to apply, a credit union must acquire the non-member loan or non-member participation interest in compliance with applicable laws and regulations and it must not be swapping or trading MBLs with other credit unions to circumvent the limit.

[15] Any loan fully secured by a 1- to 4-family residential property that *is* the borrower's primary residence is neither a commercial loan nor an MBL.

be supported by comprehensive analysis and have sufficient granularity to differentiate the level of credit risk associated with each borrower. The construct of a risk rating system usually consists of both quantitative and qualitative risk factors. Quantitative risk factors may include the borrower's financial condition, size, collateral, and guarantees. 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. The Board believes that an effective, accurate, and timely risk rating system is the foundation of sound credit risk management for commercial loans. It allows credit union management to assess credit quality, identify problem loans, monitor risk performance, and manage the risk within its commercial portfolio. A well-managed risk rating system also assists the credit union's board of directors, auditors, and NCUA in monitoring and assessing the overall health of the credit union's commercial loan portfolio and the effectiveness of the credit union's management.[16]

Direct benefit

Under the proposal, ''direct benefit'' is a concept included in the amended definition of ''associated borrower,'' which is discussed above. Direct benefit means 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- to 4-family residential property

Under the proposed rule, a ''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. A lien is considered central to the extension of credit if the borrower would not have been extended credit in the same amount or on as favorable terms without the lien. The proposed 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

Loans secured wholly or substantively by a vehicle manufactured for household use for which the lien is central to the extension of credit are generally not commercial loans for the purposes of the rule. Under the proposed rule, ''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. In other words, loans for the purchase of fleet vehicles or to carry fare-paying passengers are commercial loans. For the purposes of the rule, a ''fleet'' means five or more vehicles that are centrally controlled and used for a business purpose, including for the purpose of transporting persons or property for commission or hire.[17]

Readily marketable collateral

The Board proposes to add the term ''readily marketable collateral'' to the rule to clarify the proposed collateral requirements. The proposed rule defines this term as 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

Under the proposed rule, ''residential property'' is defined as a house, condominium, cooperative unit, manufactured home, and unimproved land zoned for 1- to 4-family residential use. The Board proposes to add this definition to the rule to clarify that loans secured by a 1- to 4-family residential property are excluded from the definition of commercial loan.[18]

iii. Definitions Moved to a Different Section

Construction and development loan

To improve the readability of the rule, the Board proposes to move the current definition of ''construction and development loan'' to proposed § 723.6. The Board believes it is more intuitive for readers for the definition to be included in that section of the rule because that is the section that addresses all of the requirements for construction and development loans.

As discussed in more detail below, the proposed definition of ''construction and development loan'' draws a distinction between construction for an income-producing property and for a commercial property. This distinction is necessary to establish the appropriate prospective market value and the financing period. In addition, the examples in the current rule have been eliminated because the proposed rule simplifies the definition of construction and development loans.

Net member business loan balance

The definition of ''net member business loan balance'' also remains substantively the same as in the current rule; however, it is moved from current § 723.21 to proposed § 723.8, which addresses the statutory limits on the aggregate amount of member business loans that may be held by a credit union. Proposed § 723.8 is discussed in greater detail below. It is more intuitive for readers for this definition to be included in § 723.8 because that is the section that addresses the method for calculating a credit union's net member business loan balance for purposes of compliance with the statutory cap and NCUA form 5300 reporting.

§ 723.3—Board of Directors and Management Responsibilities

The requirements in proposed § 723.3 address the overall elements necessary to administer a safe and sound commercial loan program. Proposed § 723.3 reinforces the NCUA Board's expectation that a credit union's board of directors is ultimately accountable for the safety and soundness of the credit union's commercial lending activities and must remain adequately informed about the level of risk in the credit union's commercial loan portfolio. The proposed rule modifies the current experience and expertise requirements for personnel involved in member business lending and delineates the qualifications required for a credit union's senior executive officers and staff. The proposal also provides options for how a credit union may meet such requirements.

The proposed rule requires a credit union's board of directors to approve a commercial loan policy that complies with proposed § 723.4. Commercial loans may be subject to business and economic changes that warrant frequent monitoring to ensure policy requirements remain effective. Consistent with the current rule, the

---

[16] NCUA Letter to Credit Unions 10–CU–02, Current Risks in Business Lending and Sound Risk Management Practices. (Jan. 2010) (citing the Office of Comptroller of the Currency, Comptroller's Handbook, Rating Credit Risk (April 2001); NCUA Accounting Bulletin 06–01, Attachment 1 (Dec. 2006).

[17] OGC Op. 12–0764 (Sept. 13, 2012).

[18] However, loans secured by a 1- to 4-family residential property that is *not* the borrower's primary residence are MBLs. Loans fully secured by a 1- to 4-family residential property that is the borrower's primary residence are neither commercial loans nor MBLs.

proposed rule requires a credit union's commercial loan policy to address commercial lending practices, procedures, and organizational structure, and be reviewed at least annually, or more frequently if there is material change in portfolio performance or economic conditions, and updated when warranted. The policy updates must be approved by the board of directors. In addition, the board of directors must understand the nature and level of risk associated with the credit union's commercial lending program and receive periodic updates from credit union management on the performance of its commercial loan portfolio, including, but not limited to, reports on overall credit risk ratings and trends, loan growth, adherence to policy and regulations, delinquencies, charge offs, and workout activities. It is also the board of directors' responsibility to ensure that credit union management takes the necessary steps to identify, monitor, and control these risks.

The credit union must also ensure its commercial lending program is staffed with personnel demonstrating appropriate expertise in managing the type of commercial lending in which the credit union is engaged. For example, if a credit union wishes to engage in commercial lending activities to finance farm equipment, acquisition of farmland, or production expenses related to farming or ranching, the credit union needs to ensure its staff has expertise in underwriting, servicing, and identifying and managing risks associated with agricultural loans.

In evaluating experience requirements, the Board is proposing a less prescriptive approach than that contained in the current rule. Specifically, the Board is proposing to eliminate the current two-year experience requirement and replace it with a broader, more flexible principles-based approach that evaluates the overall experience of the staff involved in a credit union's commercial loan program, with an emphasis on experience in commercial loan risk management. This includes experience requirements for any senior executive officers who oversee the credit union's lending department and are otherwise accountable for the performance of the commercial loan portfolio. It is essential for the senior executive officers to have a comprehensive understanding of its credit union's commercial lending activities and the ability to adequately oversee the management of the risks associated with those activities. Senior executive officers must ensure the credit union implements appropriate risk management processes to measure, monitor and control risks. Further, any staff involved in a credit union's commercial loan program must have sufficient expertise in assessing and managing the risks associated with the type of commercial lending in which a credit union is engaged. Skills should be commensurate with each particular individual's position and level of responsibility.

Specifically, a credit union should have:

1. Staff experience directly related to the specific types of commercial lending in which the credit union is engaged;
2. Demonstrated experience in conducting commercial credit analysis and evaluating the risk of a borrowing relationship using a credit risk rating system;
3. Demonstrated experience in underwriting, processing, and conducting workout activities for the types of commercial lending in which the credit union is engaged; and
4. Knowledge of the legal documentation necessary to protect the credit union from legal liability, and all relevant law and regulation impacting commercial lending activities.

In addition to the competencies listed above, managers responsible for a credit union's commercial lending program should have demonstrated experience in:

1. Overseeing commercial credit risk assessment and underwriting;
2. Managing and administering a credit risk rating system;
3. Managing a commercial loan portfolio and being held accountable for the risk in that portfolio; and
4. Managing commercial lenders and other risk managers.

Under the proposed rule, for greater flexibility, credit unions have multiple options to meet the experience requirements. For example, a credit union may meet the requirements by training and developing existing staff, hiring experienced professionals, or the use of a third party such as a CUSO or an independent contractor. The Board notes, however, that it is not prudent for credit unions newly adopting a commercial loan program to initially rely solely on training and developing existing staff, unless existing staff already possess the skills, competencies, and experience required.

Before employing the use of a third party, however, a credit union must ensure the third party meets the experience requirements outlined above. It is vital for the credit union to possess sufficient in-house expertise to fully evaluate the reasonableness and accuracy of risk assessments and recommendations provided by any third party and to effectively oversee the third party relationship. Final responsibility for services provided by the third party, especially risk assessments, remains with the credit union because the risks associated with the transaction are borne by the credit union. The third party may be utilized for underwriting and assessing the credit risk but the credit union must ultimately make the credit decision.

In addition, the credit union must ensure that there is no affiliation or contractual relationship between the third party and the borrower or any associated borrowers to avoid potential conflicts of interest. For example, a circumstance where a third party is performing underwriting services for a credit union while also being compensated by the borrower for obtaining the loan clearly violates the conflict of interest provisions of the proposed regulation. In addition, the risk assessment performed and provided by the third party must be based on the credit union's underwriting criteria, as reflected in its commercial loan policy.

§ 723.4—Commercial Loan Policy

Proposed § 723.4 is comparable to § 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. Proposed § 723.4 sets out the expectations and policy requirements for credit unions offering commercial loans and is intended to facilitate a program that accomplishes the dual objectives of providing appropriate service to the members and managing the risk to the credit unions. The proposal provides more detail for credit unions by establishing the minimum risk assessment practices and procedures that are consistent with accepted, safe and sound practice within the commercial lending industry.

As noted in the introductory language of this section, the proposal specifies that each credit union engaging in commercial lending must ensure that its policies have been approved by the credit union's board of directors. Further, policies and procedures must provide for ongoing control, measurement, and management of the credit union's commercial lending activities. In short, the policies and procedures must ensure the credit union's commercial lending activities are performed in a safe and sound manner, provide for prudent and timely risk assessment and monitoring practices, and address key corresponding operational procedures. NCUA continues to expect an appropriate separation of duties in a credit union's commercial lending procedures, to prevent potential conflicts of interest and other problems in the loan underwriting, collection, and portfolio monitoring functions. An appropriate separation of duties for underwriting, portfolio monitoring, and collection functions provides for a strong internal control to prevent fraud and error. Credit unions should strive to achieve separation of duties wherever possible.

A safe and sound lending program is beneficial to both the member and the credit union. Hence, a key principle underlying the proposal is that a credit union can meet its mission and best serve its commercial members by providing financing designed to meet the unique needs of each member, consistent with the financial capacity of both the member and the credit union. Thus, the proposed rule contemplates risk management processes that include procedures for achieving a comprehensive understanding of the borrower's operations, financial condition, and the industry and market in which the business operates. In addition, the proposal contemplates that the credit union will actively manage risks associated with its commercial loan program, which includes submitting on a regular basis to senior management and the board of directors reports on the performance of the portfolio.

Proposed § 723.4 also reinforces current supervisory expectations that credit unions will adopt a formal credit risk rating system to identify and quantify the level of risk within their commercial loan portfolios.[19] Credit risk rating systems are the standard method used by commercial lenders for identifying and quantifying credit risk at the borrower, borrowing relationship and overall commercial loan portfolio levels. The proposed rule clarifies the minimum requirements for assessing credit risk and the processes necessary to support an accurate and reliable credit risk rating system. Consistent with the proposed rule's emphasis on responsible risk management by credit unions, future examinations will benefit by greater focus on the accuracy and effectiveness of a credit union's use of its credit rating system to identify and manage risk.

Another key principle underlying the proposal is that a credit union must 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 credit union to accommodate. Accordingly, the proposal eliminates prescriptive risk management requirements for LTV ratios, minimum equity investments, portfolio concentration limits for types of loans, and personal guarantees. As a result, the need for waivers of these requirements is also eliminated. The Board emphasizes, however, that the removal of the prescriptive requirements from the rule does not relieve the credit union 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 credit unions to establish prudent limits in their policies appropriate for the credit union'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.

As proposed, § 723.4 would require that a credit union's commercial loan policy must address each of the following areas:

1. *Types of commercial loans permitted.* This provision, which is carried over from the current rule, reflects the fundamental principle that loans offered by a credit union should meet the needs of its membership. The credit union should analyze its membership and ensure its commercial lending staff has the necessary expertise, gained through experience and training, to understand the needs of the membership and the types of loans offered.

2. *Trade area.* This provision is also carried over from the current rule. A credit union must be certain that it is capable of serving its identified trade area. Effective risk management requires that the credit union has the ability to make periodic site visits to evaluate the borrower's operations and inspect the collateral.

3. *Maximum loan amounts, both in terms of loan category and to any one borrower or group of associated borrowers.* This proposed section now combines language from current § 723.6 concerning maximum loan amounts by type of loan with language from current § 723.8, describing maximum amounts for loans to one borrower or a group of associated borrowers. The proposal would impose the same limit for one borrowing relationship as the current rule, which is a maximum of 15 percent of the credit union's net worth. However, the proposed rule will allow credit unions to exceed the general limitation by 10 percent of the credit union's net worth, if the amount above the 15 percent limit is fully secured by readily marketable collateral. This is consistent with the limit allowed by other banking regulators.[20]

4. *Qualifications and experience requirements for lending staff.* The proposal reflects the importance of a properly staffed commercial loan department, which is essential to providing competent member service and to actively managing risk. Credit unions will, in developing their staffing requirements, consider relevant factors specific to the credit union and to the needs of its commercial borrowing members. Staffing should be determined based on loan volume, projected loan growth, trade area, complexity of the borrowing relationships, types of loans permitted, and any other unique influences on the credit union's commercial loan portfolio. In determining staffing levels, the credit union should consider appropriate levels of management, relationship managers, and support staff as may be required to ensure the needs of the membership are responsibly serviced in a safe and sound manner.

5. *Loan approval processes.* This new section of the proposal specifies that the credit union's policy must establish lending authority for approving credit decisions. A credit union must establish a process that assigns credit approval authority to individuals or committees making such decisions commensurate with the individual's or committee's experience in evaluating and understanding commercial loan risk. In addition, the approval authorities and system should ensure an adequate level of review and approval by senior management prior to the loan decision for complex and/or large loans or credit relationships. All lending authority limits should be assigned based on the aggregate loan relationship of the member and associated borrowers. The system should provide for adequate oversight and review of the loan approval process, with all loan approvals or denials tracked by loan department management and periodically reported to senior management.

6. *Underwriting standards.* The proposed rule clarifies the requirements for assessing risk at inception and over the life of the loan. This new section

[19] While a credit union may use a risk rating methodology developed by a third party, the credit union must perform appropriate due diligence on the methodology and determine it meets the credit union's needs for properly categorizing the risk of commercial loans.

[20] 12 CFR 32.3.

provides in greater detail the types of considerations and analyses that are required for proper commercial loan underwriting.

The level and depth of credit analysis and risk assessment should be commensurate with the overall risk the relationship poses to the credit union based on its size, credit risk rating, and complexity. The policy must address the required analysis and depth of the financial review performed to support the credit decision. It should establish the approval process, including the lending authorities and the documentation of the credit decision. It should outline the required components of the credit approval document. The approval process and documentation should provide sufficient information to allow the approving body to make a fully informed credit decision.

The credit approval document should be in a standard, logical format and provide all relevant information. Standard formats provide for a consistent and fair process for evaluating credit to all borrowers.

The borrower analysis should focus on satisfactory borrower payment history, along with a review and explanation of the financial trends of the borrower based on a reasonably long period to establish a reliable trend. The analysis should focus on income and expense trends, debt service ability, balance sheet changes and the impact of those changes on the ability to service debt. The analysis should discuss the required evaluation of related parties and the influence of those parties on the repayment ability of the borrower.

The policy must establish due diligence requirements to evaluate the other sources of income or losses affecting the guarantors or principals to determine the global financial condition and the debt service ability of the borrower. The commercial loan policy should also set the requirements for the financial reporting to support a credit decision. It should address the minimum criteria for historic reporting at the inception of the loan, as well as regular reporting after the loan is closed, and the required quality of financial information to establish an accurate and reliable assessment of financial trends. Risks should be monitored throughout the life of the loan based on periodic review of the financial position of the borrower and site visits to detect any operational changes.

The proposal also notes that underwriting standards must address the quality of the financial information used to make the credit decision and ensure that the degree of verification reflected in the financial information is sufficient to support the financial analysis and the risk assessment of the credit decision. Financial statement quality is determined by the level of assurance provided by the preparer and the required professional standards supporting the preparer's opinion. In many cases, tax returns and/or financial statements professionally prepared in accordance with generally accepted accounting principles (GAAP) will be sufficient for less complex borrowing relationships, such as those that are limited to a single operation of the borrower and principal with relatively low debt. For more complex and larger borrowing relationships, such as those involving borrowers or principals with significant loans outstanding or multiple or interrelated operations, the credit union should require borrowers and principals to provide either (i) an auditor's *review* of the financial statements prepared consistent with GAAP to obtain limited assurance (*i.e.,* a ''review quality'' financial statement), or (ii) an independent financial statement *audit* under generally accepted auditing standards (GAAS) for the expression of an opinion on the financial statements prepared in accordance with GAAP (*i.e.,* an ''audit quality'' financial statement).

In either case, the credit union's policy should establish a threshold for the required financial reporting. The policy should also establish the requirements for financial projection, which will ensure the borrower is actually planning and managing operations to achieve future goals. Financial statement projections should be required when the historic performance does not support the proposed debt repayment, or a structural change in the future operations of the borrower is anticipated and repayment depends on the success of the changes. The borrower or principals of the borrower should prepare the projection, as it is they who must execute and achieve the projected plan.

Finally, the proposal calls for the credit union to establish underwriting standards to include LTV ratio limits and methods for valuing all types of collateral authorized. For real estate valuation, the methods need to comply with Part 722 of NCUA's regulations. The standards should set minimum collateral requirements based on the collateral characteristics and risk associated with the borrowing relationships. For dynamic assets with changing quantities and value, such as accounts receivable and inventory, LTV ratios should be lower than more stable assets such as new equipment and real estate. The LTV ratios for equipment and real estate should reflect influences on the marketability of the collateral, such as age, condition, and potential alternative uses of the collateral, and be consistent with prudent commercial lending practice.

The standards should also set forth the requirements for establishing an enforceable and perfected lien position for different types of collateral. The standards should also establish procedures and processes to determine if property proposed as collateral has been affected by contamination of hazardous material, either by the borrower's own operations, historic use by previous owners, or from neighboring commercial operations, and should outline processes to limit the exposure to the credit union for any possible liability.

7. *Risk Management Processes.* The risk associated with commercial lending is dynamic due to changing influences on the market and operational conditions of the borrower. The proposed rule requires the credit union to establish policies and procedures to identify and manage risk at the inception of the loan and throughout the life of the loan. Specific components to be addressed by the credit union are set out in the proposal and include:

(i) *Use of loan covenants, when warranted.* A change in risk is generally reflected in an adverse change in the financial condition of the borrower or associated borrowers. Thus, the credit union's policy should establish the requirements for the use of financial covenants, financial reporting and regular site visits. Early detection of adverse changes in the borrower's operation will provide the credit union with the best opportunity to assist the member and protect itself from losses.

(ii) *Periodic review.* The credit union loan policy must set forth the requirements for periodic loan relationship review. The Board notes that areas to consider include frequency of site visits, periodic financial reporting, and comprehensive review of the relationship. The Board also notes that a standard practice in this respect is to review the relationship from a financial and operational standpoint on an annual basis, simultaneous with the timely submission of the fiscal year-end financial statements.

(iii) *A credit risk rating system.* The ability to quantify and report the level of risk is the paramount responsibility of the credit union. Accordingly, the proposed rule requires the credit union to incorporate a credit risk rating system to analyze and describe the credit risk of each loan. A risk rating system is a standard industry practice utilized by commercial lenders, a longstanding NCUA supervisory expectation, and required by other regulators to monitor and quantify risk.[21]

An effective risk rating system establishes risk grades that are applied to each loan, with grades ranging from low risk to high risk. The risk rating system should incorporate a sufficient number of risk grades to differentiate the level of credit risk in different loans, and should be supported by appropriate analysis of the borrower and associated borrowers.

The credit risk rating is assigned to each loan at origination and reviewed and adjusted periodically over the life of the loan. All credit unions should ensure the accuracy of the credit risk ratings and that the process for determining the risk ratings is periodically validated. Both the quantitative inputs and the expertise and judgment of staff responsible for assigning the ratings are critical in making the credit decision and in assigning risk ratings. The system should provide for well-defined and clear criteria for each risk rating and promote consistency in assigning and reviewing ratings.

The evaluation should include quantitative factors based on financial performance and qualitative factors based on management, market, and business environmental considerations. An effective risk rating system will allow for active risk management of individual member loans and the portfolio.

The procedures and policies outlined in NCUA Accounting Bulletin No. 06, Attachment 1, Loan Review Systems or any updates to this guidance must be reflected in the credit union's policy. This guidance outlines the minimum requirements for the application and administration of an effective risk rating and commercial loan review process. NCUA's assessment of a credit union's risk rating process will be a major emphasis of examinations.

(iv) *Loan exceptions.* The commercial loan policy may allow for exceptions to policy when necessary to meet the unique circumstances of a borrowing relationship and doing so would not create undue risk to the credit union. The policy must establish the process for approval and documentation of an exception to loan policy. All exceptions to the loan policy need to be tracked and periodically reported to senior management and the board.

§ 723.5—Collateral and Security

Collateral

All of the specific prescriptive limits and requirements related to collateral in the current rule have been eliminated and replaced with the fundamental principle that commercial loans must be appropriately collateralized. While the proposal simplifies the collateral requirements, it is predicated on NCUA's expectation that commercial loans require collateral sufficient to protect the credit union against the associated risk. The majority of loans granted support either the purchase of an asset or working capital to fund inventory or accounts receivable during the business cycle. At a minimum, those assets should collateralize the loan.

Accordingly, the proposal reflects the expectation that a credit union making a commercial loan will require the borrower to provide collateral that is appropriate for the type of transaction and the risk associated with the borrowing relationship. Credit unions must use sound judgment when requiring collateral and will require collateral coverage for each commercial loan in an amount that is sufficient to offset the credit risk associated with that loan.

The marketability and type of collateral should also be considered in determining the collateral requirements. Marketability can be influenced by the age, condition, and alternative uses of the collateral. For depreciating assets such as equipment or vehicles, newer collateral in good condition would warrant a relatively higher loan-to-value ratio. Collateral with limited alternative uses, such as single-purpose real estate, or assets with limited useful life, such as used equipment or vehicles, would warrant a lower loan-to-value ratio. The term of the loan should also be reflective of the anticipated useful life of the collateral, which is determined based on the type of collateral and its expected use. In addition, credit unions should consider the volatility of the asset as it relates to value and quantities. Specifically, current assets, especially accounts receivable and inventory, are dynamic, with changing market values and regular fluctuation in quantity on hand. Accordingly, when these assets serve as collateral, a lower loan-to-value ratio is warranted to account for the volatility. Also, when establishing loan-to-value limits, credit unions should align their policies with prudent commercial lending practices.

The proposal requires that a credit union must establish a policy for monitoring collateral, including systems and processes to respond to changes in asset values. For example, real estate in good condition and in demand may be inspected less frequently than other types of assets such as current assets, which can undergo more frequent changes in value and which require regular reporting and monitoring to ensure continued compliance with collateral requirements.

Unsecured commercial lending presents additional risk to the lender. Such lending should be limited and treated as an exception, to be offered only when the additional risk is adequately offset by appropriate risk mitigants. Examples of some of these risk mitigants include a stable record of profitability, superior and consistent debt service coverage, a low debt-to-worth ratio, and financially strong guarantors. The unsecured loans should be tracked and the volume of such loans periodically reported to senior management and the board. The credit union should set prudent portfolio limits for these types of loans, measured in terms of a reasonable percentage of the credit union's net worth.

Personal Guarantees

Consistent with the overall, principles-based approach underlying this proposal, the proposed rule removes the explicit requirement contained in the current rule that credit unions obtain a personal guarantee from the principal(s) of the borrower. The Board notes, however, that having the principal(s) of the borrower commit their personal liability to the repayment obligation is, in most cases, very important for commercial lending. Accordingly, the proposed rule makes clear that excusing principals from providing their personal guarantee for the repayment of the loan may only be done with appropriate corresponding underwriting parameters and portfolio safeguards. The credit union should set prudent portfolio limits for these types of loans, measured in terms of a reasonable percentage of the credit union's net worth. Commercial loans without a personal guarantee should be tracked and periodically reported to senior management and the board.

Personal guarantees provide an additional form of credit enhancement for a commercial loan. In small business, investor real estate, and privately held entity lending, it is standard industry practice for principals of the business to assume the majority of the risk by personally guaranteeing the loan. Business owners or principals

[21] NCUA Letter to Credit Unions 10–CU–02, Current Risks in Business Lending and Sound Risk Management Practices. (Jan. 2010) (citing The Office of Comptroller of the Currency, Comptroller's Handbook, Rating Credit Risk (April 2001); NCUA Accounting Bulletin 06–01, Attachment 1 (Dec. 2006).

will benefit the most from the success of the business operation; therefore, it is appropriate for principals to shoulder the bulk of the risk by committing their personal guarantee.

A personal guarantee by the principal offers additional financial support to back the loan, but more importantly it solidifies the long-term commitment by the principal to the success of the business operation. The most effective guarantee will be from the principals who have control of the borrower's operation and have sufficient financial resources at risk. A firm commitment by such a principal is vital to preserving the value of the borrower's business, either by improving operations or, in the worst case, by preserving asset values in the event of default and liquidation. The guarantor's economic incentive is to manage the business successfully and retain value, which will ultimately serve to offset any deficiency the guarantor might otherwise be obligated to pay.

§ 723.6—Construction and Development Loans

Construction and development lending represents an important and necessary service that credit unions can provide to their membership. The Board is also concerned, however, that construction and development lending presents risk, in addition to credit risk, in the areas of loan disbursement administration and valuation of collateral. Credit unions that elect to pursue this line of business must protect against those risks by ensuring they have specific expertise and experience, supported by appropriate systems, to mitigate those risks. In addition to these minimum requirements for evaluating credit risk, the proposed rule outlines separate requirements that pertain exclusively to construction and development lending. The proposed rule clarifies the definition of a construction and development loan, describes alternative methods for valuing a construction project, and explains which costs are considered allowable in determining value of the project and therefore may be funded from loan proceeds. Finally, the proposal outlines required procedures to be followed in the administration of construction and development loans.

The proposal sets forth a new definition for construction and development loans that distinguishes between income-producing property and projects built for a commercial purpose. This distinction is necessary for determining the duration of the financing period, as established in this section under the prospective market value method of valuing a construction project. As specified in the proposal, ''income producing'' means any property that generates income from the rental or sale of the units constructed with loan proceeds and the repayment of the loan is dependent on the successful completion of the project. ''Commercial purpose,'' by contrast, is a term that applies to structures that do not directly generate income but enhance the operation of a commercial or industrial operation, such as a warehouse, manufacturing facility, and management office space. The proposal also clarifies that a construction and development loan includes any loan for the construction or renovation of real estate where prudent practice requires multiple disbursements as the project progresses and the ultimate valuation of the project and collateral protection is determined from the completed project.

The proposed rule also establishes procedures for the valuation of collateral for construction and development loans. As noted above, in this context, there is significant risk, aside from credit risk to the lender, so the proposal provides significant detail regarding collateral value and preserving that value through diligent loan administration.

As proposed, the rule would outline two distinct methods for determining collateral value: One focused on cost, the other on market value. The proposed rule states explicitly that the credit union must use the lesser value resulting from these two valuation methods in its determination of collateral value. This protection ensures the sufficiency of the investment by the borrower into the project. Requiring credit unions to use the valuation method that projects the lesser value will ensure that the borrower has capital at risk and will help the credit union to establish the appropriate balance in the sharing of risk between lender and borrower. Requiring an evaluation of the prospective market value will guard against the risk of financing overbuilding in the local real estate market.

The first method entails an evaluation of the cost to complete the project. The proposal describes allowable costs for valuation and funding purposes consistent with prudent commercial practice. This description supersedes two legal opinion letters issued by NCUA's Office of General Counsel in 2001 and 2005, respectively.[22]

The proposal also describes a second valuation method, which is the prospective market value method. The prospective market value method is described in the Uniform Standards of Professional Appraisal Practice (Statement 4), which discusses the method for valuing a completed and stabilized construction project. The language in the proposed rule describes two different aspects of this approach, based on whether the property is held for a commercial or an income-producing use. The first method, ''as-completed,'' is for a commercial purpose building, while the second, ''as-stabilized,'' is for income-producing real estate.

Finally, the proposed rule clarifies the requirements for administering a construction and development loan process, including requiring appropriate disbursement controls, to ensure the project is adequately funded and managed to reduce risk. The proposed rule requires a submission of a line-item budget by the borrower and calls for it to be reviewed and accepted by a qualified individual representing the credit union's interest. It outlines the necessary components of the disbursement process that will ensure that funds are disbursed as planned and in accordance with the budget for work completed and to ensure that the collateral protection has not been adversely affected by intervening liens.

With the clarification of allowable costs, the establishment of the concept of prospective market value, and an outline of required loan administration practices, the proposed rule sets out policies and procedures that are in line with contemporary commercial construction lending practices.

§ 723.7—Prohibited Activities

The prohibitions contained in current § 723.2 have been moved to proposed § 723.7 and are essentially unchanged, except for minor clarifications in the wording that are not intended to reflect substantive change. This section of the proposed rule also now includes provisions governing conflicts of interest, which have been taken virtually intact from § 723.5(b) of the current rule. The proposal also adds a clause to clarify what it means to be ''independent from the transaction'' and specifically provides that any third party providing advice or support to the credit union in connection with its commercial loan program may not receive compensation of any sort that is contingent on the closing of the loan. This would include, for example, a broker or finder who anticipates receiving remuneration from the borrower or a related party upon the funding of the loan. The proposal recognizes that such a party has an

[22] OGC Op. 01–0422 (June 7, 2001); OGC Op. 05–0243 (May 25, 2005).

interest that could conflict with the interest of the credit union in making a sound credit risk decision. The Board believes that having the prohibitions and the conflicts of interest provisions in a single section of the rule makes sense from an organizational standpoint and will facilitate understanding of and compliance with its provisions.

§ 723.8—Aggregate Member Business Loan Limit; Exclusions and Exceptions

As discussed above, one of the underlying principles for the proposed revisions to the MBL rule is the recognition that there are safety and soundness risks inherent in the making of commercial loans, and that managing those risks entails substantially greater effort and attention than merely applying a rigid limit on the aggregate amount a credit union is allowed to invest in such loans. Nevertheless, the FCU Act does impose such a limit, and one purpose of the rule is to address that statutory limit. Section 723.8 of the proposed rule accomplishes that objective.

Proposed § 723.8 sets out the statutory aggregate limits of Section 107A of the FCU Act.[23] The general aggregate statutory limit on MBLs is applied in the current rule as the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets.[24] The Board notes that while the minimum net worth requirement for most credit unions to be well-capitalized is the 7 percent leverage ratio, it can be a higher amount if a credit union is subject to a risk-based net worth requirement that is higher than the amount required by the 7 percent leverage ratio. Thus the MBL limit should not be expressed as an absolute percentage but rather as 1.75 times the applicable net worth requirement for a credit union to be categorized as well-capitalized. For greater consistency with the statute, proposed § 723.8(a) more faithfully incorporates the statutory language contained in the FCU Act.

The proposal also clarifies the distinction between commercial loans subject to the safety and soundness provisions and MBLs subject to the statutory limit. The approach taken in the proposal is to indicate that ''member business loan'' generally means any commercial loan, as defined in the rule. As discussed above, two types of MBLs are expressly excluded from the proposed commercial loan definition: Loans secured by a 1- to 4-family residential property and loans secured by a vehicle manufactured for household use. The Board emphasizes, however, that while these loans are not considered to be commercial loans subject to the safety and soundness provisions in the rule, appropriate risk management is still required.

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

1. Loans in which a federal or state agency (or its political subdivision) fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full; and

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.[25]

Further, loans secured by a 1- to 4-family residential property that is *not* the primary residence of the borrower are not commercial loans but they are included in the MBL definition, and therefore, must be included in the aggregate limit calculation.

TABLE—COMPARISON OF MEMBER BUSINESS LOAN AND COMMERCIAL LOAN DEFINITIONS

Type of loan	MBL	Commercial loan
Loan fully secured by a 1- to 4-family residential property (borrower's primary residence).	No	No.
Member business loan secured by a 1- to 4-family residential property (*not* the borrower's primary residence).	Yes[26]	No.
Member business loan secured by a vehicle manufactured for household use.	Yes[27]	No.
Business loan with aggregate net member business loan balance less than $50,000.	No	No.
Commercial loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions.	No	No.
Commercial loan in which a federal or state agency (or its political subdivision) fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full.	No	Yes.[28]
Non-member commercial loan or non-member participation interest in a commercial loan made by another lender.	No	Yes.[29]

The Board emphasizes that a credit union's non-member commercial loans or participation interests in non-member commercial loans made by another lender[30] continue to be excluded from

[23] 12 U.S.C. 1757a.

[24] In the current rule, the 12.25 percent figure is a shorthand reference to how the cap applies to the requirement to maintain at least 7 percent of total assets to be well capitalized—1.75 times 7 percent equals 12.25 percent.

[25] Non-member loans and non-member participation interests are excluded from the statutory MBL limit, but credit unions are currently subject to a regulatory requirement to seek prior approval from NCUA for non-member loan balances to exceed the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets.

[26] If the outstanding aggregate net member business loan balance is greater than $50,000.

[27] If the outstanding aggregate net member business loan balance is greater than $50,000.

[28] If the outstanding aggregate net member business loan balance is greater than $50,000.

[29] If the outstanding aggregate net member business loan balance is greater than $50,000.

[30] Federally insured credit unions are authorized to purchase participation interests in loans made by other lenders to credit union members. 12 U.S.C. 1757(5)(E); 12 CFR 701.22. The borrower need not be a member of the purchasing credit union, only a member of one of the participating credit unions. 12 CFR 701.22(b)(4). Additionally, federal credit unions generally may purchase eligible obligations of its members from any source if the loans are those the FCU is empowered to grant. 12 U.S.C. 1757(13); 12 CFR 701.23(b). Certain well capitalized federal credit unions may also purchase whole loans from other federally insured credit unions, including commercial loans, without regard to

Continued

the MBL definition [31] and are not counted for call report purposes or in calculating the statutory aggregate amount of MBLs, provided the credit union acquired the loan or participation interest in compliance with all relevant laws and regulations and the credit union is not, in conjunction with one or more other credit unions, trading MBLs to circumvent the aggregate limit. However, the proposed rule eliminates the need to apply for prior approval from the NCUA regional director for a credit union's non-member loan balances to exceed the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets.[32]

The current rule's application requirement was driven in part by safety and soundness concerns.[33] Under the proposal, however, safety and soundness is of paramount concern, and the bulk of the rule focuses on those considerations. Accordingly, rather than continuing to impose the requirement that the total of a credit union's non-member loan balances may not exceed the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets unless it receives prior NCUA approval, the proposal's focus is on the risks associated with that balance and how the credit union should manage the risks. The application requirement in the current rule was also intended to address concerns that the MBL rule's treatment of participation interests could create a loophole to the statutory limit, and that some credit unions may use the authority to purchase non-member loans and non-member participation interests as a device to swap loans and evade the aggregate limit.[34] To preserve the existing safeguard against evasion, the proposal retains in substance the current rule's stipulation that, for the exclusion to apply, a credit union must acquire the non-member loan or non-member participation interest in compliance with applicable laws and regulations and it must not be swapping or trading MBLs with other credit unions to circumvent the aggregate limit.[35] The Board notes that participation interests in member business loans and member business loans purchased from other lenders continue to count against a credit union's aggregate limit on net member business loan balances.

The proposed rule also identifies those credit unions that are, by statute, exempt from the aggregate MBL limit. Specifically, it provides that credit unions that have a low-income designation or that participate in the Community Development Financial Institutions program are exempt from compliance with the aggregate MBL limit. Credit unions chartered for the purpose of making commercial loans are also exempt from compliance with the aggregate MBL limit. An additional statutory exemption was provided for credit unions that had a history of primarily making member business loans, determined as of the date of enactment of the Credit Union Membership Access Act of 1998 (CUMAA), which amended the FCU Act to include certain new restrictions on member business loans. The Board continues to apply the ''history of primarily making member business loans'' exemption by reference to the date of CUMAA's enactment; [36] therefore, the proposal removes the outdated provisions in the current rule that relate to the evidentiary documentation necessary to demonstrate a credit union's qualification for the exemption. The Board also emphasizes that, regardless of the status of a credit union's exemption from the aggregate limit, all credit unions are subject to the safety and soundness provisions of the rule.

Finally, the proposal establishes the method for calculating a credit union's net member business loan balances for the purpose of complying with the statutory cap and reporting on NCUA form 5300. That method is consistent with the current rule, but the requirements for calculating the net member business loan balances is moved from the definitions section in current § 723.21 to proposed § 723.8 for greater ease of reference and improved readability. Consistent with the current rule, the proposal provides that a federally insured credit union's net member business loan balance is determined by calculating 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.

§ 723.9—Transitional Provisions

Proposed § 723.9 would implement the transition from the current prescriptive rule to the proposed, principles-based rule. This section covers two different scenarios and describes the way in which the proposed rule, if adopted, would impact those credit unions currently operating under a waiver or an enforcement action.

As discussed more fully below, the Board is additionally soliciting comment on potential approaches with respect to those federally insured, state-chartered credit unions currently operating under an NCUA-approved state rule.

i. Existing Waivers or Enforcement Constraints

In view of the principles-based approach taken in the proposed rule, proposed § 723.9(a) provides that any waiver previously issued by NCUA concerning any aspect of the current rule becomes moot upon the effective date of any final MBL rule except waivers that were granted for a single borrower or borrowing relationship to exceed the limits set forth in § 723.8 of the current rule, 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 § 723.4(c) of the proposed rule.

All blanket waivers granted to credit unions for current § 723.8 will terminate on the effective date of any final MBL rule. The Board notes that any credit union that qualified for a waiver concerning any of the hard regulatory limits contained in the former rule will, for the most part, already have the types of policies and procedures in place regarding its commercial loan program

whether they are obligations of their members. 12 CFR 701.23(b)(2).

[31] *See* 68 FR 56537, 56543 (Oct. 1, 2003) (''[P]urchases of nonmember loans and participation interests, as authorized under certain conditions in NCUA's rules and some state laws and rules, do not involve the provision of member loan services, and the acquired loan assets are not MBLs . . . [and] they need not count against the purchasing credit union's aggregate MBL limit. The Board believes it is important to avoid unnecessary interference with the ability of credit unions to place their excess funds in a member that best serves the credit union, its members, and the credit union system.'')

[32] 12 CFR 723.16(b).

[33] *See* 68 FR at 56544.

[34] *Id.*

[35] 12 CFR 723.16(b)(2)(iv).

[36] *See* 64 FR 28721, 28726 (May 27, 1999).

that are contemplated by the proposed rule. Accordingly, the Board anticipates that there will be little if any disruption arising from this transition. In keeping with the principles-based approach, waivers and waiver requests are not part of the proposed rule.

In contrast to the effect of the proposed rule on waivers, proposed § 723.9(b) clarifies that any constraints imposed on a credit union in connection with its commercial lending program, such as may be contained in a Letter of Understanding and Agreement, would survive the adoption of the proposed rule and remain intact. Thus, the proposed rule specifies that any particular enforcement measure to which a credit union may uniquely be subject takes precedence over the more general application of the regulation. A constraint may take the form of a limitation or other condition that is actually imposed as part of a waiver. In such cases, the constraint would survive the adoption of the proposed rule in final form.

ii. State Regulation of Business Lending

The Board solicits comment on how best to approach the issue of state regulation of business lending. Broadly speaking, there are two threshold questions that arise in this context: first, how to address those states that currently have an NCUA-approved MBL rule in place; and second, whether to continue the convention, as set out in the current rule, of permitting states to submit a version of an MBL rule to the Board for its approval as provided for in § 723.20 of the current rule. Each of these questions is addressed below.

As a preliminary matter, the Board notes that, while it may authorize a state supervisory authority (SSA) to play a role in the regulation of business lending, that role is necessarily limited. Congress granted the Board the sole authority to interpret the MBL provisions of the FCU Act and to promulgate implementing regulations, and FCUs and federally insured, state-chartered credit unions (FISCUs) alike are subject to them.[37] An SSA does not have independent ability to interpret the FCU Act, but under the current rule may make its case to the Board that its proposed state rule is consistent with NCUA's interpretation of the FCU Act and Part 723. Until now, the Board has chosen to delegate authority to SSAs to administer a state MBL regulation under the conditions outlined in current § 723.20. In making this delegation in any given case, the Board has been focused on whether the state regulation contains comparable risk management requirements and properly applies the statutory limit on MBLs. There are, at present, seven states in which the Board has approved the state rule.[38]

To address the regulation of business lending by FISCUs, the Board is seeking comment on three options currently under consideration, as well as any alternative approaches.

The following chart briefly highlights key provisions of the three options. Below the chart, each option is described in further detail.

Key provisions	Grandfathers 7 States with MBL rules previously approved by NCUA Board	Permits States to submit new MBL rules for NCUA Board approval
Option A	Yes	No.
Option B	No	Yes.
Option C	Yes	Yes.

The first option (Option A), for which comment is solicited, would be to allow SSAs that currently administer a state MBL rule to preserve their rules in their current format, thus allowing FISCUs in those states to continue to operate in compliance with the pertinent state rule. In this respect, the Board notes that each of the seven state rules is based on the model of Part 723 in its current form.

Under this approach, FISCUs in these seven states would continue to comply with the applicable provisions in their state. However, no other SSA would be permitted to submit a rule for NCUA consideration and approval. Instead, aside from FISCUs operating in the seven grandfathered states, all other FISCUs would be subject to Part 723.

A second option (Option B), for which comment is also solicited, would be for NCUA to require SSAs in these seven states to make conforming amendments to their rules and resubmit them to NCUA for an updated approval. For these SSAs (and any other SSA that seeks to implement its own rule), the new state MBL rules would need to reflect the same principles and incorporate the guidance contained in any final rule, but could be more restrictive if the state so chose.

A third option (Option C), for which comment is solicited, would combine certain provisions of Option A and Option B. Specifically, Option C would permit SSAs that currently administer a state MBL rule to preserve their rules in their current format, thus permitting FISCUs in those states to continue to operate in compliance with the applicable state rule. However, rather than prohibiting other SSAs from submitting their own state rules for NCUA consideration and approval, Option C would permit SSAs to submit such rules as long as they conform with language similar to the beginning of current § 723.20(a). In determining whether or not to approve a state MBL rule, current § 723.20(a) notes, ''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. . . .'' In past practice, the Board has generally approved state rules that are substantially similar to NCUA's rule or more restrictive if the state so chose.

The Board invites public comment on whether Option A, Option B, or Option C should be adopted in the final rule, and how any federal parity provisions in state law would affect these options. The Board also welcomes commenters' suggestions for any alternative approaches to addressing the state regulation of business lending.

C. Amendments to the Loan Participation Rule

As discussed above, the proposed rule amends the definition of ''associated member'' in the current MBL rule to be more consistent with the combination rules applicable to banks by introducing the concepts of direct benefit, common enterprise, and control.[39]

NCUA's loan participation rule contains a similar definition for ''associated borrower,''[40] which was amended by the Board in 2013 to track closely with the definition in the MBL rule.[41] In order to maintain that consistency, the proposed rule also makes parallel amendments to § 701.22(a) by modifying the current definition of ''associated borrower,'' and by adding new definitions of ''common enterprise,'' ''control,'' and ''direct benefit'' to the loan participation rule.

D. Delayed Implementation

The Board recognizes that the proposed shift to a principles-based rule represents a significant change in approach that will require a period of adjustment for both credit unions and examiners. Accordingly, should this proposal be finalized, the Board will delay implementation of the final rule

[37] 12 U.S.C. 1757a.

[38] The seven states currently operating with NCUA Board-approved MBL rules are Connecticut, Illinois, Maryland, Oregon, Texas, Washington, and Wisconsin.

[39] 12 CFR 32.5.

[40] 12 CFR 701.22(a).

[41] 78 FR 37946 (June 25, 2013).

for 18 months, to allow NCUA and state supervisory authorities adequate time to adjust to the new requirements, including training staff, and for affected credit unions to make necessary changes to their commercial lending policies, processes, and procedures in compliance with the new rule.

D. Request for Public Comment

The Board invites comment on all issues discussed in this proposal. In particular, the Board solicits specific comment on the proposal's principles-based regulatory approach and on how best to approach the issue of state regulation of business lending. Further, commenters should not feel constrained to limit their comments to the issues discussed above. Rather, commenters are encouraged to discuss any other relevant MBL issues they believe NCUA should consider that are consistent with and permissible under the existing statute.

III. Regulatory Procedures

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires that, in connection with a notice of proposed rulemaking, an agency prepare and make available for public comment an initial regulatory flexibility analysis that describes the impact of a proposed rule on small entities. A regulatory flexibility analysis is not required, however, if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include credit unions with assets less than $50 million) [42] and publishes its certification and a short, explanatory statement in the **Federal Register** together with the rule.

As of December 2014, of the 4,050 federally insured credit unions with total assets less than $50 million, 619 credit unions hold business loans on their balance sheets, including both member and non-member loans. Among the 619 credit unions, 317 credit unions have business loans less than 15 percent of net worth and are not regularly originating and selling or participating out business loans. Therefore, they would be exempt from § 723.3 (board of directors and management responsibilities) and § 723.4 (commercial loan policy) under the proposed rule—where the incremental paperwork burden associated with the transition for this rule stems from.

The remaining 302 credit unions with assets less than $50 million would be subject to § 723.3 and § 723.4 under the proposed rule because their level of activity in commercial lending is material to their financial and operational safety and soundness. However, the revised definition of commercial loan generally excludes loans secured by vehicles manufactured for household use and 1- to 4-family non-owner occupied residential property that trigger the safety and soundness provisions of the current rule. The average member business loan balance for credit unions with less than $50 million in assets is only $70,891. Thus, it is likely many of the outstanding member business loans currently held by small credit unions, and subject to the current rule, would be exempt under the proposed rule. Thus, NCUA anticipates fewer than 302 small credit unions would actually be subject to the proposed rule (except for § 723.8—the statutory limit provisions). The 302 credit unions only represent 7% of total credit unions with assets less than $50 million.[43] They hold approximately $513 million in business loans in aggregate, which represents 1% of the total business loans in the credit union industry.

	2014	
	Number of credit unions	Percent of total
Credit unions with total assets below $50 million	4,050	100
Credit unions with total assets below $50 million and with MBLs	619	15
Credit unions with total assets below $50 million, with MBLs, and are exempted from § 723.3 and § 723.4	317	8
Credit unions with total assets below $50 million, with MBLs, and are not exempted from § 723.3 and § 723.4	302	7

The proposed amendments would provide federally insured credit unions with significant regulatory relief via greater flexibility and individual autonomy in safely and soundly providing commercial and business loans. This is achieved by eliminating the current rule's prescriptive underwriting criteria, various limits on the composition of the commercial loan portfolio, the limit on participations in non-member business loans, and the associated waiver requirements. What remains in the proposed rule is largely consistent with existing fundamental regulatory requirements and supervisory expectations for commercial lending, and therefore not a significant impact on the operation of these institutions. NCUA has determined and certifies that the proposed rule, if adopted, will not have a significant economic impact on a substantial number of small credit unions within the meaning of the RFA.[44]

B. Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden.[45] For purposes of the PRA, a paperwork burden may take the form of either a reporting or a recordkeeping requirement, both referred to as information collections. NCUA recognizes that this proposed rule requires credit unions to comply with certain requirements that constitute an information collection within the meaning of the PRA. Under the proposed rule, credit unions that are engaged in business lending activities and not exempted from § 723.3 and § 723.4 will need to ensure their loan policies and procedures cohere to these requirements, including a formal credit risk rating system to identify and quantify the level of risk within their commercial loan portfolios. However, by replacing the prescriptive requirements in the current rule with a principles-based regulatory approach,

[42] Recently, the Board proposed to increase the asset threshold used to define small entity under the RFA from $50 million to $100 million. 80 FR 11954 (Mar. 5, 2015).

[43] These credit unions hold $7.8 billion in total assets and $869 million in total net worth, which account for 0.7% of total assets and 0.7% of total net worth in the credit union industry, respectively.

[44] 5 U.S.C. 601–612.

[45] 44 U.S.C. 3507(d); 5 CFR part 1320.

the proposed rule also relieves credit unions from the current requirement to obtain MBL related waivers and provides a high degree of flexibility in designing and operating their commercial loan programs.

Currently, NCUA receives a significant number of MBL-related waiver requests each year. NCUA processed 630 and 336 MBL related waiver requests, in 2013 and 2014 respectively. The average number of hours for a credit union to prepare a waiver request is an estimated 8 hours. Accordingly, NCUA expects that the proposed rule will provide an estimated total of 3,864 hours relief to credit unions, on an annual basis.

Eliminating the waiver requirement:

Total number of MBL related waivers requested by FICUs annually: 483
Frequency of response: Annually
Number of hours to prepare 1 waiver request: 8
Total number of hours: 8 hours × 483 = 3,864

Under the proposed rule, credit unions that are engaged in business lending activities and not exempted from § 723.3 and § 723.4 may need to revise their loan policies and procedures. As the end of 2014, there were a total of 1,553 federally insured credit unions that may need to revise their policies. For purposes of this analysis, NCUA estimates that it will take roughly 16 hours on average for a credit union to meet this requirement. Using these estimates, information collection obligations imposed by this aspect of the rule are analyzed below:

Revising commercial loan policies and procedures:

FICUs that are engaged in business lending and are not exempted from § 723.3 and § 723.4: 1,553
Frequency of response: one-time
Initial hour burden: 16
16 hour × 1,553 = 24,848

The proposed rule also requires credit unions that are engaged in business lending activities and not exempted from § 723.3 and § 723.4 to have a formal risk rating system to quantify and manage risks associated with their business lending activities. The majority of credit unions already have risk rating systems in place. Based on a survey of NCUA field staff, NCUA estimates that a total of 142 federally insured credit unions do not currently have a formal risk rating system. The information collection obligations imposed by this aspect of the rule are analyzed below.

Number of FICUs developing a risk rating system: 142
Frequency of response: one-time
Initial hour burden: 160
160 hour × 142 = 22, 720

The total estimated one-time net paperwork burden for this proposal is 43,704 hours, with annual recurring paperwork burden reduction of 3,864 hours. In accordance with the requirements of the PRA, NCUA intends to obtain a modification of its OMB Control Number, 3133–0101, to support these changes. Simultaneously with its publication of this rule, NCUA is submitting a copy of the proposed rule to OMB, along with an application for a modification of the OMB Control Number.

The PRA and OMB regulations require that the public be provided an opportunity to comment on the paperwork requirements, including an agency's estimate of the burden of the paperwork requirements. The Board invites comment on: (1) Whether the paperwork requirements are necessary; (2) the accuracy of NCUA's estimates on the burden of the paperwork requirements; (3) ways to enhance the quality, utility, and clarity of the paperwork requirements; and (4) ways to minimize the burden of the paperwork requirements.

Comments should be sent to the NCUA Contact and the OMB Reviewer listed below:

NCUA Contact: Tracy Crews, National Credit Union Administration, 1775 Duke Street, Alexandria, Virginia 22314–3428, Fax No. 703–837–2861, Email: *OCIOPRA@ncua.gov*.

OMB Contact: Office of Management and Budget, ATTN: Desk Officer for the National Credit Union Administration, Office of Information and Regulatory Affairs, Washington, DC 20503.

C. Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency,[46] voluntarily complies with the Executive Order. The proposed rule, if adopted, will also apply to federally insured, state-chartered credit unions. By law, these institutions are already subject to numerous provisions of NCUA's rules, based on the agency's role as the insurer of member share accounts and the significant interest NCUA has in the safety and soundness of their operations. The proposed rule may have an occasional direct effect on the states, the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. The proposed rule may supersede provisions of state law, regulation, or approvals. The proposed rule could lead to conflicts between the NCUA and state financial institution regulators on occasion. Accordingly, NCUA requests comment on ways to eliminate, or at least minimize, potential conflicts in this area. As noted above, NCUA solicits specific comment on how best to approach the issue of state regulation of business lending. Commenters may also wish to provide recommendations on the potential use of delegated authority, cooperative decision-making responsibilities, certification processes of federal standards, adoption of comparable programs by states requesting an exemption for their regulated institutions, or other ways of meeting the intent of the Executive Order.

D. Assessment of Federal Regulations and Policies on Families

NCUA has determined that this rulemaking will not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act of 1999.[47]

List of Subjects

12 CFR Part 701

Advertising, Aged, Civil rights, Credit, Credit unions, Fair housing, Individuals with disabilities, Insurance, Marital status discrimination, Mortgages, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination, Signs and symbols, Surety bonds.

12 CFR Part 723

Credit, Credit unions, Reporting and recordkeeping requirements.

12 CFR Part 741

Bank deposit insurance, Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on June 18, 2015.

Gerard S. Poliquin,

Secretary of the Board.

For the reasons discussed above, NCUA proposes to amend 12 CFR parts 701, 723, and 741 as follows:

PART 701—ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS

■ 1. The authority citation for part 701 continues to read as follows:

[46] 44 U.S.C. 3502(5).

[47] Public Law 105–277, 112 Stat. 2681 (1998).

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1758, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1786, 1787, 1789. Section 701.6 is also authorized by 15 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 *et seq.;* 42 U.S.C. 1981 and 3601–3610. Section 701.35 is also authorized by 42 U.S.C. 4311–4312.

■ 2. Amend § 701.22(a) by revising the definition for Associated borrower and adding the definitions for Common enterprise, Control, and Direct benefit to read as follows:

§ 701.22 Loan participations.

* * * * *

(a) For purposes of this section, the following definitions apply:

Associated borrower means 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.

Common enterprise means (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. An employer will not be treated as a source of repayment because of wages and salaries paid to an employee, unless the standards described in paragraph (2) are met;

(2) Loans or extensions of credit are made:

(i) To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and

(ii) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence means 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with another borrower. Gross receipts and expenditures include gross revenues or expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments; or

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

Control means 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 percent 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; or

(3) Has the power to exercise a controlling influence over the management or policies of another person or entity.

* * * * *

Direct benefit means 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.

* * * * *

PART 723—MEMBER BUSINESS LOANS; COMMERCIAL LENDING

■ 3. The authority citation for Part 723 continues to read as follows:

Authority: 12 U.S.C. 1756, 1757, 1757A, 1766, 1785, 1789.

■ 3. Revise §§ 723.1 through 723.8 and add § 723.9 to read as follows:

Sec.

* * * * *

* * * * *

§ 723.1 Purpose and scope.

(a) *Purpose.* This part is intended to accomplish two broad objectives. First, it sets out policy and program responsibilities that a federally insured credit union must adopt and implement as part of a safe and sound commercial lending program. Second, it incorporates the statutory limit on the aggregate amount of member business loans that a federally insured credit union may make pursuant to Section 107A of the Federal Credit Union Act. The rule distinguishes between these two distinct objectives.

(b) *Credit unions and loans covered by this part.* This part applies to federally insured natural person credit unions, except that 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 are not subject to § 723.3 and § 723.4 of this part. This part does not apply to loans:

(1) Made by a corporate credit union, as defined in part 704 of this chapter;

(2) Made by a federally insured credit union to another federally insured credit union;

(3) Made by a federally insured credit union to a credit union service organization, as defined in part 712 and § 741.222 of this chapter; or

(4) Fully secured by a lien on a 1- to 4- family residential property that is the borrower's primary residence.

(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 nonpreferential loans.

(2) If a federal credit union makes a commercial loan through a program in which a federal or state agency (or its political subdivision) insures repayment, guarantees repayment, or provides an advance commitment to purchase the loan in full, and that program has requirements that are less restrictive than those required by this rule, then the federal credit union may follow the loan requirements of the relevant guaranteed loan program. A federally insured, state-chartered credit union that is subject to this part and that makes a commercial loan as part of a loan program in which a federal or state agency (or its political subdivision) insures repayment, guarantees repayment, or provides an advance commitment to purchase the loan in full, and that program has requirements that are less restrictive than those required by this rule, then the federally insured, state-chartered credit union may follow the loan requirements of the relevant guaranteed loan program, provided that its state supervisory authority has determined that it has authority to do so under state law.

(3) The requirements of § 701.23 of this chapter apply to a federal credit union's purchase, sale, or pledge of a

commercial loan as an eligible obligation.

(4) The requirements of § 701.22 of this chapter apply to a federally insured credit union's purchase of a participation interest in a commercial loan.

§ 723.2 Definitions.

For purposes of this part, the following definitions apply:

Associated Borrower means 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.

Commercial loan means any loan, line of credit, or letter of credit (including any unfunded commitments), and any interest a credit union obtains in such loans made by another lender, to individuals, sole proprietorships, partnerships, corporations, or other business enterprises for commercial, industrial, agricultural, or professional purposes, but not for investment or personal expenditure purposes. Excluded from this definition are loans made by a corporate credit union; loans made by a federally insured credit union to another federally insured credit union; loans made by a federally insured credit union to a credit union service organization; loans secured by a 1- to 4- family residential property (whether or not it is the borrower's primary residence); any loan(s) to a borrower or an associated borrower, the aggregate balance of which is equal to less than $50,000; any loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions; and loans secured by a vehicle manufactured for household use.

Common enterprise means

(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. An employer will not be treated as a source of repayment because of wages and salaries paid to an employee, unless the standards described in paragraph (2) of this definition are met;

(2) Loans or extensions of credit are made:

(i) To borrowers who are related directly or indirectly through common control, including where one borrower is directly or indirectly controlled by another borrower; and

(ii) Substantial financial interdependence exists between or among the borrowers. Substantial financial interdependence means 50 percent or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with another borrower. Gross receipts and expenditures include gross revenues or expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments; or

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

Control means 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 percent 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; or

(3) Has the power to exercise a controlling influence over the management or policies of another person or entity.

Credit risk rating system means a formal process that identifies and assigns a relative credit risk score to each commercial loan in a federally insured credit union's portfolio, using ordinal ratings to represent the degree of risk. The credit risk score is determined through an evaluation of quantitative factors based on financial performance and qualitative factors based on management, operational, market, and business environmental factors.

Direct benefit means 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.

Immediate family member means a spouse or other family member living in the same household.

Loan secured by a 1- to 4-family residential property means a loan that, at origination, is secured wholly or substantially by a lien on a 1- to 4-family residential property for which the lien is central to the extension of the credit; that is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien. A loan is wholly or substantially secured by a lien on a 1- to 4-family residential property if the estimated value of the real estate collateral at origination (after deducting any senior liens held by others) is greater than 50 percent of the principal amount of the loan.

Loan secured by a vehicle manufactured for household use means a loan that, at origination, is secured wholly or substantially by a lien on a new and used passenger car and other vehicle 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 fare-paying passengers, for which the lien is central to the extension of credit. A lien is central to the extension of credit if the borrower would not have been extended credit in the same amount or on terms as favorable without the lien. A loan is wholly or substantially secured by a lien on a vehicle manufactured for household use if the estimated value of the collateral at origination (after deducting any senior liens held by others) is greater than 50 percent of the principal amount of the loan.

Loan-to-value ratio means, with respect to any item of collateral, the aggregate amount of all sums borrowed and secured by that collateral, including outstanding balances plus any unfunded commitment or line of credit from another lender that is senior to the federally insured credit union's lien position, divided by the lesser of the purchase price or market value for collateral held 12 months or less, and market value for collateral held longer than 12 months. The market value of the collateral must be established by prudent and accepted commercial lending practices and comply with all regulatory requirements. For a construction and development loan, the collateral value is the lesser of cost to complete or prospective market value, as determined in accordance with § 723.6 of this part.

Net worth means a federally insured credit union's net worth, as defined in part 702 of this chapter.

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 unit, cooperative unit, manufactured home (whether completed or under construction), or unimproved land zoned for 1- to 4-family residential use. A boat or motor home, even if used as a primary residence, or timeshare property is not residential property.

§ 723.3 Board of directors and management responsibilities.

Prior to engaging in commercial lending, a federally insured credit union must address the following board responsibilities and operational requirements:

(a) *Board of directors.* A federally insured credit union's board of directors, at a minimum, must:

(1) Approve a commercial loan policy that complies with § 723.4 of this part. The board must review its policy on an annual basis, prior to any material change in the federally insured credit union's commercial lending program or related organizational structure, and in response to any material change in portfolio performance or economic conditions, and update it when warranted.

(2) Ensure the federally insured credit union appropriately staffs its commercial lending program in compliance with paragraph (b) of this section.

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

(b) *Required expertise and experience.* A federally insured credit union making, purchasing, or holding any commercial loan must internally possess the following experience and competencies:

(1) *Senior executive officers.* A federally insured credit union's senior executive officers overseeing the commercial lending function must understand the federally insured 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.

(2) *Qualified lending personnel.* A federally insured credit union must employ qualified staff with experience in the following areas:

(i) Underwriting and processing for the type(s) of commercial lending in which the federally insured credit union is engaged;

(ii) Overseeing and evaluating the performance of a commercial loan portfolio, including rating and quantifying risk through a credit risk rating system; and

(iii) Conducting collection and loss mitigation activities for the type(s) of commercial lending in which the federally insured credit union is engaged.

(3) *Options to meet the required experience.* A federally insured credit union may meet the experience requirements in paragraphs (b)(1) and (2) of this section by conducting internal training and development, hiring qualified individuals, or using a third-party, such as an independent contractor or a credit union service organization. However, with respect to the qualified lending personnel requirements in paragraph (b)(2) of this section, use of a third-party is permissible only if the following conditions are met:

(i) The third-party has no affiliation or contractual relationship with the borrower or any associated borrowers;

(ii) The actual decision to grant a loan must reside with the federally insured credit union;

(iii) Qualified federally insured credit union staff exercises ongoing oversight over the third party by regularly evaluating the quality of any work the third party performs for the federally insured credit union; and

(iv) The third-party arrangement must otherwise comply with § 723.7 of this part.

§ 723.4 Commercial loan policy.

Prior to engaging in commercial lending, a federally insured credit union must adopt and implement a comprehensive written commercial loan policy and establish procedures for commercial lending. The board approved policy must ensure the federally insured credit union's commercial lending activities are performed in a safe and sound manner by providing for ongoing control, measurement, and management of the federally insured credit union's commercial lending activities. At a minimum, a federally insured credit union's commercial loan policy must address each of the following:

(a) Type(s) of commercial loans permitted.

(b) Trade area.

(c) Maximum amount of assets, in relation to net worth, allowed in secured, unsecured, and unguaranteed commercial loans and in any given category or type of commercial loan and to any one borrower or group of associated borrowers. The policy must specify that the aggregate dollar amount of commercial loans to any one borrower or group of associated borrowers may not exceed the greater of 15 percent of the federally insured credit union's net worth or $100,000, plus an additional 10 percent of the credit union's net worth if the amount that exceeds the credit unions 15 percent general limit is fully secured at all times with a perfected security interest by readily marketable collateral as defined in section 723.2 of this part.

(d) Qualifications and experience requirements for personnel involved in underwriting, processing, approving, administering, and collecting commercial loans.

(e) Loan approval processes, including establishing levels of loan approval authority commensurate with the individual's or committee's proficiency in evaluating and understanding commercial loan risk, when considered in terms of the level of risk the borrowing relationship poses to the federally insured credit union.

(f) Underwriting standards commensurate with the size, scope and complexity of the commercial lending activities and borrowing relationships contemplated. The standards must, at a minimum, address the following:

(1) The level and depth of financial analysis necessary to evaluate the financial trends and condition of the borrower and the ability of the borrower to meet debt service requirements;

(2) Thorough due diligence of the principal(s) to determine whether any related interests of the principal(s) might have a negative impact or place an undue burden on the borrower and related interests with regard to meeting the debt obligations with the credit union;

(3) Requirements of a borrower-prepared projection when historic performance does not support projected debt payments. The projection must be supported by reasonable rationale and, at a minimum, must include a projected balance sheet and income and expense statement;

(4) The financial statement quality and the degree of verification sufficient to support an accurate financial analysis and risk assessment;

(5) The methods to be used in collateral evaluation, for all types of collateral authorized, including loan-to-value ratio limits. Such methods must be appropriate for the particular type of collateral. The means to secure various types of collateral, and the measures

taken for environmental due diligence must also be appropriate for all authorized collateral; and

(6) Other appropriate risk assessment including analysis of the impact of current market conditions on the borrower and associated borrowers.

(g) Risk management processes commensurate with the size, scope and complexity of the federally insured credit union's commercial lending activities and borrowing relationships. These processes must, at a minimum, address the following:

(1) Use of loan covenants, if appropriate, including frequency of borrower and guarantor financial reporting;

(2) Periodic loan review, consistent with loan covenants and sufficient to conduct portfolio risk management. This review must include a periodic reevaluation of the value and marketability of any collateral;

(3) A credit risk rating system. Credit risk ratings must be assigned to commercial loans at inception and reviewed as frequently as necessary to satisfy the federally insured credit union's risk monitoring and reporting policies, and to ensure adequate reserves as required by generally accepted accounting principles (GAAP); and

(4) A process to identify, report, and monitor loans approved as exceptions to the credit union's loan policy.

§ 723.5 Collateral and security.

(a) A federally insured credit union must require collateral commensurate with the level of risk associated with the size and type of any commercial loan. Collateral must be sufficient to ensure adequate loan balance protection along with appropriate risk sharing with the borrower and principal(s). A federally insured credit union making an unsecured loan must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk.

(b) A federally insured credit union 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.

§ 723.6 Construction and development loans.

In addition to the foregoing, the following requirements apply to a construction and development loan made by any federally insured credit union.

(a) For the purposes of this section, a construction or development loan means 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 property types referenced in this section. The collateral valuation for securing a construction or development loan depends on the satisfactory completion of the proposed construction or renovation where the loan proceeds are disbursed in increments as the work is completed. A loan to finance 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.

(b) A federally insured credit union that elects to make a construction or development loan must ensure that its commercial loan policy includes 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.

(1) For the purposes of this section, cost to complete means the sum of all qualifying costs necessary to complete a construction project and documented in an approved construction budget. Qualifying costs generally include on- or off-site improvements, building construction, other reasonable and customary costs paid to construct or improve a project, including general contractor's fees, and other expenses normally included in a construction contract such as bonding and contractor insurance. Qualifying costs include the value of the land, determined as the lesser of appraised market value or purchase price for land held less than 12 months, and as the appraised market value for land held longer than 12 months. Qualifying costs also include interest, a contingency account to fund unanticipated overruns, and other development costs such as fees and related pre-development expenses. Interest expense is a qualifying cost only to the extent it is included in the construction budget and is calculated based on the projected changes in the loan balance up to the expected ''as-complete'' date for owner-occupied non-income producing commercial real estate or the ''as-stabilized'' date for income producing real estate. Project costs for related parties, such as developer fees, leasing expenses, brokerage commissions, and management fees, are included in qualifying costs only if reasonable in comparison to the cost of similar services from a third party. Qualifying costs exclude 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.

(2) For the purposes of this section, prospective market value means the market value opinion determined by an independent appraiser in compliance with the relevant standards set forth in the Uniform Standards of Professional Appraisal Practice. Prospective value opinions are intended to reflect the current expectations and perceptions of market participants, based on available data. Two prospective value opinions may be required to reflect the time frame during which development, construction, and occupancy occur. The prospective market value ''as-completed'' reflects the property's market value as of the time that development is to be completed. The prospective market value ''as-stabilized'' reflects the property's market value as of the time the property is projected to achieve stabilized occupancy. For an income producing property, stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease over a reasonable period of time and at comparable terms and conditions to other similar properties.

(c) A federally insured credit union that elects to make a construction and development loan must also assure its commercial loan policy meets the following conditions:

(1) Qualified personnel representing the interests of the federally insured credit union must conduct a review and approval of any line item construction budget prior to closing the loan;

(2) A credit union approved requisition and loan disbursement process is established;

(3) Release or disbursement of loan funds occurs only after on-site inspections, documented in a written report by qualified personnel representing the interests of the federally insured credit union, certifying that the work requisitioned for payment has been satisfactorily completed, and the remaining funds available to be disbursed from the construction and development loan is sufficient to complete the project; and

(4) Each loan disbursement is subject to confirmation that no intervening liens have been filed.

§ 723.7 Prohibited activities.

(a) *Ineligible borrowers.* A federally insured credit union may not grant a commercial loan to the following:

(1) Any senior management employee, including the federally insured credit union 's chief executive officer, any assistant chief executive officers, and the chief financial officer (*i.e.,* comptroller), and any of their immediate family members;

(2) Any person meeting the definition of an associated borrower with respect to persons identified in paragraph (a)(1) of this section; or

(3) Any compensated director, unless the federally insured credit union's board of directors approves granting the loan and the compensated director was recused from the board's decision making process.

(b) *Equity agreements/joint ventures.* A federally insured credit union may not grant a commercial loan if any additional income received by the federally insured credit union or its senior management employees is tied to the profit or sale of any business or commercial endeavor that benefits from the proceeds of the loan.

(c) *Conflicts of interest.* Any third party used by a federally insured credit union to meet the requirements of this part must be independent from the commercial loan transaction and may not have a participation interest in a loan or an interest in any collateral securing a loan that the third party is responsible for reviewing, or an expectation of receiving compensation of any sort that is contingent on the closing of the loan, with the following exceptions:

(1) A third party may provide a service to the federally insured credit union that is related to the transaction, such as loan servicing.

(2) The third party may provide the requisite experience to a federally insured credit union and purchase a loan or a participation interest in a loan originated by the federally insured credit union that the third party reviewed.

(3) A federally insured credit union may use the services of a credit union service organization that otherwise meets the requirements of § 723.3(b)(3) of this part even if the credit union service organization is not independent from the transaction, provided the federally insured credit union has a controlling financial interest in the credit union service organization as determined under GAAP.

§ 723.8 Aggregate member business loan limit; exclusions and exceptions.

This section incorporates the statutory limits on the aggregate amount of member business loans that may be held by a federally insured credit union and establishes the method for calculating a federally insured credit union's net member business loan balance for purposes of the statutory limits and NCUA form 5300 reporting.

(a) *Statutory limits.* The aggregate limit on a federally insured credit union's net member business loan balances is 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.

(b) *Definition.* For the purposes of this section, member business loan means any commercial loan as defined in 723.2 of this part, except that the following commercial loans are not member business loans and are not counted toward the aggregate limit on a federally insured credit union's member business loans:

(1) Any loan in which a federal or state agency (or its political subdivision) fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full; and

(2) Any non-member commercial loan or non-member participation interest 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.

(c) *Exceptions.* Any loan secured by a lien on a 1- to 4-family residential property that is not the borrower's primary residence, and any loan secured by a vehicle manufactured for household use that will be used for a commercial, corporate, or other business investment property or venture, or agricultural purpose, is not a commercial loan but it is a member business loan (if the outstanding aggregate net member business loan balance is greater than $50,000) and must be counted toward the aggregate limit on a federally insured credit union's member business loans.

(d) *Statutory exemptions.* A federally insured credit union that has a low-income designation, or participates in the Community Development Financial Institutions program, or was chartered for the purpose of making member business loans, or which as of the date of enactment of the Credit Union Membership Access Act of 1998 had a history of primarily making commercial loans, is exempt from compliance with the aggregate member business loan limits in this section.

(e) *Method of calculation for net member business loan balance.* For the purposes of NCUA form 5300 reporting, a federally insured credit union's net member business loan balance is determined by calculating 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.

§ 723.9 Transitional provisions.

This section governs circumstances in which, as of the effective date of this part, a federally insured credit union is operating in accordance with an approved waiver from NCUA or is subject to any enforcement constraint relative to its commercial lending activities.

(a) *Waivers.* Upon the effective date of this part, any waiver approved by NCUA concerning a federally insured credit union's commercial lending activity is rendered moot except for waivers granted for borrowing relationships limits as required in section 723.8 of the previous rule or similar provision in a grandfathered state rule. Borrowing relationships granted a waiver from that provision will be grandfathered however the debt associated with those relationships may not be increased

(b) *Enforcement Constraints.* Limitations or other conditions imposed on a federally insured credit union in any written directive from NCUA, including but not limited to items specified in any Document of Resolution, any published or unpublished Letter of Understanding and Agreement, Regional Director Letter, Preliminary Warning Letter, or formal enforcement action, are unaffected by the adoption of this part. Included within this paragraph are any constraints or conditions embedded within any waiver issued by NCUA. As of the effective date of this part, all such limitations or other conditions remain in place until such time as they are modified by NCUA.

PART 741—REQUIREMENTS FOR INSURANCE

■ 5. The authority citation for part 741 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766(a), 1781–1790, and 1790d; 31 U.S.C. 3717.

Subpart B—[Amended]

■ 6. Amend § 741.203 by revising paragraph (a) to read as follows:

§ 741.203 Minimum loan policy requirements.

* * * * *

(a) Adhere to the requirements stated in part 723 of this chapter concerning commercial lending and member business loans, § 701.21(c)(8) of this chapter concerning prohibited fees, and § 701.21(d)(5) of this chapter concerning non-preferential loans; and

* * * * *

[FR Doc. 2015–15466 Filed 6–30–15; 8:45 am]

BILLING CODE 7535–01–P