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Part III

National Credit Union Administration

12 CFR Parts 701, 723, and 741
Member Business Loans; Commercial Lending; Final 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: Final rule.

SUMMARY: As part of NCUA's Regulatory Modernization Initiative, the NCUA Board (Board) is amending 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 final 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 a broad principles-based regulatory approach. As such, the amendments also eliminate the current MBL waiver process, which is unnecessary under a principles-based rule.

DATES: This final rule is effective January 1, 2017, except for amendatory instruction number 4 adding § 723.7(f), which is effective May 13, 2016.

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SUPPLEMENTARY INFORMATION:

I. Background

The Board promulgated its first regulation governing MBLs in 1987 (previously section 701.21(h) and currently part 723 of NCUA's regulations) and has since made a number of revisions to the rule, including substantive amendments to incorporate provisions included in Section 107A of the Federal Credit Union Act (FCU Act). Section 107A was enacted into law in 1998 in Title II of the Credit Union Membership Access Act (CUMAA).[1] Among other things, CUMAA limited 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.[2] The statutory MBL limit is incorporated in part 723 of NCUA's regulations.[3] Part 723 also defines MBLs,[4] establishes minimum safety and soundness standards for making MBLs, and implements various statutory exceptions from the aggregate MBL limit.[5]

The Board has not significantly amended part 723 since 2003.[6] Over the past 12 years, however, the credit union industry has gained valuable experience as the level of commercial loan activity has increased [7] and as credit unions navigated the 2008–2009 recession. Once an ancillary product offered by a small number of credit 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. Today, credit unions represent an important source of credit for small businesses.

% OF CREDIT UNIONS THAT OFFER BUSINESS LOANS

Credit unions with total assets . . .	2004 (%)	September 2015 (%)
Below $100 million ...	13	21
Between $100 and $500 million	53	77
Greater than $500 million	72	94
Total throughout industry	19	36

II. Proposed Rule

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.'' [8] 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.

Recognizing that credit unions generally have conducted business lending safely, and that NCUA has been largely successful in effectively supervising credit unions in this area, the Board determined the time was right for NCUA to modernize the MBL rule and to permit credit unions a greater degree of autonomy in optimizing their MBL programs to meet the specific needs of their member-borrowers. Specifically, at its June 18, 2015 meeting, the Board issued for a 60-day comment period a proposed rule to

[1] 12 U.S.C. 1757a; Public Law 105–219, 112 Stat. 913 (1998).

[2] 12 U.S.C. 1757a.

[3] 12 CFR part 723.

[4] 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. 12 CFR 723.1(a). However, there are several exceptions to this general definition. 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).

[5] 12 U.S.C. 1757a.

[6] *See* 68 FR 56537 (Oct. 1, 2003).

[7] Based on Call Report data as of September 2015, total business loans including unfunded commitments at federally insured credit unions grew from $13.4 billion in 2004 to $56 billion in September 2015, 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 4.5 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.

[8] 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).

amend the MBL rule and provide reasonable regulatory relief to federally insured credit unions.[9]

The proposed rule would provide credit unions with greater flexibility and individual autonomy in safely and soundly serving the business borrowers in their membership. The proposed rule would significantly alter the overall approach to regulating business lending, by shifting from a prescriptive rule to a principles-based rule. Specifically, the proposed rule would eliminate detailed collateral criteria and portfolio limits focusing instead on broad, yet well-defined, principles that clarify regulatory expectations for federally insured credit unions engaged in business lending activities.

The proposal also sought to eliminate some unintended consequences of the current prescriptive approach, such as causing credit unions to manage their lending practices to regulatory restrictions instead of focusing on sound risk management practices. The proposal also would eliminate the current MBL waiver process, which in some cases had hampered credit unions' ability to meet the commercial credit needs of their members. The current waiver process requires significant time and resources from both credit unions and NCUA, and has at times prevented credit unions from timely acting on borrowers' applications.[10]

The proposal would also modernize the MBL rule by providing greater emphasis on risk management. The current rule does not distinguish between commercial loans and MBLs. MBLs are defined by the FCU Act and the current MBL rule, but commercial loans are not. 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. Thus, the proposed rule distinguished between the specific category of statutorily defined MBLs and the broader universe of commercial loans that a credit union may extend to a borrower for commercial, industrial, agricultural, and professional purposes. Prudent risk assessment is necessary for all commercial loans, and the proposal focused on the principles and supervisory expectations for safe and sound commercial lending.

The proposed rule also incorporated 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 reinforced that a credit union's board of directors is ultimately 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.

III. Public Comments

The public comment period for the proposed MBL rule ended on August 31, 2015. NCUA received nearly 3,100 comments on the proposal. However, many commenters submitted multiple or duplicate comments or letters that contained, or appeared to be mostly based on, form language or standardized industry talking points and included minimal unique substantive comment (''form letters''). Approximately 85 percent of the total comments received appeared to be form letters or duplicative submissions.

Approximately three-quarters of the total comments received on the proposed rule were submitted by banks, bank trade associations, or other bank-affiliated parties. Of these, roughly 95 percent appeared to be form letters. The remaining one-quarter of the total comments received were submitted by credit union or other trade associations, state credit union leagues, federal credit unions, federally insured state-chartered credit unions, credit union service organizations (CUSOs), state supervisory authorities (SSAs), members of Congress, individuals, and other commenters. Of these, slightly more than half appeared to be form letters. Overall, nearly 500 comments were generally unique comments or comments consisting mostly of original or unique content.

General Comments

With the exception of bank commenters, most commenters expressed overall support for the proposal to modernize the MBL rule, in particular the conceptual shift from the current prescriptive regulation to a principles-based regulatory approach. A significant number of commenters fully supported the proposal. Most commenters, however, indicated overall support for the rule but expressed concern about some aspect of the proposal, or recommended adjustments or provided suggestions on ways to improve specific provisions of the rule.

Commenters indicated support for the rule for one or more of the following reasons. A significant number of commenters indicated that a principles-based rule will provide credit unions with the necessary flexibility to develop and maintain MBL programs to best fit their members' needs, and provide much needed regulatory relief. Commenters noted the shift to a regulation based on broad principles represents a sound rulemaking approach. Commenters also indicated that safety and soundness for commercial lending is better achieved through supervision and examination, rather than through prescriptive one-size-fits-all regulatory requirements. Moreover, commenters stated the amendments will allow each credit union to tailor its MBL program to fit its specific risk tolerances and strategic goals, thus enabling credit unions to act in service of their members, rather than in compliance with strict regulation. Other commenters noted that the amendments will allow credit unions to establish credit risk management programs that are appropriate for the size, complexity, and risk profile of their organization and to operate MBL programs in a safe and sound manner. Commenters also stated that credit unions with the appropriate experience, sound lending practices, and strong leadership should be allowed more autonomy in their lending decisions. These commenters noted that the current prescriptive rule hinders credit unions' ability to compete for and conduct sound business lending. Commenters also noted that the amendments simplify and improve the regulation. Additionally, many commenters expressed support for the removal of the many restrictions in the current rule not mandated by the FCU Act.

A significant number of commenters, while generally supportive of the overall rule, also provided substantive input on the specific provisions of the proposed rule. Comments on specific aspects of the proposal are further detailed in the section-by-section analysis below.

Bank commenters generally expressed opposition to the proposal, in overall concept and principle. Most bank commenters indicated they opposed the rule for one or more of the following general policy reasons. A significant number of bank commenters suggested that the proposal disregards Congressional intent to limit credit union business lending. Other bank commenters maintained that credit unions are not fulfilling their mission and purpose by increasing their business lending activity. Bank commenters further argued that there is no public benefit to credit union expansion into commercial lending, and that the proposed changes could result in unfair competition for banks or have

[9] 80 FR 37898 (July 1, 2015).

[10] There are currently over 1,000 active MBL-related waivers. In 2014 and 2015, NCUA processed 336 and 225 MBL waivers, respectively.

a negative impact on the bank industry. Other bank commenters expressed concern that credit unions are ill-prepared to expand their commercial lending activity and allowing credit unions to increase their share of the commercial lending market could cause another financial crisis. Bank commenters also asserted that the proposal poses safety and soundness concerns that could place the National Credit Union Share Insurance Fund (NCUSIF) and American taxpayers at risk. In addition, bank commenters suggested that NCUA is ill-prepared to supervise credit union commercial lending. Bank commenters also generally argued that the credit union tax-exemption is unfair and credit unions should therefore not be permitted to increase their business lending activities.

A small number of commenters expressed neutrality or did not expressly support or oppose the proposal. For example, one commenter questioned whether the proposal will truly benefit any credit unions other than the largest component of the industry, for example, those credit unions with assets greater than $1 billion. In addition, a few commenters indicated the amendments may create uncertainty for credit unions. In addition, a number of commenters asserted that the proposed rule could have gone further in providing relief and flexibility to credit unions involved in business lending, for example, by redefining the parameters of the statutory exemptions for credit unions chartered for the purpose of making, or that have a history of primarily making MBLs.

Discussion

The Board emphasizes that the proposed amendments are fully consistent with the provisions of the FCU Act. As amended by CUMAA, the FCU Act, among other things, 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.[11] The FCU Act, however, does not mandate prescriptive safety and soundness standards for credit union business loans. The current MBL rule's prescriptive requirements, including the collateral and security requirements, equity requirements, and loan limits, were established under the Board's broad safety and soundness mandate and general rulemaking authority.[12] The Board is within its statutory authority in promulgating this final rule to remove those prescriptive requirements. The amendments do not expand credit unions' business loan authority or modify the statutory MBL limit established by Congress in CUMAA.

Credit unions have a long history of meeting the business lending needs of their members. This history dates back to the U.S. credit union industry's inception in 1908. From their roots, credit unions have played a role in supplying credit to farmers, immigrants, and small business owners. In fact, the first credit union chartered in the United States, St. Mary's Bank Credit Union, had as its primary lending focus ''to establish neighborhood business.''

In enacting CUMAA in 1998, Congress stated:

> Credit unions . . . are exempt from Federal . . . taxes because they are member-owned, democratically operated, not-for profit organizations generally managed by volunteer boards of directors and because they have the specified mission of meeting the credit and savings needs of consumers, especially persons of modest means.

Congress has long recognized that credit unions should have authority to grant member business loans. Indeed, the FCU Act clearly provides that credit unions may be chartered for the purpose of making or have a history of primarily making MBLs. Congress has also recognized the importance of making capital available to lower-income communities by exempting all low-income designated credit unions from the MBL cap. Today, many credit union members are small business owners who need access to reliable commercial credit. Credit unions that offer member-business loans continue to fulfill their missions of meeting the credit and savings needs of their members.

According to a 2001 study for the Small Business Administration (SBA), while banks tend to reduce lending during economic stress, credit unions continue to lend to small businesses. This means that, in the past, credit unions have partially offset the fluctuations in the amounts of small business loans supplied by banks.[13] For example, while lending at banks contracted during the recent recession, credit unions continued to lend. Between year-end 2007 and 2010, total loans at banks decreased by 7 percent, while credit union lending increased by 7 percent. During this period, total commercial loans at banks decreased by 13 percent, whereas total credit union MBLs increased by 41 percent, including a 63 percent increase in SBA loans.[14]

While credit unions play an important role in the overall lending market, the volume of business lending by credit unions is still minor in comparison to banks. As of September 30, 2015, credit unions held $52.7 billion in member business loans outstanding. FDIC-insured banks and savings institutions held $3.8 trillion in business loans. Thus, credit union business lending is only 1.4 percent of total business lending done by financial institutions.[15]

Nevertheless, results from the 2011 SBA study suggest that credit union lending to small businesses adds to the overall availability of small business loans.[16] Empirical results suggest that each dollar of new member business lending by credit unions generated 81 cents of an entirely new credit source for small businesses. In other words, the majority of credit union member business lending is new lending that would not have occurred otherwise. As a whole, the report's findings suggest that credit union lending to small businesses could play an increasingly important role in ensuring the sector has adequate access to credit.

As noted above, over the last 5 years, NCUA has endeavored to modernize its regulations by providing responsible regulatory relief to credit unions. However, regulatory modernization has also meant, in some cases, revising or adopting rules that are unpopular with the credit union industry. Examples include the Board's recent modernization of its rules on interest rate risk, loan participations, CUSOs, liquidity and contingency funding, and risk-based capital (RBC). These prudent rule changes were opposed by industry stakeholders, but necessary to ensuring the safety and soundness of the credit union industry, and they demonstrate NCUA's continued commitment to responsible regulation.

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[11] 12 U.S.C. 1757a.

[12] The Board has broad rulemaking authority to ensure the industry and the NCUSIF remains safe and sound. Section 120 of the FCU Act authorizes the Board to prescribe rules and regulations for the administration of the FCU Act. 12 U.S.C. 1766(a). Further, Title II of the FCU Act provides that the Board may insure members' accounts and administer the NCUSIF, and may prescribe regulations for FICUs that are necessary to carry out that purpose. 12 U.S.C. 1781(b)(9), 1789(11).

[13] James A. Wilcox, *The Increasing Importance of Credit Unions in Business Lending,* SBA Office of Advocacy (Sept. 2011).

[14] *Id.* Data includes all FDIC insured institutions. Commercial loans include loans secured by nonfarm nonresidential properties, farmland, and multifamily residential properties, construction and development loans, farm loans and commercial and industrial loans.

[15] *Id.*

[16] *Id.*

As stated in the preamble to the proposed rule, the Board emphasizes that credit unions generally have conducted business lending safely, and the supervision process has been largely successful in addressing most of those credit unions that did not perform as well. NCUA has been insuring and supervising credit unions that make member business loans since it became an independent agency in 1970. Credit union business loan portfolios have generally performed well. Delinquency and net charge-off rates over the last 10 years are comparable to similar sized banks, including during the recession. Member business loans have not been a disproportionate contributor to credit union failures or NCUSIF losses. According to the Office of Inspector General's Material Loss Reviews, only five credit unions that failed at a loss to the NCUSIF between 2010 and 2014 were cited as having member business loans as a contributing factor to the failure.

Credit unions have made MBLs successfully through various economic cycles, including the recent recession. Consider the following:

- As of September, 2015, 98 percent of the credit unions that have member business loans are well capitalized.
- As of September, 2015, 83 percent of credit unions making business loans have a composite CAMEL rating of 1 or 2, compared to 71 percent of credit unions that do not make business loans.
- Business loan delinquency and loss performance data for credit unions and banks over the last 10 years indicate credit union business lending has performed on par with similar size banks over this time period.

Further, credit unions are subject to more stringent capital (net worth) standards than banks, with both a higher statutory leverage requirement and a higher risk weight tier for concentrations of business loans.

Accordingly, and for the reasons discussed in greater detail below, the Board is adopting this final rule to modernize NCUA's current regulations regarding business lending by shifting from a prescriptive rule to a principles-based rule.

IV. Final Rule

After careful consideration of all the public comments, the Board has made several changes based on the comments. Initially, the Board made changes for improved clarity of several definitions, including ''associated borrower,'' ''commercial loan,'' and ''loan-to-value ratio.'' In addition, the Board has modified the single-borrower limitation to exclude the government-guaranteed portion of a loan; narrowed the scope of ineligible borrowers under the rule's prohibited activities provision to allow senior staff who are not involved in the credit union's loan underwriting, servicing, and collection process to be eligible to receive commercial loans; shortened the final rule's implementation timeline; and provided provisions to allow any business lending rule adopted by a state supervisory authority that at least covers all the provisions in part 723 and is no less restrictive, upon determination by NCUA, to govern in place of part 723 for federally insured state-chartered credit unions in the state. The final rule is discussed in greater detail below.

Supervision

The final rule will 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 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 amendments also eliminate the current MBL waiver process, which is unnecessary under a principles-based rule. The principles are predicated on NCUA's expectation that credit unions will maintain prudent risk management practices and sufficient capital commensurate with the risks associated with their commercial lending activities.

The Board emphasizes that the final rule represents a meaningful shift in regulatory approach, and supervisory expectations will adapt accordingly. NCUA remains committed to rigorous and prudential supervision of credit union commercial lending activities. Moving forward, 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 credit unions are expected to embrace these overarching principles in administering, underwriting, and servicing commercial loans.

The Board recognizes that clear and timely supervisory guidance is important to the effective implementation of this final rule. Thus, before this final rule takes effect in whole, NCUA will issue supervisory guidance to examiners that will be shared with credit unions. The Board notes that the guiding principles of the rule are consistent with prevailing sound practices found in well-managed commercial lending programs. In turn, the supervisory guidance will also be consistent with these principles and align closely with the standards in place by federal banking agencies.

A significant number of commenters expressed concern about supervisory expectations with respect to the amended rule. Several commenters were concerned that if the supervisory guidance does not fully and clearly define NCUA's expectations, credit unions may face uncertainty in implementing changes to their commercial loan policies and procedures. Several commenters suggested the forthcoming guidance should provide credit unions with a safe harbor by clearly detailing the minimum requirements that are acceptable for a safe and sound business lending program. Other commenters urged NCUA to draw on existing commercial lending guidance issued by federal banking agencies.

Many commenters noted that supervisory guidance should not be cited by examiners as equivalent to regulation and rule of law. Commenters expressed concern that the current prescriptive regulatory requirements will simply migrate over into supervisory guidance, mitigating the rule's improved flexibility. Other commenters were concerned that the guidance will be even more restrictive than the current regulation.

Commenters were also concerned about examiner judgment and consistency under the new rule. Commenters expressed concern that examiners will not be properly trained or have adequate expertise to properly evaluate individual credit union lending policies under a principles-based rule. Commenters also stated the principles-based approach will require a significant amount of judgment by examiners, and that clear guidance prior to implementation should be provided to examiners to ensure exam consistency. Commenters also noted the importance of adequate training for examiners.

Commenters asked for clarification on the appeals process if a conflict arises during the MBL examination process. At least one commenter requested detail on how the principles-based rule will be enforced.

A number of commenters also suggested the supervisory guidance should be formally issued for public comment or asked for the opportunity to review the guidance before the final rule is implemented.

While the Board appreciates the value in affording the opportunity for public comment, formal notice-and-comment procedures for the forthcoming supervisory guidance are not required. The Board notes that supervisory guidance does not require notice and comment rulemaking under the Administrative Procedure Act (APA), and thus, it does not have the force and effect of law or regulation.[17] The purpose of supervisory guidance and other interpretive rules is generally ''to advise the public of the agency's construction of the statutes and rules that it administers.'' [18] The final rule is intended to provide credit unions with greater flexibility and autonomy in providing business loans to their members. The forthcoming supervisory guidance regarding credit union commercial lending is not intended to supplant credit unions' business decisions or to impose the same rigid and prescriptive requirements contained in the current MBL rule. Rather, the guidance will provide examiners and credit unions with clear information about NCUA's supervisory expectations with respect to the final rule, and establish a consistent framework for the exam and supervision process for the review of credit union commercial lending.

The Board agrees clear and detailed supervisory expectations are both necessary and important and that it is incumbent on NCUA to develop comprehensive guidance and training for its examiners. By having detailed guidance that includes representative examples, examiners and credit unions will have a mutual understanding of the key supervisory expectations. The Board views comprehensive guidance as crucial to achieving a smooth transition to a more flexible standard as well as to mitigate the risk of inconsistent enforcement. The Board does not agree that guidance should be limited to a description of minimum expectations. Rather, it believes the guidance should provide a range of acceptable practices that are commensurate with the size, risk and complexity typically found in credit unions' MBL programs. Such guidance will provide examiners and credit unions greater understanding of how to scale their expectations to differing and unique circumstances. The forthcoming guidance will require some degree of specificity and include examples that relate to a broadly representative variety of potential scenarios and conditions. Importantly, the guidance will provide sufficient detail and clarity for the agency's supervisory expectations and ensure proper consistency of interpretation.

NCUA guidance and training will include a comprehensive focus upon the core elements of a sound MBL program including: Overarching principles for managing commercial loan risk; critical components of commercial loan policies; the credit approval process; credit risk-rating systems; structuring of credit packages to properly align members' needs with financial abilities to repay; and credit risk management processes for underwriting, ongoing loan administration and risk monitoring. The guidance and training will further address various aspects of business lending such as the use of personal guarantees, collateral valuation and management, construction and development lending, loan collection, and appropriate reporting to senior management and the board of directors.

The Board emphasizes that it is not NCUA's goal to second-guess credit unions' reasonable business decisions, and it anticipates that open communications between a credit union and its examiner should resolve most disputes about which commenters have raised concern. Nevertheless, conflicts may arise during the MBL examination process. All rights and procedures generally available to a credit union in appealing an NCUA examination matter are likewise available to a credit union under this final rule.

Delayed Implementation

The final rule's shift to a principles-based rule represents a fundamental change in approach that will require a period of adjustment for both credit unions and examiners. Accordingly, the Board proposed to delay implementation of the final rule 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. Many commenters supported the proposed 18-month implementation timeframe, and some commenters advocated for a longer timeframe. Most commenters, however, urged the Board to make the final rule effective as soon as possible. Some commenters suggested implementation timelines between 6 to 12 months would allow sufficient time to train examination staff while providing regulatory relief more quickly.

The Board will provide some measure of regulatory relief to credit unions as soon as reasonably possible. The Board notes that many commenters in particular asked that implementation of the personal guarantee provision be expedited to allow credit unions to better serve their members. Accordingly, the personal guarantee provision in § 723.5(b) of this final rule will become effective 60 days after publication in the **Federal Register**. Implementation of the remaining provisions of this final rule will be delayed until January 1, 2017, to allow adequate time for both regulators and credit unions to adjust to the new requirements.

To better facilitate an early implementation of the personal guarantee provision, the Board has made modifications to § 723.5(b) in order to improve its reading as a stand-alone provision. The final rule adds a transitional provision, § 723.5(b)(1), to clarify that during the final rule's implementation period (*i.e.,* between the effective date of § 723.5(b) and the January 1, 2017 effective date of the remainder of the rule) a credit union that makes a member business loan, as defined in current § 723.1, and decides not to require a personal guarantee on the loan is not required to seek a waiver for the current requirement for personal liability and guarantee pursuant to current § 723.10. However, it must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk.

V. Section-by-Section Analysis

A detailed discussion of the final rule's key provisions follows.

§ 723.1—Purpose and Scope

Section 723.1 of the proposed rule articulated and summarized the rule's overall purpose. It also described which credit unions and loans are covered by Part 723, and which other regulations apply to commercial loans made by federally-insured credit unions.

[17] Section 4(b)(A) of the APA provides that, unless another statute states otherwise, the notice-and-comment requirement does not apply to ''interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice.'' 5 U.S.C. 553(b)(A). The term ''interpretative rule,'' or ''interpretive rule,'' is not defined by the APA, but the United States Supreme Court has noted that the critical feature of interpretive rules is that they are ''issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers.'' *Perez* v. *Mortgage Bankers Ass'n,* 135 S. Ct. 1199, 1203–04, 191 L. Ed. 2d 186 (2015) (citing, *Shalala* v. *Guernsey Memorial Hospital,* 514 U.S. 87, 99, 115 S. Ct. 1232, 131 L.Ed.2d 106 (1995)).

[18] *Id.*

Other Regulations That Apply

One commenter suggested proposed § 723.1(c) could be improved by more clearly delineating between those other regulations that are applicable to FCUs and to FISCUs. The Board agrees that greater clarity is desirable and has revised the language in the final rule to more clearly distinguish between the other lending regulations that apply to FCUs versus FISCUs.

Exemption for Small Credit Unions

The proposed rule exempted 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 rule's commercial loan definition, would be alleviated from the burden of having to develop a full commercial loan policy and commercial lending organizational infrastructure.

A number of commenters disagreed with exempting institutions under $250 million from certain requirements. Commenters argued that these smaller institutions should not be exempted, since limited involvement and lack of familiarity with commercial lending is likely to lead to mistakes or misjudgments as to risk management that could result in losses to the credit union. Another commenter noted that commercial lending presents an elevated level of risk compared with consumer lending, and credit unions engaged in commercial lending must understand the inherent differences between consumer and commercial credit. This commenter expressed concern that the exemption minimizes the importance of these differences and may have negative consequences for the safety and soundness of the credit union industry. One commenter stated that any credit union engaging in commercial lending above the most de minimis of portfolios should have a commercial lending policy, procedure, and program in place commensurate with its activity. Another commenter said while it may not be necessary for certain institutions to have an extensive commercial lending infrastructure, it is important from a safety and soundness perspective for any financial institution to develop and follow appropriate policies for any type of lending they may engage in, regardless of the frequency with which they originate such loans. Another commenter argued that there should be no exemptions for policy and infrastructure based on asset size, and credit unions that intend to make commercial loans should have a full policy and an infrastructure to support commercial lending on any scale.

The majority of commenters, however, were supportive of the exemption. A significant number of commenters agreed that smaller credit unions, and credit unions that hold a de minimis number and amount of commercial loans, should be provided relief from the policy and infrastructure requirements. Most commenters supported a $250 million asset threshold for exemption. However, a number of commenters asserted that the exemption could be improved by raising the asset threshold to allow more credit unions to receive regulatory relief. For example, some commenters argued the asset threshold for exemption should be raised to $500 million or eliminated entirely. Commenters advocating for eliminating or raising the asset threshold argued that relief should be focused on a credit union's complexity and asset size alone does not determine its complexity. At least one commenter indicated the asset size threshold is unnecessary and not a good proxy for determining the risk of a credit union with a de minimis amount of commercial loans. Another commenter recommended the exemption should be available to all credit unions, regardless of asset size, through an exception that would remove the $250 million asset threshold but retain the 15 percent of net worth limitation. Thus, larger credit unions with only minimal engagement in commercial lending relative to their net worth and assets could also receive relief.

The Board reiterates its intent in providing an exemption from § 723.3 and § 723.4 is to avoid the inclusion of credit unions that infrequently originate minimal amounts of loans that technically meet the regulatory commercial loan definition. In the final rule, a credit union with less than $250 million in assets that holds a relatively small amount of commercial loans compared to its net worth and originates and sells commercial loan participations infrequently is alleviated from the burden of more rigorous staffing and infrastructure requirements. The Board has clarified in this final rule how both the 15 percent of net worth and regularly originating and selling or participating out commercial loans standards in the proposed rule will be measured by specifying credit unions with less than $250 million in assets must satisfy both of the following conditions:

- The credit union's aggregate amount of outstanding commercial loan balances and unfunded commitments,[19] plus any outstanding commercial loan balances and unfunded commitments of participations sold, plus any outstanding commercial loan balances and unfunded commitments sold and serviced by the credit union total less than 15 percent of the credit union's net worth.
- In a given calendar year the amount of originated and sold commercial loans the credit union does not continue to service total less than 15 percent of the credit union's net worth.

The exemption provision is not intended to create a means by which a credit union can frequently generate and sell substantial amounts of commercial loans, while keeping its held-in-portfolio amount below 15 percent of net worth, to strategically avoid the requirements of § 723.3 and § 723.4. As such, the final rule includes language that makes it clear the ''less than 15 percent of net worth'' exemption threshold is measured against all commercial loans originated by the credit union to include commercial loans on the balance sheet, commercial loans sold and serviced, and commercial loans sold and not serviced. By adopting this clarifying language in the final rule, it will be easier for credit unions to determine when they qualify for the exemption.

As discussed in the preamble to the proposed rule, the 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 § 723.3 and § 723.4 and it coheres to standard industry practices. The $250 million asset threshold is consistent with similar provisions the Board adopted in NCUA's derivatives [20] and liquidity and contingency funding plans [21] regulations.

With regard to commenters' suggestions to raise or eliminate the asset size threshold, extending this exemption to credit unions over $250 million in assets could encourage some credit unions, regardless of their capacity and member business loan needs, to unduly restrict the volume of

[19] The aggregate amount of outstanding commercial loan balances and unfunded commitments amounts include any such balances outstanding, including those that were originated and purchased by the credit union.

[20] 12 CFR part 703.

[21] 12 CFR 741.12.

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 exemption acknowledges that small portfolio exposures coupled with a generally inactive business lending program do not warrant the adoption of the broader risk management standards included in the rule. Conversely, credit unions that are holding a substantial portfolio of business loans, and that are $250 million in assets or greater, have sufficient size and capacity to incorporate these common prudential standards into their operations. Accordingly, the less than $250 million threshold is retained as part of the exemption criteria in the final rule.

The Board emphasizes that while credit unions qualifying for the exemption will not be required to meet the policy and infrastructure requirements of § 723.3 and § 723.4, all credit unions need to have a board-approved loan policy covering their lending activity in general. Qualifying credit unions 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 rule.

§ 723.2—Definitions

For clarity and improvement, the proposed rule modified the definitions for certain terms in the current rule, included new definitions for terms not currently defined in the MBL rule, and moved definitions to more relevant sections of the proposed regulation. The modified, new, and moved definitions are discussed below.

Modified definitions:

Associated borrower

The proposed rule replaced the current rule's definition of ''associated member'' with the term ''associated borrower,'' and updated the definition to improve clarity and to incorporate elements of the combination rules applicable to banks. The proposed definition also introduced the concepts of direct benefit, common enterprise, and control into the associated borrower definition.

Commenters generally expressed support for the proposed definition of associated borrower. At least one commenter appreciated that it provides more consistency with the combination rules applicable to other banking institutions. Another commenter stated the new definition better aligns the calculation of aggregate loan exposure with all financial institutions, as well as requiring credit unions to place greater emphasis on evaluating and underwriting an entire relationship as opposed to a stand-alone transaction. One commenter supported bringing the associated member concept more in line with bank regulations, but suggested the banks' special treatment rules for partnerships, joint ventures, and associations should also be incorporated into the rule.

Several commenters suggested the definition should be further clarified. For example, one commenter stated that while the definition may help credit unions definitively decide who is an associated borrower, clarity is needed on whether credit unions are permitted to have more conservative criteria in their policies for identifying associated borrowers. Another commenter said it is unclear how a credit union can verify that it knows all of the associated borrowers of a borrowing entity. This commenter proposed adding additional language so a credit union can safely rely on the borrower's disclosure, unless the credit union has actual knowledge of a different corporate structure. One commenter asked how loan limits to one borrower should be calculated when dealing with minority owners of businesses when the business is financially sound and operates without any guarantor support. Another commenter noted that the definition does not take into consideration the sponsor relationship, which is unique to credit unions.

The Board notes that a clear understanding of the overall borrowing relationship plays an important role in the credit risk assessment of a commercial borrower. Consistent with common industry practice, lenders are expected to make credit decisions based on a full understanding of the risks posed by their commercial borrowers, including the influences of other individuals and/or entities that may have a material impact on the borrower's operational activities and/or loan repayment ability. This influence stems from interdependent business actions between different borrowers and borrowers that share management and ownership. As such, credit unions are expected to require commercial borrowers to disclose associated individuals and/or entities so that they can understand the overall borrowing relationship and perform appropriate risk assessment. Associated relationships can be complex, and therefore it is necessary to have consistent and definitive criteria for identifying borrower-related interests. The proposed definition is generally consistent with accepted industry practices and guidelines from other financial regulators.

The Board agrees, however, that the final rule should incorporate elements of the banks' special treatment rules for partnerships, joint ventures, and associations. Accordingly, the Board has amended the final definition to provide three exceptions applying to loans involving partnerships, joint ventures, and associations to address the treatment of limited partners, the connection between the partners and the influence of the partners on the partnerships, joint ventures, or associations. First, if the borrower is a partnership, joint venture or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is a member or partner of the borrower, and neither a direct benefit nor a common enterprise exists, such other person is not an associated borrower for purposes of the rule. Second, if the borrower is a member or partner of a partnership, joint venture, or association, and the other entity with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is the partnership, joint venture, or association and the borrower is a limited partner of that other entity, and by the terms of a partnership or membership agreement valid under applicable law, the borrower is not held generally liable for the debts or actions of that other entity, such other entity is not an associated borrower. Finally, if the borrower is a member or partner of a partnership, joint venture, or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is another member or partner of the partnership, joint venture, or association, and neither a direct benefit nor a common enterprise exists, such other person is not an associated borrower under the final rule.

This topic will also be further discussed in the forthcoming supervisory guidance.

Additionally, as discussed in more detail below, for consistency, the parallel definitions in NCUA's loan participation rule is also amended in an equivalent manner.[22]

[22] 12 CFR 701.22(a).

Loan-to-Value Ratio

The proposed rule modified the current definition of ''loan-to-value ratio'' (LTV) to clarify how this ratio should be calculated. The proposed definition excluded outstanding exposures from other lenders that are subordinated to the credit union's lien position from the numerator of the LTV ratio. In addition, the proposed definition clarified 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.

Many commenters appreciated the change to exclude from the LTV ratio outstanding exposures from other lenders that are subordinated to the credit union's lien position. Several commenters said the change was much needed in order to bring LTV ratio calculations in alignment with customary commercial loan calculations. One commenter indicated that excluding junior liens from LTV ratio calculations is more consistent with other financial institution requirements. Commenters also supported the amendment's clarification of the valuation basis for collateral.

A significant number of commenters, however, argued for more flexibility in the requirement to use the ''lesser of purchase price or market value for collateral held 12 months or less.'' Many commenters suggested the 12-month requirement should be eliminated. Several commenters contended the definition is too inflexible because it does not include improvements made to the collateral. Another commenter observed that valuations can increase with improvements; thus, the value of a property should never be considered static. One commenter noted there are situations where a 12-month standard is unworkable or unreasonable, for example, in non-disclosure states the consideration of property transfer is not publicly available or readily ascertainable. This commenter suggested that a better approach is to require that credit unions use robust appraisal review and underwriting processes to manage risk. Another commenter said the definition should be revised to require the purchase price to be used for LTV only when the funds of a loan are used to purchase the collateral. One commenter asserted that if collateral is already owned, even if only for less than 12 months, the market value is a more appropriate calculation to be used in the denominator for lending purposes. Another commenter said the definition is too rigid, and credit unions should be allowed to use an appraised market value approach to valuation even where collateral has been owned for less than six months. A different commenter suggested the definition of market value in NCUA's appraisal rule should be used in the denominator of the LTV for any real estate transaction regardless of whether the actual purchase price is lower. This commenter argued market value represents the best approximation of the expected yield if the credit union were forced to liquidate the collateral.

Several commenters suggested that if the 12-month requirement is retained, the definition should be expanded to cover purchase price plus the cost of any improvements. Of these, several commenters argued it is appropriate to include improvement costs because market value of the collateral can materially increase in a short period of time due to improvements or other factors (for example, zoning changes, other entitlements, infrastructure enhancements, etc.). According to one commenter, limiting the assumed value to only the purchase price would needlessly restrict credit unions from being competitive lenders on such projects. Another commenter noted that borrowers who acquire property below cost or who independently finance property improvements should not be held captive to that value for the next 12 months. Several commenters contended that instituting a time limit as part of the definition of cost is prescriptive and inconsistent with a principles-based approach. One commenter said a prescriptive definition is excessive and unnecessary. A different commenter suggested that imposing a prescriptive definition implies appraisals cannot be trusted. The same commenter argued that while cost can be arbitrary, appraisals may be regarded as reliable and appropriately reflecting the market values at the time of completion.

One commenter generally observed that the definition as drafted is more appropriate in a residential context rather than a business or commercial setting. Another commenter suggested the definition appears to address real estate collateral rather than negotiable, inventory, and equipment collateral.

One commenter asserted that the proposed definition of collateral market value is not consistent with that used by other federal agencies involved in commercial lending (for example, SBA and USDA), which allow the use of ''as is,'' ''as completed'' and ''as stabilized'' methodologies to determine the market valuation of income producing properties for loan guarantee purposes.

The Board has carefully considered these comments and agrees that the proposed requirement to use 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'' may not be appropriate for all scenarios. The Board agrees that in certain cases, cost of improvement should be considered when those expenditures add value and are capitalized in accordance with Generally Accepted Accounting Principles (GAAP). However, the expenses necessary to maintain the collateral, and those generally considered operating expenses, such as real estate taxes or maintenance of the structure, should not be included in the valuation of the cost component of collateral. To provide more flexibility, the final rule replaces ''the lessor of the purchase price or market value for collateral held 12 months or less, and market value for collateral held longer than 12 months'' with ''the current collateral value.'' The current collateral value is the most up-to-date value of the collateral based on appropriate valuation methodologies according to standard industry practices. The forthcoming supervisory guidance will provide additional detail with respect to determining current collateral value for various types of collateral in different scenarios.

The Board reemphasizes that commercial loans must be appropriately collateralized. The type and marketability of collateral should be considered in determining the collateral requirements. The LTV ratio requirement established by a credit union should accomplish sufficient risk sharing between the borrower/principals and the credit union to provide adequate protection in the event of borrower default and the repayment of the loan is ultimately dependent on the liquidation of collateral. In a construction and development loan, establishing a borrower's investment requirement on the cost of the project will ensure the borrower infuses sufficient capital and establishes a stronger incentive and commitment toward the success of the project.

Net Worth

For consistency, the proposed definition of ''net worth'' provided 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. The Board received no substantive comment on the proposed definition and is therefore retaining the definition in this final rule without change.

New definitions:

Commercial Loan

The Board proposed to add a new definition to the rule in order 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.[23] The proposed rule generally defined a ''commercial loan'' as any credit a credit union extends to a borrower for commercial, industrial, agricultural, and professional purposes, with several specific exceptions.

Most commenters that offered input on this aspect of the proposal were supportive of the Board's objective in adding a definition for commercial loans to delineate between MBLs subject to the statutory limit and business purpose loans subject to the rule's safety and soundness provisions. One commenter said the distinction will provide credit unions with needed flexibility. Several commenters, however, disagreed with creating a distinction between commercial loans and MBLs. A number of commenters said the distinction between commercial loans and MBLs is too complex and unnecessary. At least one commenter suggested that drawing a distinction between MBLs and commercial loans provides no real benefit, and simply adds to credit unions' reporting burden. Several comments suggested the rule adds unnecessary burden and complexity to the tracking and monitoring of these loan types on the 5300 Call Report. One commenter indicated that the definition does not provide the necessary clarity for accurate 5300 reporting. The Board understands these concerns. However, the distinction is imperative to distinguishing MBLs subject to the statutory cap and commercial loans subject to the rule's safety and soundness provisions. The Board notes that the 5300 form will be modified and detailed instructions will be provided to credit unions prior to the implementation of the final rule.

A number of commenters suggested that further clarification is needed. For example, the proposed rule generally defined a ''commercial loan'' as any credit a credit union extends to a borrower for commercial, industrial, agricultural, and professional purposes, *but not for investment or personal expenditure purposes.* One commenter suggested that the phrase, ''not for investment . . . purposes'' is ambiguous, noting that certain commercial loans would be considered to be for investment purposes, such as financing commercial real estate (*e.g.*, apartment buildings, shopping centers, etc.). The Board agrees that the term ''not for investment . . . purposes'' could cause confusion and has removed it from the final definition.

Several commenters expressed specific support for the seven categories of loans excluded from the commercial loan definition. In particular, commenters indicated they would experience significant regulatory relief because certain MBLs, such as loans secured by a 1- to 4-family residential property that is not the member's primary residence, will no longer be subject to full commercial lending safety and soundness requirements. Several commenters asked for clarification on the specific types of loans exempted from the commercial loan definition. For example, a commenter asked for clarification for loans to a borrower or an associated borrower with an ''aggregate balance'' less than $50,000, observing that the current rule refers to ''aggregate net balances'' such that portions of a loan secured by shares or by government guarantees are deducted from the determination of the loan amount. The commenter requested clarification on whether the ''aggregate balance'' is different from the ''net member business loan balance.'' To provide more clarity, the Board has changed the phrase ''aggregate balance'' to ''the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union'' in the final rule.

A number of commenters suggested that more types of loans should be exempt from the definition, including loans that present zero or remote risk of loss to a credit union. For example, one commenter suggested that loans fully secured by deposits should be exempt. Another commenter recommended excluding loans fully guaranteed by the SBA or other government agency because such loans are in essence risk-free. A different commenter contended that for loans that are partially insured or guaranteed, or that have a partial commitment to purchase, should be specifically excluded from the commercial loan definition, to the extent of the amount insured or guaranteed, and the amount of the purchase commitment. As indicated above, the Board notes that the portion of a loan secured by shares or deposits in the credit union may be deducted from the outstanding loan balance plus any unfunded commitments in counting against the $50,000 commercial loan threshold. However, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union to a borrower or an associated borrower is greater than $50,000, a partially cash secured loan will be considered a commercial loan and thus subject to the appropriate safety and soundness provisions.

However, loans guaranteed by the SBA or other government agencies cannot prudently be excluded from the commercial loan definition, because credit unions could potentially lose the government guarantee if they do not comply with program requirements of the corresponding government agencies. Also, these loans are commercial in nature and require similar safety and soundness provisions as other types of commercial lending.

One commenter recommended tying the small loan exception (*i.e.,* loans under $50,000) to a percentage of the credit union's net worth instead of the absolute size of the loan. However, the intent of the small loan exception is to provide regulatory relief to credit unions that offer small-dollar loans for commercial purposes. Tying the exception to a percentage of net worth could result in large commercial loans not being underwritten and managed using appropriate commercial risk management practices. Therefore, the final rule maintains the current small loan threshold of $50,000.

Finally commenters noted it is redundant to require credit unions to have both a commercial loan policy and an MBL policy. To clarify, the Board does not expect credit unions to maintain separate policies for commercial loans and MBLs. Member business loans that are also commercial loans should follow the credit union's commercial loan policy. Member business loans that are not commercial loans should follow the credit union's general loan policy or other specific loan policy as the credit union deems appropriate.

Common Enterprise

As noted above, the proposed definition of ''associated borrower'' included any person or entity engaged in a ''common enterprise'' with the borrower.

Most commenters that provided feedback on this definition said greater flexibility is needed for credit unions to determine common enterprise and common control. Several commenters suggested the definition is too restrictive and contrary to a principles-based rule. One commenter asserted the definition

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

is too prescriptive and credit unions should be allowed to take a more conservative approach in determining if a common enterprise exists. Another commenter suggested the definition as proposed could lead to instances where two unrelated borrowers are improperly covered as a common enterprise, for example, where two unrelated, separate trusts may derive income from the same publicly-traded stock. One commenter indicated the common enterprise definition requires more analysis than is practical. Several commenters suggested that a more practical approach is to count any borrower who has a joint interest with another borrower or entity as an associate borrower.

However, the proposed definition is more consistent with how the term is defined in similar bank regulations, and it provides important clarification for how ''common enterprise'' relates to the definition of ''associated borrower.'' As discussed earlier, understanding of the overall borrowing relationship is critical in managing the credit risk associated with commercial loans. It is essential to understand the effects posed by the existence of common control and financial interdependence amongst multiple parties who are borrowing from the credit union. Credit unions must remain mindful that in business lending, the borrowers and principals often have multiple credit relationships with the credit union and the borrowing entities often have an interdependence through operations or common ownership and management. The common enterprise definition in the final rule identifies the related parties that have direct influence on the overall risk through connected operations and management, while eliminating other borrowing relationships where the borrower and principles have only a passive investment or involvement. Accordingly, this definition is adopted as proposed.

Control

The proposed definition of ''associated borrower'' also incorporated the concept of controlling interests. Under the proposal, ''control'' would exist when, among other things, a person or entity directly or indirectly, or acting through or together with one or more persons or entities, owns, controls, or has the power to vote 25 percent or more of any class of voting securities of another person or entity. A number of commenters raised concerns with respect to the 25 percent rule for control. Several commenters disagreed with the 25 percent threshold by asserting that, in practice, a majority requires the power to vote more than 50 percent of shares outstanding. Several commenters stated the 25 percent threshold is unnecessarily prescriptive. A few commenters suggested the rule should clarify that control does not exist when the person having control qualifies under only temporary conditions, for example, where a Power of Attorney is assigned due to death.

The Board agrees that a majority control usually exists when an individual or entity owns 50 percent or more of a business entity. However, the proposed 25 percent threshold was established in recognition that owners with a material ownership stake that is less than a majority stake may still have significant influence over a business entity's operations. As a dimension of credit risk management, the 25 percent control threshold is widely utilized in the marketplace and is more consistent with similar definitions employed in comparable bank regulations. As such, the definition of ''control'' is adopted as proposed in the final rule.

Credit Risk Rating System

The proposed rule defined ''credit risk rating system'' as a formal process to identify and measure risk through the assignment of risk ratings, or credit risk grades, a standard means for establishing the level of risk associated with a commercial loan and the overall commercial loan portfolio.

Most commenters supported the proposed definition. At least one commenter, however, observed that the definition requires the use of an ordinal number to represent the degree of risk and suggested the definition should allow flexibility for a rating system to use a non-numerical risk rating (for example, low/medium/high or A/B/C/D).

This definition is adopted as proposed, but the Board clarifies that non-numerical risk ratings are also acceptable under the final rule.

Direct Benefit

Under the proposal, ''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.

Commenters generally supported the proposed definition. One commenter suggested replacing the word ''property'' with the phrase ''tangible and intangible assets.'' This commenter suggested that the proposed use of the word ''property'' could imply that the ''direct benefit'' definition would only apply to real estate.

The definition of ''direct benefit'' is adopted, unchanged, in the final rule, but the Board clarifies that reference to ''property'' in the final definition is not intended to mean only real property.

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. The proposed definition was intended to clarify that loans secured by a 1- to 4-family residential property are not commercial loans for the purposes of the rule.

Most commenters were strongly supportive of excluding 1- to 4-family residential property loans from the rule's commercial loan definition. Commenters noted that by excluding these loans from the commercial loan definition, credit unions will be able to grant such loans without the need for a commercial lending policy and additional board responsibilities. Commenters were also generally supportive of the proposed definition of the term. Accordingly, the Board has determined to finalize the definition without change.

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 final rule. The Board proposed ''vehicle manufactured for household use'' to mean 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.

Commenters were generally supportive of this definition; therefore, the definition is finalized as proposed. However, one commenter requested clarification on whether a personal vehicle used to transport fare-paying passengers on a part-time basis (*e.g.* Uber or Lyft) would qualify as a commercial loan. The Board clarifies that in general any vehicle loan that exceeds $50,000 and is secured by a vehicle used to transport fare-paying passengers (*e.g.,* a commercial ride-share vehicle) will be considered a commercial loan under the final rule. The Board understands, however, that in some circumstances a member may purchase a vehicle primarily for personal use and use it only for a portion of the time to generate ride-share revenue. It is incumbent upon the lending credit union to determine the intended use of a financed vehicle and the borrower's level of dependence on ride-share revenue to repay the loan. For example, if more than 50 percent of the repayment source will come from ride-share activity and the loan or associated borrower relationship exceeds $50,000, the vehicle loan should be treated as a commercial loan and underwritten accordingly.

Readily Marketable Collateral

The Board proposed to add the term ''readily marketable collateral'' to the rule to clarify the proposed collateral requirements. The proposal defined 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.

Some commenters expressed concern that, as defined in the proposal, the term ''readily marketable collateral'' was not sufficiently clear. Others suggested that borrowers may not have realistic access to this type of collateral and asked that the term be expanded to also include broader types of collateral.

The definition will not be expanded to include broader types of collateral, for the reason explained below. However, the Board does agree that lenders should be clear on what is meant by ''readily marketable.'' Under comparable existing bank regulations in use for decades, this term refers to financial instruments that must be ''salable under ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions, on an auction or similarly available daily bid and ask price market. Readily marketable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral.''

The purpose of including readily marketable collateral in NCUA's regulation is to provide a means for qualifying credit unions to increase their single obligor limit to a business loan borrower to as much as 25 percent of the credit union's net worth. But, any amount above the 15 percent of net worth limit is only prudent if it is fully secured by marketable collateral as described above. Many member business borrowers may lack the capacity to provide readily marketable collateral in which the lender can perfect a security interest. As such, it is expected that single-borrower limits set above 15 percent of net worth will occur on a more limited basis rather than become the norm. Therefore the final rule adopts this definition as proposed.

Residential Property

The Board proposed to define ''residential property'' as a house, condominium, cooperative unit, manufactured home, and unimproved land zoned for 1- to 4-family residential use. The definition was added to the rule to clarify that loans secured by a 1- to 4-family residential property are excluded from the definition of commercial loan.[24]

At least one commenter suggested the residential property definition should include trailers and campers, which are often used as residences in certain geographical areas. One commenter noted that the definition does not specifically address townhouses. Another commenter recommended that the definition refer specifically to FFIEC guidance in defining single family residence.

The Board sees a distinction between trailers or campers and manufactured homes and clarifies that such recreational-type vehicles are not residential property for the purposes of the final rule. While trailers and campers may in some instances be used as residences, they are potentially more transient and tend to lack the permanency and continuity that generally characterizes a manufactured home or other residential property. However, townhouses and other similar housing styles share essentially the same characteristics as houses, condominiums or cooperative units and, therefore, fall within the scope of the final definition.

Definitions moved to a different section:

Construction and Development Loan

To improve the readability of the rule, the Board proposed to move the current definition of ''construction and development loan'' to § 723.6 because that is the section that addresses all of the requirements for construction and development loans. The Board received no comments on the proposal to move this definition to § 723.6 and has adopted the technical change in this final rule. The substantive definition is discussed below.

Net Member Business Loan Balance

The proposed definition of ''net member business loan balance'' was substantively the same as in the current rule; however, the Board proposed to move it 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. The Board received no comments on the proposal to move this definition to § 723.8 and has adopted the technical change in this final rule. The substantive definition is discussed in greater detail below.

§ 723.3—Board of Directors and Management Responsibilities

Proposed § 723.3 of the final rule addressed the overall elements necessary to administer a safe and sound commercial loan program. It reinforced the 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 proposal modified the experience and expertise requirements in the current rule for personnel involved in member business lending and delineated the qualifications required for a credit union's senior executive officers and staff. It also provided options for how a credit union may meet such requirements. In addition, the proposal required a credit union's board of directors to approve a commercial loan policy that complies with § 723.4, which is discussed below.

Board Responsibility

Generally, commenters expressed concern that the rule will place too much burden or responsibility on volunteer credit union boards of directors. Commenters suggested that imposing too much responsibility on volunteer boards will make it increasingly difficult for credit unions to find members willing to serve as board members. Specific concerns expressed included: The rule places unclear or unduly high expectations on credit union boards of directors; it requires too much ongoing oversight; it shifts managerial responsibilities to directors; it invites too much involvement by the board; it may be construed to mean that boards should be involved in day-to-day operations; that

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

a perceived increase in director responsibility and liability will deter potential volunteers and MBL activity; and, the lack of specific director duties in the regulation increases the potential for disagreements between credit unions and examiners.

None of these comments change the fact that a credit union's board of directors has a fiduciary duty to the membership. Thus the board responsibilities provisions in the final rule reinforces the 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 Board agrees that guidance in this area would benefit both credit unions and examiners and will include a discussion of board and management responsibilities in the revisions to its examiner training and forthcoming guidance for commercial lending.

The Board does not expect directors to involve themselves in procedural or day-to-day operational aspects of business lending. Rather, directors are expected to set the strategic direction of their credit union, approve the guiding risk management policies, remain informed about the nature and levels of risk, and require that the institution is appropriately staffed. By spelling out general responsibilities for senior executive officers and lending personnel, the rule avoids being overly prescriptive and at the same time gives directors a guideline for how to delineate between their role and that of staff responsible for hands-on management of commercial lending. Lastly, the Board notes that business lending is a complex and potentially higher-risk activity that is not appropriate for all credit unions. If a credit union's board and/or management team does not possess the experience, skills and resources to manage MBLs, it should refrain from making such loans until it does.

Experience Requirements

Most commenters agreed with the Board's proposal to eliminate the current rule's specific two-year staff experience requirement, and indicated that qualitative requirements are preferable to prescriptive staffing requirements. Other comments, however, favored the continuation of the two-year requirement (or another prescriptive experience standard), noting that adequate training and experience are crucial to a safe, sound, and successful commercial lending program. Several commenters noted that oftentimes two years of experience is not sufficient to support the complexity of offering a full range of MBLs and to further manage risk within the portfolio, but a qualitative requirement will enable credit unions to independently determine and evaluate the degree of experience needed in order to successfully manage its commercial loan program. One commenter suggested that the shift from an arbitrary experience requirement to a qualitative standard will better align the knowledge, skill, and experience of staff with the size, complexity, and risk profile of each credit union.

Several commenters expressed concern about proposed § 723.3(b)(2), which requires expertise in three distinct areas. These commenters suggested the rule should clarify that while management should have experience in all three areas, staff will not necessarily have or need experience in all three areas.

The Board agrees that having an experience requirement expressed in years is overly simplistic and may be unreliable as a means to ensure adequately skilled credit staff are in place. Rather, a requirement that includes specific knowledge, skills and abilities is preferred. The rule establishes criteria that is appropriate and necessary for managing commercial loan risk. The elimination of a discreet years-of-experience requirement also makes it easier for a credit union with a well-run commercial loan department to develop staff internally rather than being forced to hire external candidates because of the current rule's two-year criterion.

The competencies and skills outlined in the rule are considered basic proficiencies necessary to safely manage credit risk both at the individual loan-relationship level as well as the overall portfolio. The Board is aware that in some cases the credit risk management function may be managed by multiple personnel, each with specific responsibilities based on their roles and respective skill sets. When the commercial loan relationship with a member is managed by more than one individual, it is incumbent on the group who is managing the member relationship to possess the required competencies and skills. The credit union should establish its credit risk management program to include well-defined roles and responsibilities and thereby ensure effective coordination between the key credit functions.

§ 723.4—Commercial Loan Policy

Section 723.4 of the proposal set out the expectations and policy requirements for credit unions offering commercial loans. The proposal specified 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. The proposal also reinforced 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.[25] It also eliminated 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 would also be eliminated. Finally, the proposal required that a credit union's commercial loan policy must address a number of specified areas, as enumerated in the rule.

Most commenters were strongly supportive of allowing credit unions to establish their own individualized commercial lending policies instead of imposing prescriptive requirements through regulation. Several commenters, however, suggested that elements included in the commercial loan policy requirements were overly detailed and more properly characterized as procedures that should not be included in the policy. NCUA maintains that the rule reflects the necessary elements to be included in credit unions' commercial lending policies.

A number of commenters also suggested the rule should allow for the commercial loan policy to be approved by a committee of the board because board functions are often split among various board committees. The final rule clarifies that a credit union's board of directors can delegate the responsibility to its committee. However, the board of directors is ultimately accountable for the safety and soundness of the credit union's commercial lending activities.

Commenters generally supported the requirement for a credit risk rating system but requested further guidance to lay out detailed supervisory

[25] 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.

expectations on what will be deemed an acceptable credit risk rating system. One commenter encouraged NCUA to leverage existing guidance from federal bank regulators addressing credit risk rating systems. The Board agrees that clear guidance is beneficial and plans to further address this topic in the forthcoming supervisory guidance. NCUA will leverage the existing information from other financial regulators where appropriate.

At least one commenter requested clarification on whether the requirement that credit unions identify and track loan exceptions will apply retroactively to all existing loans. The Board clarifies that upon full implementation of the final rule, credit unions will be required to identify and track loan exceptions only on a prospective basis. Another commenter suggested that tracking all loan exceptions would be burdensome, and credit unions should only track certain types of exceptions. The Board emphasizes that it is important for credit unions to track all types of loan exceptions.

Several commenters recommended that the rule allow for credit unions to combine their MBL and commercial lending policies to avoid redundancy. Commenters also suggested that credit unions should have flexibility to incorporate the required credit risk rating system into its existing policies, such as an enterprise risk management policy. As mentioned above, the Board does not expect credit unions to maintain separate policies for commercial loans and MBLs. Credit unions may also incorporate required credit risk rating systems into other existing policies.

Single-Borrower Limit

Under the proposal, a credit union's commercial lending 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 union's 15 percent general limit is fully secured at all times with a perfected security interest by readily marketable collateral, as defined by the rule. Most commenters supported this change. However, several commenters expressed concern that the amendment imposes a prescriptive limitation without the ability to request a waiver. Commenters suggested that removing the waiver option creates a hardship and competitive disadvantage for small credit unions and is contrary to the rule's overall objective of shifting from a prescriptive to principles-based rule. Commenters also expressed concern that basing the single borrower limit on a percentage of net worth could cause a problem for smaller credit unions. A few commenters suggested that, alternatively, the limit should be based on a percentage of shares and undivided earnings. Several commenters suggested the single-borrower limit should be eliminated entirely.

However, a single-borrower limit based on a percentage of the lender's net worth is an essential component of credit risk management that prevents imprudent concentrations in any single borrower. While the provision is modeled after similar bank rules, the primary objective in retaining an explicit limit on single-borrower concentrations is safety and soundness. In expanding the rule to allow for concentrations of up to 25 percent, the Board is providing flexibility for credit unions while maintaining an appropriate limit for protection against one borrower's impact on the capital of the credit union. For these reasons, the limit on single-borrower concentrations in the final rule is not subject to waivers.

A key element of measuring single-borrower exposure is to determine the associated individuals and entities that comprise the borrower's business relationships. The identification of associated borrowers captures those parties who are interdependent and have operational influence with the borrower due to shared ownership and management. NCUA cautions that credit unions that grant the maximum regulatory limit of credit to an associated borrower relationship will inhibit their ability to meet any subsequent financing needs of the associated borrowers.

Several commenters suggested that the rule should exclude government-guaranteed loan balances from the single-borrower limit. The Board agrees that this additional flexibility would be beneficial to credit unions and would not raise significant safety and soundness concerns. Thus, the final rule adopts this change.

Financial Statement Quality

A notable number of commenters raised concerns about the proposed financial statement quality standards. Commenters suggested the requirement for audited or reviewed financial statements for more complex and larger borrowing relationships should be less prescriptive and left to the discretion of each credit union. Commenters noted there may be larger relationships where the loan and collateral is not complex and obtaining audited or reviewed financial statements would not provide any major support to the loan but would cause the borrower to incur additional expense. Commenters also stated that ''more complex'' borrowing relationships are undefined and examiners may interpret a large or complex relationship differently than commercial underwriters. In addition, several commenters argued that requiring auditor review or audited financial statements in all cases will put credit unions at a competitive disadvantage with banks and other lending institutions that do not currently have these requirements. One commenter noted that, due to the cost and complexity of obtaining a financial statement prepared in accordance with GAAP, most lending institutions only require tax returns for less complex borrowing activities. Another commenter recommended that, to reduce costs, credit unions should be allowed to meet financial statement quality standards by obtaining tax returns, rather than costly GAAP-audited financial statements. This would allow credit unions to develop policies and procedures for financial reporting that are appropriately commensurate with the complexity of their lending activities and relationships. A different commenter observed that smaller credit unions often do not have the sophistication or resources to undergo CPA auditing and CPA prepared and audited statements should not be required under the rule.

The Board agrees that the degree of accuracy and assurance of financial statement quality standards should correspond with the level of risk in the transaction and size and complexity of the borrowing relationship. As the size and complexity of the relationship increases, the quality of the financial information should be commensurate. 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: (1) An auditor's review of the financial statements prepared consistent with GAAP to obtain limited assurance (*i.e.,* a ''review quality'' financial statement), or (2) 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).

Credit unions should address the criteria and thresholds for the required financial reporting in their policies. Credit unions should allow exceptions in their credit policies if they determine the relationship does not require the same level of assurance and they are satisfied that the lesser quality still provides them with accurate reporting of the borrower's financial performance. Credit unions will be expected to address the issue of exceptions in their loan policies. Any exception should be documented by staff and approved by the appropriate designated internal authority.

§ 723.5—Collateral and Security

Under the proposal, all of the specific prescriptive limits and requirements related to collateral in the current rule were eliminated and replaced with the fundamental principle that commercial loans must be appropriately collateralized.

A minority of commenters were opposed to the elimination of the current rule's prescriptive collateral requirements. These commenters argued that the elimination of these important safety and soundness checks and balances represents lax regulatory policy and will result in unsafe and unsound commercial lending practices. Most commenters, however, were strongly supportive of the elimination of prescriptive collateral requirements. These commenters said the change in approach will help credit unions better serve their members. One commenter indicated the new rule will level the playing field for credit unions. One commenter noted the change will allow credit unions to offer more flexible financing options for strong borrowers with satisfactory cash flow and capitalization. Another commenter said the modernized collateral requirements will provide credit unions with more options to mitigate risks associated with different collateral types, and allow for more competitive loan terms for members.

Many commenters specifically supported the elimination of unsecured lending limitations. One commenter indicated this particular change will allow credit unions to provide financing to professionals with strong incomes but limited or depreciated collateral value. Another said it will allow credit unions to expand product offerings. A different commenter indicated that service to small businesses will improve, particularly those that despite excellent cash flow have limited lendable assets and those that use cash accounting. Several commenters, however, urged NCUA to leave in place the current limits on unsecured loans. One commenter contended that unsecured loans pose additional risks and should be held to a minimum in order to maintain the quality and integrity of credit union member business lending.

A significant number of commenters strongly supported the elimination of the current LTV requirement. Commenters generally agreed LTV limits are best left to the individual credit union. One commenter observed that the current 80 percent LTV limit serves as a good rule of thumb, but such a prescriptive limitation undermines lenders' ability to account for other factors that may mitigate credit risk such as a high debt service coverage ratio, strong guarantors, or high liquidity. Several commenters, however, suggested that if the rule does not impose maximum LTV requirements, some state-chartered credit unions may be subject to conflicting state regulations that do impose maximum LTV limits. As such, those commenters recommended the final rule direct credit unions to set their LTV limits no higher than allowed by their respective state regulations. At least one commenter appreciated the proposal's increased flexibility but indicated that retaining regulatory limits would protect the industry from the acts of imprudent lenders. This commenter suggested that the final rule set regulatory LTV limits similar to the supervisory LTV limits for real estate loans addressed in FDIC's real estate lending standards.

NCUA will issue guidance to examiners to outline appropriate industry methods for valuing collateral and for establishing an appropriate maximum LTV for various collateral types. The Board agrees with commenters who suggest NCUA's guidance for LTV ratio limits should be consistent with that set by bank regulators. The forthcoming supervisory guidance will focus on credit unions' processes for establishing collateral protection sufficient to offset the specific risk associated with the borrowing relationship. The Board recognizes the commenters' concerns about removal of portfolio and relationship limits for unsecured loans but emphasizes unsecured lending should be an exception, not the norm, to be practiced on a limited basis and only to accommodate financially strong members. Credit unions should address portfolio limits and appropriate risk monitoring and reporting for unsecured loans in their credit policies.

The Board reiterates that for loans granted by credit unions to support either the purchase of an asset or working capital to fund inventory or accounts receivable during the business cycle, those assets should collateralize the loan.

Accordingly, the final rule sets 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 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 rule 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 lending should be granted on a limited basis with strict policy limits and appropriate monitoring and management reporting.

A strong majority of commenters also expressed broad support for the elimination of the current rule's requirement that credit unions must obtain a personal guarantee from the principal(s) of the borrower. Commenters generally indicated that the change will enable credit unions to better serve their members. Commenters noted the current requirement is burdensome and time consuming and, even if a waiver is granted, significantly inhibits credit unions' ability to offer commercial loans. Others noted the current requirement has been very restrictive and has resulted in the loss of business on many occasions. For example, one commenter noted the current requirement for professional partnerships for full personal guarantees from 51 percent of the owners is unrealistically burdensome and has prevented credit unions from making good loans. Another commenter said the current rule has made it difficult to meet the needs of its membership, which includes uniquely structured entities such as Native Corporations whose corporate structure makes it impractical to obtain individual guarantees.

Commenters also indicated that allowing credit unions more flexibility in taking personal guarantees will enable them to be more competitive with banks and other lenders, which have greater flexibility in this area. One commenter said the current prescriptive requirements make it difficult to compete with banks and other lenders on well-qualified borrowers. Multiple commenters said they will continue to take personal guarantees where appropriate, but flexibility in this regard is critical. Another commenter agreed that personal guarantees are generally prudent, but said the elimination of strict rules requiring guarantees is advantageous for credit unions.

A notable number of commenters, however, opposed the elimination of the current rule's personal guarantee requirement. Those commenters suggested that eliminating the personal guarantee is unsafe and unsound and will introduce unnecessary risk into many credit union portfolios. At least one commenter expressed doubt as to whether credit unions can exercise the judgment necessary to determine if a guarantee is appropriate or not. In addition, several commenters asserted that credit unions making loans without taking a personal guarantee would effectively be making impermissible non-member loans because the personal guarantee by a member is what makes an MBL a ''member'' business loan.

By granting flexibility to credit unions to individually decide whether to require personal guarantees or not, the Board is not implying that their function or importance as a risk mitigation has diminished. The Board clarifies that the rule allows credit unions to grant loans without the personal guarantee of the principal(s) only when there are strong mitigating factors to offset the additional risk created when the loan is not guaranteed by the primary beneficiary of the transaction, which is generally the principal(s) of the borrower. The Board does not agree that competitive pressure is a justification to grant a loan without the personal liability or guarantee of the controlling interest of the borrower. The credit union's decision to forego the use of a guarantee should only be approved when it meets the needs of a financially strong member and other credit-risk mitigations exist.

The Board reiterates that having the principal(s) of the borrower commit their personal liability to the repayment obligation is, in many cases, very important for commercial lending. Accordingly, the 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 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.

As discussed above, numerous commenters suggested that implementation of the personal guarantee provision should be expedited to afford credit unions with this regulatory relief as soon as possible. The Board is persuaded that the change will enable credit unions to better serve their members and it will be prudent to provide this measure of regulatory relief to credit unions as soon as reasonably possible. Accordingly, the personal guarantee provision in § 723.5(b) of this final rule is effective 60 days after publication of the final rule in the **Federal Register**. In the interim, credit unions may continue to seek a waiver of the personal guarantee requirement under current § 723.10(e). Once the new personal guarantee provision goes into effect (60 days after publication in the **Federal Register**), a credit union making a member business loan (as defined in current § 723.1) will no longer be required to seek a waiver if it decides that a full and unconditional guarantee from the principal(s) of the borrower is not necessary and it determines and documents in the loan file that mitigating factors sufficiently offset the relevant risk.

§ 723.6—Construction and Development Loans

The proposed rule outlined separate requirements that pertain exclusively to construction and development lending. Construction and development lending represents an important and necessary service that credit unions can provide to their membership. However, construction and development lending presents risk, in addition to credit risk, in the areas of loan disbursement administration and valuation of collateral.

The proposed rule clarified the definition of a construction and development loan, described alternative methods for valuing a construction project, and explained which costs are considered allowable in determining value of the project and therefore may be funded from loan proceeds. The proposal also outlined required procedures to be followed in the administration of construction and development loans.

The Board proposed a new definition for construction and development loans that distinguished between income-producing property and projects built for a commercial purpose. The Board proposed ''income producing'' to mean 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, applied 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 clarified that a construction and development loan includes any loan for the construction or renovation of real estate where prudent practice requires multiple controlled 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 established procedures for the valuation of collateral for construction and development loans. The proposal outlined two distinct methods for determining collateral value: One focused on cost, the other on market value. The first method entails an evaluation of the cost to complete the project. The proposal described allowable costs for valuation and funding purposes consistent with prudent commercial practice. The proposed rule also described 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 rule described 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 clarified 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.

Most commenters were generally supportive of the proposed changes. At least one commenter noted that the amendments should make the construction and development loan requirements more consistent with expectations of commercial borrowers and help credit unions to more effectively provide loans to members. Another commenter indicated that the easing of unnecessary and arbitrary limits on construction and development loans will help credit unions to better serve their members and communities.

Most commenters supported removing the current 15 percent aggregate limit on these types of loans. One commenter said this change would be very positive for credit unions. One commenter indicated that removal of the limit on construction and development loan balances will enable credit unions to offer construction financing to more businesses at the same time. The same commenter also noted that under the current rule, construction projects are sometimes delayed in order for the credit union to stay under a restrictive limit.

Most commenters also supported the removal of the minimum equity requirement of 25 percent on construction and development loans. One commenter noted the 25 percent requirement is a best practice but it is not always achievable, even on loans that are strong for other reasons. One commenter noted that the removal of the equity requirement will lift unnecessary hurdles that have put credit unions at a competitive disadvantage under the current rule. Another commenter observed that the current restriction has curtailed credit unions' willingness to participate in certain projects. Another commenter noted the change brings NCUA's rule more in line with industry standards.

Other commenters, however, expressed concern that removal of the prescriptive limits creates too much risk. At least one commenter recommended keeping both the 15 percent aggregate limit as well as the 25 percent equity requirement in place in this area. One commenter supported the removal of regulatory limits, but suggested that each credit union's individual policy should set a limit on construction and development loans because of the overall inherent risk and experience necessary to manage the development process.

Several commenters expressed opposition to the requirement of using the lesser of purchase price or appraised value for collateral held less than 12 months. At least one commenter argued that the appraised value should always be used. Another commenter said it is too restrictive to require two appraisals due merely to the passage of time.

At least one commenter suggested the rule should be more flexible with respect to the requirement for obtaining on-site inspections prior to any loan disbursement. Another commenter noted it can be cost prohibitive on smaller projects that submit a draw schedule to hire a third party to review line-item budgets.

One commenter asked for clarification on the definitions of hard cost and soft cost. Another commenter recommended that the rule more clearly distinguish between construction and development loans and loans for renovation.

The Board agrees that the rule's increased flexibility on limits will provide credit unions with greater opportunity to meet the potential business needs of their members. The risks associated with construction and development lending are unique and complex. NCUA encourages credit unions to weigh the decision to provide construction and development loans carefully and only after they have made a determination that staff responsible can clearly understand and manage the risks. The rule establishes minimum process requirements to ensure the credit union can adequately administer an effective construction and development process. The administration of construction and development loans is generally more involved than other types of lending because of the requisite monitoring requirements, and therefore administration costs are likely to be higher. Some credit unions may find these higher administrative costs prohibitive if they lack the economies of scale to support the more intensive credit risk management process. Credit unions lacking adequate resources and/or experience should refrain from construction and development lending.

The Board notes the concerns expressed by commenters who caution about the risk of construction and development lending and the levels of expertise necessary to safely conduct it. The rule requirements are designed to ensure credit unions follow sound practices such as the use of qualified individuals, development of budgeting and planning, and monitoring of projects throughout the construction and development lending process. The Board understands that the specific expertise required to properly manage a project may not reside with the credit union staff and allows credit unions to obtain the necessary expertise by hiring qualified third parties. By establishing an effective administration of the process, the credit union can detect any variance from the original plan earlier in the process. This advantages both the credit union and the member because an early detection of problems affords the credit union and its member the best opportunity to develop a mutually beneficial solution.

Considering the general support of most commenters, the Board has decided to adopt the requirements of proposed § 723.6 unchanged in this final rule. The process outlined is standard construction financing practice and serves both the credit union and the member.

§ 723.7—Prohibited Activities

The Board proposed to move the prohibitions contained in current § 723.2 to proposed § 723.7, essentially unchanged, except for minor clarifications in the wording. This section of the proposed rule also included provisions governing conflicts of interest, which had been taken virtually intact from § 723.5(b) of the current rule. The proposal also added a clause to clarify what it means to be ''independent from the transaction'' and specifically provided 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.

A number of commenters indicated that the current prohibitions are unnecessarily prescriptive and should not be retained in the final rule. One commenter stated that outright prohibition of insider commercial loans is overly harsh. This commenter acknowledged that insider loans present an opportunity for abuse, but argued that such loans can be effectively managed through enhanced due diligence, reporting and policy requirements, and aggregate lending limits. At least one commenter argued that Regulation O,[26] which governs insider lending for banks, bans preferential loans to insiders but does not impose an outright prohibition on all loans to insiders. The commenter suggested NCUA should adopt a similar approach to Regulation O, whereby additional due diligence, board responsibilities, and aggregate limits are required for insider loans, but the rule allows for such loans to be made. Another commenter suggested that, rather than prohibiting insider loans, the rule should implement similar safeguards that govern insider credit transactions in connection with personal loans and mortgages.

The Board carefully considered these comments but has determined not to incorporate an approach similar to Regulation O because the bank rule depends to a large extent on public disclosures as a deterrent to improper insider commercial lending activities. Because credit unions are not-for-profit, cooperative, non-publicly traded institutions, disclosure provisions similar to those contained in Regulation O may have limited efficacy in the credit union context. The Board, however, recognizes that the rule could provide greater flexibility to permit credit unions to provide insider loans while maintaining safeguards against insider abuse and conflicts of interest. Accordingly, the final rule narrows the scope of ineligible borrowers to permit credit unions to provide commercial loans to senior staff (and their family members) who have no influence over and are not directly or indirectly involved in the commercial loan underwriting, servicing, and collection process.

Proposed § 723.7(c) also restricted a third party that is providing business loan services to one or more credit unions from receiving compensation contingent upon the closing of a loan. Several commenters argued that CUSOs should be exempted from this provision. One commenter contended the rule should not prohibit compensation contingent on a loan closing, especially where a CUSO is providing the services, since the CUSO and credit union are united by common ownership and their interests do not conflict. Another commenter similarly argued that CUSOs should be exempted from this provision as they are generally credit union owned with interests of the CUSO and credit union in alignment. One commenter said a CUSO should be viewed as avoiding the client relationship since it is owned by credit unions and functions as the collaborative extension of those owners. Another commenter argued the condition of a loan closing is only improper if there is a conflict of interest. This commenter disagreed that CUSOs pose the same conflict as other third parties, such as borrower-paid loan finders or brokers. Another commenter asserted fees and payment terms and conditions should be left to each credit union and their vendors to negotiate. This commenter observed that fees payable at closing are not uncommon and they represent the culmination of work product.

CUSOs, simply by definition, are not necessarily an extension of particular credit unions. CUSOs' interests are not necessarily or completely in alignment with a particular credit union's interests. In fact, CUSOs are for-profit and legally separate entities. Under NCUA's CUSO regulation, a CUSO is generally defined as ''any entity in which a [federally insured credit union] has an ownership interest or to which a FICU has extended a loan, and that entity is engaged primarily in providing products or services to credit unions or credit union members.''[27] CUSO ownership is not restricted to credit unions nor is any level of credit union ownership required to make an entity a CUSO. A CUSO may be wholly owned by one credit union, owned by multiple credit unions, or could have no credit union owners. Further, under the CUSO rule, a federal credit union can invest in or loan to a CUSO only if the CUSO is structured as a corporation, limited liability company, or limited partnership and it obtains written legal advice that the CUSO is established in a manner that will limit potential exposure of the credit union to no more than the amount of funds invested in, or loaned to, the CUSO.[28] A federally insured credit union and CUSO must be operated in a manner that demonstrates to the public the separate corporate existence of the credit union and the CUSO.[29]

For these reasons, CUSOs are not exempted from final § 723.7(c). While in many cases a CUSO and its credit union owner may share a common interest, this is not always true, and the rule is intended to guard against potential conflicts. The Board notes, however, that the rule permits a credit union to use the services of a CUSO even if it is not independent from the transaction, provided the credit union has a controlling financial interest in the CUSO as determined under GAAP.

Additionally, the Board clarifies that the final rule permits fees to be *payable at* closing, but not *contingent upon* closing.

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

Proposed § 723.8 set out the statutory aggregate limits mandated by Section 107A of the FCU Act. Specifically, Section 107A states, in pertinent part that no insured credit union may make any member business loan that would result in a total amount of such loans outstanding at that credit union at any one time equal to more than the lesser of 1.75 times the actual net worth of the credit union; or 1.75 times the minimum net worth required under

[26] 12 CFR part 215.

[27] 12 CFR 712.1(d).

[28] 12 CFR 712.3(a).

[29] 12 CFR 712.4(a).

section 1790d(c)(1)(A) of this title for a credit union to be well capitalized.[30]

This 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.[31] For greater consistency with the statute, however, the Board proposed to incorporate the statutory language contained in the FCU Act in § 723.8(a).

The proposal also clarified the distinction between commercial loans subject to the safety and soundness provisions and MBLs subject to the statutory limit. The following table was included in the preamble to the proposed rule to illustrate and compare the member business loan and commercial loan definitions under the proposed rule.

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	No[32]	No.
Member business loan fully secured by a 1- to 4-family residential property (*not* a member's primary residence)	Yes[33]	No.
Member business loan secured by a vehicle manufactured for household use	Yes[34]	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[35].
Non-member commercial loan or non-member participation interest in a commercial loan made by another lender	No	Yes[36].

In addition, the proposed rule clarified that a credit union's non-member commercial loans or participation interests in non-member commercial loans made by another lender[37] continue to be excluded from the MBL definition[38] 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 eliminated the current rule's requirement 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.[39]

The proposed rule also identified those credit unions that are, by statute, exempt from the aggregate MBL limit, including credit unions that have a low-income designation or that participate in the Community Development Financial Institutions program. Credit unions chartered for the purpose of making business loans were also exempted under the proposed rule, consistent with the statute. 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 CUMAA. NCUA continues to apply the ''history of primarily making member business loans'' exemption by reference to the date of CUMAA's enactment;[40] therefore, the proposal removed the outdated provisions in the current rule that relate to the evidentiary documentation necessary to demonstrate a credit union's qualification for the exemption.

Finally, the proposal established 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 Call Report Form 5300. The proposed method was consistent with the current rule but, as noted above, the requirements for calculating the net member business loan balances were moved from the definitions section in current § 723.21 to proposed § 723.8 for greater ease of reference and improved readability.

Statutory Limit

A number of commenters asked for an increase to the aggregate MBL limit, arguing that the current limit is too restrictive and significantly impedes credit union business lending. One commenter recommended the rule be changed from ''the lesser'' to ''the greater'' of 1.75 times actual net worth or 1.75 times the minimum net worth required to be well capitalized. The Board cannot make these amendments under current law, because raising the statutory MBL limit would require a legislative change.

Most commenters were strongly supportive of presenting the statutory limit as a multiple of net worth rather than a percentage of assets. Commenters generally agreed the rule should be in closer conformity with the statute. Commenters also said the amendment was a useful clarification and not an increase in the cap nor a circumvention of congressional intent. One commenter noted the 12.25 percent shorthand reference is not required by the FCU Act and is an unnecessary provision.

Some commenters, however, were opposed to removing the 12.25 percentage of assets reference from the regulatory expression of the statutory cap. Opposing commenters contended such a change is contrary to the FCU Act and constitutes an improper attempt by NCUA to raise the cap without congressional approval. Those

[30] 12 U.S.C. 1757a(a).

[31] 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.

[32] If a member's primary residence.

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

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

[35] If the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is greater than $50,000.

[36] If the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is greater than $50,000.

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

[38] *See* 68 FR 56537, 56543 (Oct. 1, 2003).

[39] 12 CFR 723.16(b).

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

commenters alleged that if both the proposed MBL and risk-based capital (RBC) [41] rules are adopted as proposed, in effect the statutory cap will nearly double. They argued the proposal would thus render the cap meaningless.

The Board disagrees with these opposing comments. The proposal incorporated the statutory language essentially verbatim. As such, the removal of the 12.25 percentage of assets reference is not only fully consistent with the FCU Act, it is in fact more faithful to the statute. The 12.25 percent expression of the cap was established through regulation, not statutorily mandated. The Board maintains that the elimination of the unnecessary 12.25 percentage reference improves clarity and more accurately incorporates the statutory language contained in the FCU Act. Accordingly, the Board is finalizing § 723.8(a) as proposed.

Several commenters asked for clarification about how the RBC rule, as finalized, will impact the statutory MBL limit. As noted above, the language in the FCU Act establishes the aggregate MBL limit as the lesser of 1.75 times the actual net worth of the credit union or 1.75 times the amount to be well capitalized under prompt corrective action rules. The recently finalized RBC rule establishes the amount to be well capitalized under prompt corrective action to be greater of 7 percent of total assets (leverage ratio) or the amount required by the risk-based net worth requirement. The final RBC rule changes the risk-based requirement to be 10 percent of risk-weighted assets. Thus, where actual net worth is greater than the minimum to be well capitalized, the limit on MBLs is 1.75 times the greater of the following calculations:

1. Calculate the minimum amount of capital (in dollars) required by the leverage ratio, which is 7 percent times total assets.
2. Calculate the minimum amount of capital (in dollars) required by the risk-based capital ratio, which is 10 percent times total risk-weighted assets, and solve for the minimum amount of net worth needed after accounting for other forms of qualifying capital allowed under the final RBC rule.[42]

MBL Definition

Several commenters suggested changes to the MBL definition and its exceptions. The FCU Act defines the term ''member business loan'' and the exclusions from that term. The Board does not have authority to amend the MBL definition through regulation. The proposed rule incorporated the MBL definition and its exceptions as specifically mandated by statute, and the Board adopts these provisions, unchanged, in the final rule.

Non-Member Loan Participations

As noted above, under the current MBL rule, participation interests in member business loans and member business loans purchased from other lenders count against a credit union's aggregate limit on net member business loan balances. Non-member business loans and non-member participation interests [43] in business loans are currently excluded from the aggregate MBL limit, but credit unions are subject to a regulatory requirement to seek prior approval from NCUA for their non-member business 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.[44]

Commenters were divided on the proposal to eliminate the current rule's requirement to apply for prior approval from the NCUA Regional Director for a credit union's non-member commercial loans or participation interests in non-member commercial loans made by another lender 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. Some commenters argued that continuing the current approach of excluding loan participations from the statutory MBL limit could create an opportunity for abuse; cause bad loans to be syndicated broadly; result in unsafe concentrations in loan participations; or create a loophole to the MBL cap. Opposing commenters also objected to the elimination of regulatory oversight of the concentrations of these loans by way of the current application requirement for NCUA approval. One commenter said that eliminating the application requirement could encourage credit unions to have unhealthy concentrations that would be devastating during a down economic cycle.

On the other hand, numerous commenters supported the continued exclusion of non-member loan participations from the statutory limit, noting that loan participations are an important tool for credit unions to manage loan concentrations, liquidity, and overall risk.

Commenters indicated that the current approach to non-member loan participations fosters collaboration within the credit union industry and allows credit unions to better serve their members while managing their statutory cap and overall balance sheet. Commenters also noted that the current exclusion of non-member participation loans from the MBL cap provides credit unions an opportunity to add geographic and asset class diversification to their MBL portfolio; provides a healthy strategy for balance sheet management; and results in better credit quality. Several commenters argued that counting non-member participations against the statutory MBL limit would unnecessarily suppress the amount of a credit union's loanable capital, to the detriment of its members. Some commenters were also supportive of eliminating the requirement to apply for NCUA approval for non-member loan balances to exceed the regulatory cap. Several commenters noted that the current application requirement is not statutorily mandated, overly burdensome, and unnecessary.

The Board emphasizes that NCUA's current approach with respect to MBL loan participations has been unchanged since 2003. In its April 2003 proposed rule, the Board stated:

> The Federal Credit Union Act expressly requires a credit union to include only MBLs it makes to its members in calculating its statutory aggregate MBL limit. . . . . Participation interests purchased by a credit union from an originating eligible organization are not loans made by the participating credit union. The Board, therefore, proposes that these loans need not be included in calculating the participating credit union's aggregate loan limits.[45]

In its October 2003 final rule, the Board clarified that business purpose loans to members are included in the aggregate limit whether the loan is made by the credit union or purchased from another lender, but non-member loans and non-member participation interests are excluded from the aggregate limit. The Board also established a regulatory framework for credit unions to seek prior approval from NCUA for their

[41] A final RBC rule was issued by the Board on October 15, 2015. *See* 80 FR 66626 (Oct. 29, 2015).

[42] For those credit unions subject to the risk-based requirement; that is, those credit unions with assets greater than $100 million.

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

[44] 12 CFR 723.16.

[45] 68 FR 16450, 16451 (April 4, 2003).

non-member business 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. In support of its position with respect to non-member loans and participation interests, the Board noted:

> The statutory language establishing the aggregate limit provides that ''no insured credit union may *make* any *member* business loan that would result in the total amount of such loans outstanding'' in excess of the limit (citation omitted). The Board believes that this language lends itself to several possible interpretations. The narrowest interpretation would apply the limit only to loans *made* by a credit union to its *members* and not to loans and loan interests purchased from another lender. . . . In the proposed rule, the Board requested comment on [this] least constraining interpretation of the aggregate limit on MBLs. . . . The Board believes this proposal is consistent with the plain language of the Federal Credit Union Act establishing a limit on member business loans made by a FICU. The Board also believes the proposal is consistent with the congressional intent that credit unions not make business loans at the expense of the consumer loan needs of members and that the credit union system not take on undue risk as a result of over-concentration of MBLs (citation omitted). In the proposal . . . the Board noted that a credit union's member-elected board of directors would meet its own members' loan demands first and purchase loans made by other lenders only as a means of placing excess funds to maximize returns to their member shareholders.[46]

The Board further elaborated on its rationale for adopting the current approach, concluding as follows:

> [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. The Board continues to believe that these purchases will be made only as a productive method of placing excess funds after member loan demands are met, and that 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 the manner that best serves the credit union, its members, and the credit union system.[47]

After careful consideration of the public comments on this issue, the Board continues to subscribe to the views articulated in 2003 and has determined to adopt the proposed approach without change. The current approach of excluding non-member loans and participation interests from the statutory limit provides for an important balance sheet management tool and is essential for certain credit unions to meet member demand for business loans while adhering to the statutory cap. The Board continues to maintain that a plain reading of the FCU Act requires a credit union to include only loans it makes to its members in calculating its aggregate MBL limit. Participation interests purchased by credit unions from other originating lenders are not loans ''made'' by the participating credit union. Furthermore, purchases of non-member loans and participation interests do not involve the provision of member loan services, and the acquired interests are not ''member'' business loans. Thus, consistent with the current rule, non-member commercial loan participations are not included in calculating the participating credit union's aggregate MBL limit under the final rule.

As the Board noted in 2003, CUMAA's legislative history supports this interpretation as consistent with the congressional goal that credit unions fulfill their mission of meeting the credit and savings needs of their members. Selling MBL participations permits an originating credit union to obtain additional liquidity, enabling it to meet loan demand for both consumer and small business members. A credit union that purchases participation interests in business loans from other originating lenders does so as a means of investing its excess funds. Because they are member-owned and controlled, credit unions generally purchase participation interests only after member loan demands are met. In addition, participations diversify the risk of MBLs within the credit union system, ultimately making credit unions safer and better able to meet the needs of individual consumer and small business members. The Board notes that the portion of a participated business loan that is retained by the originating credit union is counted against its aggregate MBL limit. Also, participation interests in *member* business loans count against a credit union's aggregate limit on net member business loan balances.

Consistent with the proposal, the final rule removes the current requirement for credit unions to seek prior approval from NCUA for their non-member business 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. As discussed in the proposed rule, the current rule's application requirement was driven in part by safety and soundness concerns. Under this final rule, however, 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 final rule focuses 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. To preserve the existing safeguard against evasion, the final rule 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 statutory aggregate limit. Attempts to circumvent the statutory aggregate limit will not be tolerated and will be treated as a violation of this final rule. A credit union that demonstrates a pattern or practice of evading the MBL cap, as with any other regulatory violation, will be subject to commensurate supervisory action.

Finally, 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.

Exceptions and Exemptions

A number of commenters suggested the Board revisit its interpretation of the statutory exemptions from the aggregate MBL limit for those credit unions with a ''history of primarily making MBLs'' or ''chartered for the purpose of making MBLs'' to allow more credit unions to benefit from those exemptions. Several commenters also suggested that the ''chartered for the purpose'' exemption should allow existing credit unions operating near the statutory cap to apply for this charter or a similar charter designation. Other commenters stated generally that the Board should not liberalize or expand any of the statutory exemptions.

As noted in the proposed rule, NCUA continues to apply the ''history of primarily making'' exemption by reference to the date of CUMAA's enactment. Commenters did not express

[46] 68 FR 56537, 56543 (Oct. 1, 2003) (emphasis added).

[47] Id.

concerns about the removal of the outdated provisions in the current rule that relate to the evidentiary documentation necessary to demonstrate a credit union's qualification for the exception. Therefore, the provision is finalized as proposed.

In addition, the Board clarifies that the ''chartered for the purpose of making MBLs'' exemption is only applicable to new charters, and not to existing federal credit unions. State-chartered credit unions wishing to convert to a federal charter, or vice versa, may also qualify for the exemption.

Calculation for Net MBL Balance

Consistent with the current rule, the proposal provided 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 GAAP.

A number of commenters expressed concern that the rule implies a CPA or legal true sale opinion is required for every transaction. Commenters noted that true sales opinions are extremely cumbersome, expensive, and difficult to obtain. The Board clarifies that the current rule does not require a true sale opinion and the final rule does not alter this current approach.

§ 723.9—Transitional Provisions

Proposed § 723.9 was intended to implement the transition from the current prescriptive rule to the proposed principles-based rule for those credit unions currently operating under a waiver or an enforcement action.

Commenters did not raise any significant concerns about the proposed transition provisions, and the Board adopts them in this final rule without change. Accordingly, consistent with the proposal, the final rule provides that any waiver previously issued by NCUA concerning any aspect of the current rule becomes moot upon the effective date of the final 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 is reduced and in compliance with the requirements of § 723.4(c) of the final rule. Additionally, all blanket waivers granted to credit unions for current § 723.8 will terminate on the effective date of this final rule.

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, will survive the adoption of the final rule and remain intact. The 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 will survive the adoption of this final rule.

§ 723.10—State Regulation of Business Lending

The Board has long held 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.[48] 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. To date, 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.[49]

The proposed rule solicited public comment on three approaches to the issue of state regulation of business lending. The first approach, Option A, 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. However, no other SSA would be permitted to submit a rule for NCUA consideration and approval. The second approach, Option B, would be for NCUA to require SSAs currently operating with NCUA Board-approved MBL rules 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. The third approach, Option C, would permit SSAs that currently administer a state MBL rule to preserve their rules in their current format. Option C would also permit SSAs to submit their own state rules for NCUA consideration and approval, as long as certain conditions are met.

Most commenters that provided input on this aspect of the proposal favored Option C, or otherwise supported maximum flexibility for states to adopt or maintain state-specific MBL rules. Option B also garnered significant support.

Specific comments regarding the state regulation of business lending included the following: A number of commenters expressed general support for the dual chartering system. Commenters said states should be allowed to maintain and preserve their own unique rules, and SSAs should have ample flexibility to maintain existing state regulatory schemes. Commenters said NCUA should continue to respect the role of the states and adopt a final rule permitting state-specific rules. At least one commenter indicated SSAs should continue to be viewed as equal partners with NCUA, with the ability to continue their own regulatory efforts. Another commenter contended that state regulators are more familiar with the intricacies of each credit union within their state and should be permitted to adopt their own regulatory framework.

[48] 12 U.S.C. 1757a.

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

A few commenters observed that all credit unions benefit from the innovation that is possible under a dual regulatory scheme. Another commenter argued that state rules give NCUA unique testing environments and the current regime has allowed for many advances in member business lending and for improvements in NCUA's MBL rule. One commenter observed that any state-to-state variations in the regulation of business lending have not proven to be an issue under the current rule. Overall, most commenters recommended that the final rule incorporate provisions similar to current § 723.20 and current § 741.203, such that the existing regime allowing for state-specific MBL rules be retained.

As noted above, NCUA's longstanding position is that NCUA has the exclusive authority to administer the provisions of the FCU Act concerning member business loans, and all FISCUs are subject to part 723 unless the Board has specifically delegated authority to an SSA to administer a comparable state version of the rule.[50] FISCUs in states with an NCUA-approved state rule may comply with the state rule and need not comply with Part 723. The general premise for this current convention is that part 723 imposes certain restrictions and requirements which all FISCUs must follow, but a state may elect to impose comparable restrictions in its own rule, thereby retaining a measure of oversight over its institutions. Under the existing regime, an SSA with an approved rule may rescind its state rule without first having to obtain NCUA's approval,[51] but it must seek NCUA Board approval to adopt any variances from those rules the Board previously approved.[52] The Board has also employed an expedited review process for states whose rule had already been approved once and which were simply being updated to conform to NCUA's rule amendment. Thus, as an insurer, NCUA has been primarily concerned with reviewing and approving any state rule amendments to ensure any deviations in the state rule accomplish the overall objectives of NCUA's rule and, at a minimum, meet the requirements of NCUA's rule.

In a similar vein, the Board has determined in this final rule to delegate authority to SSAs to administer a state MBL regulation that is *at least as stringent* as NCUA's rule. Specifically, in the final rule, the Board is essentially adopting Option C, which was the approach recommended by most commenters who chose one of the three proposed options. Under new § 723.10 and amended § 741.203 of the final rule, the seven SSAs that currently administer a state-specific MBL rule may preserve their rules in their current format. Further, any SSA that wishes to adopt its own state-specific rule for federally insured credit unions chartered in that state may do so provided the state rule covers at least all of the provisions in part 723 and is no less restrictive, upon determination by NCUA.[53] Federally insured state-chartered credit unions in such states will not be subject to the provisions in Part 723.

Since the final rule shifts from a prescriptive to a principles-based approach, the Board views the requirements of this final rule as generally less stringent or less restrictive than its current MBL rule. So, it is appropriate to view the seven state-specific prescriptive rules as already meeting, or as *more* restrictive than, this principles-based final rule. The final rule therefore allows for the grandfathering of existing state rules approved by NCUA. SSAs with grandfathered state rules may continue to administer their NCUA-approved rules in their current format, and FISCUs in such states will continue to be exempt from Part 723. However, any amendment or modification to an existing NCUA-approved state rule must be consistent with this rule, but modification of one part of an existing NCUA-approved state rule will not cause other parts of that rule to lose their grandfathered status.

Amendments to the Loan Participation Rule

As discussed above, the proposed rule amended 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.[54]

NCUA's loan participation rule contains a similar definition for ''associated borrower,'' [55] which was amended by the Board in 2013 to track closely with the definition in the MBL rule.[56] In order to maintain that consistency, the proposed rule also made parallel amendments to § 701.22(a) to the loan participation rule.

NCUA did not receive any comments regarding the proposed changes to its loan participation rule. Therefore, the Board is adopting parallel amendments to § 701.22 to reflect this final rule's definitions of ''associated borrower,'' ''common enterprise,'' ''control,'' and ''direct benefit.''

III. Regulatory Procedures

A. Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires that, in connection with a rulemaking, an agency prepare and make available for public comment a regulatory flexibility analysis that describes the impact of a 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 $100 million) and publishes its certification and a short, explanatory statement in the **Federal Register** together with the rule.

As of September 2015, of the 4,588 federally insured credit unions with total assets less than $100 million, 976 credit unions hold business loans on their balance sheets, including both member and non-member loans. Among the 976 credit unions, 379 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 are exempt from § 723.3 (board of directors and management responsibilities) and § 723.4 (commercial loan policy) under the final rule—where the incremental paperwork burden associated with the transition for this rule stems from.

The remaining 597 credit unions with assets less than $100 million are subject to § 723.3 and § 723.4 under the 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 per loan for credit unions with less than $100 million in assets is only $96,894. Thus, it is likely many of the outstanding member business loans currently held by small credit unions, and subject to the current

[50] *See* 64 FR 28721, 28728 (May 27, 1999).

[51] 70 FR 75719, 75721 (Dec. 21, 2005).

[52] 68 FR 56537, 56546 (Oct. 1, 2003).

[53] All such state rules must be consistent with the MBL provisions in the FCU Act. That is, the definition of a member business loan, the exemptions from the definition of a member business loan, the aggregate loan limit, and the state's interpretation of the exceptions from the aggregate loan limit must adhere to the statute.

[54] 12 CFR 32.5.

[55] 12 CFR 701.22(a).

[56] 78 FR 37946 (June 25, 2013).

rule, are exempt under the final rule. Thus, NCUA anticipates fewer than 597 small credit unions will actually be subject to the final rule (except for § 723.8—the statutory limit provisions). The 597 credit unions only represent 13 percent of total credit unions with assets less than $100 million.[57] They hold approximately $1,788 million in business loans in aggregate, which represents 3 percent of the total business loans in the credit union industry.

	September 2015	
	Number of credit unions	Percent of total
Credit unions with total assets below $100 million	4,588	100
Credit unions with total assets below $100 million and with MBLs	976	21
Credit unions with total assets below $100 million, with MBLs, and are exempted from § 723.3 and § 723.4	379	8
Credit unions with total assets below $100 million, with MBLs, and are not exempted from § 723.3 and § 723.4	597	13

The amendments will 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 final 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 this final rule will not have a significant economic impact on a substantial number of small credit unions within the meaning of the RFA.[58]

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.[59] 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. The final rule requires credit unions to comply with certain requirements that constitute an information collection within the meaning of the PRA. Under the 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, the 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 336 and 225 MBL related waiver requests, in 2014 and 2015 respectively. The average number of hours for a credit union to prepare a waiver request is an estimated 17 hours. Accordingly, NCUA expects that the final rule will provide an estimated total of 4,777 hours of relief to credit unions, on an annual basis.

Eliminating the waiver requirement.

Total number of MBL related waivers requested by FICUs annually: 281.

Frequency of response: Annually.

Number of hours to prepare 1 waiver request: 17.

Total number of hours of relief: 17 hours × 281 = 4,777.

Under the final 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 of September 2015, there were a total of 1,532 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: 1,532.

Frequency of response: One-time.

Initial hour burden: 16.

16 hour × 1,532 = 24,512.

The final 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 139 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: 139.

Frequency of response: One-time.

Initial hour burden: 160.

139 hour × 160 = 22,240.

The total estimated one-time net paperwork burden for this proposal is 46,752 hours, with annual recurring paperwork burden reduction of 4,777 hours. In accordance with the requirements of the PRA, NCUA will submit a copy of the rule to the Office of Management and Budget for its review and approval.

C. Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. NCUA, an independent regulatory agency, as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order to adhere to fundamental federalism principles. The final rule also applies 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

[57] These credit unions hold $28.4 billion in total assets and $3.2 billion in total net worth, which account for 2.4 percent of total assets and 2.5 percent of total net worth in the credit union industry, respectively.

[58] 5 U.S.C. 601–612.

[59] 44 U.S.C. 3507(d); 5 CFR part 1320.

NCUA has in the safety and soundness of their operations. The final 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 final rule may supersede provisions of state law, regulation, or approvals. The final rule could lead to conflicts between the NCUA and state financial institution regulators on occasion. Accordingly, the proposed rule requested comment on ways to eliminate, or at least minimize, potential conflicts in this area. NCUA solicited specific comment on how best to approach the issue of state regulation of business lending, as well as 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. Based on the public comments received, the Board has made adjustments in the final rule to preserve existing state rights in the regulation of credit union business lending. For example, the final rule includes provisions to grandfather existing state-specific commercial and member business loan rules, and to allow state supervisory authorities to administer a state commercial and member business loan rule that is no less restrictive than the provisions in NCUA's rule.

D. Assessment of Federal Regulations and Policies on Families

NCUA has determined that this final rule will not affect family well-being within the meaning of Section 654 of the Treasury and General Government Appropriations Act of 1999.[60]

List of Subjects in 12 CFR Part 723

Credit, Credit unions, Reporting and recordkeeping requirements.

By the National Credit Union Administration Board on February 18, 2016.

Gerard S. Poliquin,

Secretary of the Board.

For the reasons discussed above, NCUA amends 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:

Authority: 12 U.S.C. 1752(5), 1757, 1765, 1766, 1781, 1782, 1787, 1789; Title V, Pub. L. 109–351, 120 Stat. 1966.

■ 2. Amend § 701.22 by revising the definition of ''associated borrower'' and adding definitions of ''common enterprise,'' ''control,'' and ''direct benefit'' to read as follows:

§ 701.22 Loan participations.

* * * * *

(a) * * *

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. Exceptions to this definition for partnerships, joint ventures and associations are as follows:

(1) If the borrower is a partnership, joint venture or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is a member or partner of the borrower, and neither a direct benefit nor a common enterprise exists, such other person is not an associated borrower.

(2) If the borrower is a member or partner of a partnership, joint venture, or association, and the other entity with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is the partnership, joint venture, or association and the borrower is a limited partner of that other entity, and by the terms of a partnership or membership agreement valid under applicable law, the borrower is not held generally liable for the debts or actions of that other entity, such other entity is not an associated borrower.

(3) If the borrower is a member or partner of a partnership, joint venture, or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is another member or partner of the partnership, joint venture, or association, and neither a direct benefit nor a common enterprise exists, such other person is not an associated 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.

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

■ 4. Effective May 13, 2016, § 723.7 is amended by adding paragraph (f) to read as follows:

§ 723.7 What are the collateral and security requirements?

* * * * *

(f) *Transitional provision:* A federally insured credit union that, between May 13, 2016 and January 1, 2017, makes a member business loan and does not require the full and unconditional personal guarantee from the principal(s) of the borrower who has a controlling interest in the borrower is not required to seek a waiver from the requirement for personal guarantee, but it must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk.

■ 5. Revise part 723 to read as follows:

PART 723—MEMBER BUSINESS LOANS; COMMERCIAL LENDING

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

§ 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.* (1) This part applies to federally insured natural person credit unions. However, a federally insured natural person credit union is not subject to § 723.3 and § 723.4 of this part if it meets all of the following conditions:

(i) The credit union's total assets are less than $250 million.

(ii) The credit union's aggregate amount of outstanding commercial loan balances and unfunded commitments, plus any outstanding commercial loan balances and unfunded commitments of participations sold, plus any outstanding commercial loan balances and unfunded commitments sold and serviced by the credit union total less than 15 percent of the credit union's net worth.

(iii) In a given calendar year the amount of originated and sold commercial loans the credit union does not continue to service total less than 15 percent of the credit union's net worth.

(2) This part does not apply to loans:

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

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

(iii) 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

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

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

(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. Exceptions to this definition for partnerships, joint ventures and associations are as follows:

(1) If the borrower is a partnership, joint venture or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is a member or partner of the borrower, and neither a direct benefit nor a common enterprise exists, such other person is not an associated borrower.

(2) If the borrower is a member or partner of a partnership, joint venture, or association, and the other entity with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is the partnership, joint venture, or association and the borrower is a limited partner of that other entity, and by the terms of a partnership or membership agreement valid under applicable law, the borrower is not held generally liable for the debts or actions of that other entity, such other entity is not an associated borrower.

(3) If the borrower is a member or partner of a partnership, joint venture, or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is another member or partner of the partnership, joint venture, or association, and neither a direct benefit nor a common enterprise exists, such other person is not an associated 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 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); loans fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions; loans secured by a vehicle manufactured for household use; and loans that would otherwise meet the definition of commercial loan and which, when the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union to a borrower or an associated borrower, are equal to less than $50,000.

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 current collateral value. The current collateral value 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 union's 15 percent general limit is fully secured at all times with a perfected security interest by readily marketable collateral as defined in § 723.2 of this part. Any insured or guaranteed portion of a commercial loan made 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, is excluded from this limit.

(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.

(1) *Transitional provision.* A federally insured credit union that, between May 13, 2016 and January 1, 2017, makes a member business loan and does not require the full and unconditional personal guarantee from the principal(s) of the borrower who has a controlling interest in the borrower is not required to seek a waiver from the requirement for personal guarantee, but it must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk.

(2) [Reserved].

§ 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 plus the cost of any improvements. 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 directly or indirectly involved in the credit union's commercial loan underwriting, servicing, and collection process, 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 a member'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 $50,000 or greater) 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 a 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 January 1, 2017, 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.* As of January 1, 2017, any waiver approved by NCUA concerning a federally insured credit union's commercial lending activity is rendered moot except for waivers granted for borrowing relationship limits. Borrowing relationships granted a waiver 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 January 1, 2017, all such limitations or other conditions remain in place until such time as they are modified by NCUA.

§ 723.10 State regulation of business lending.

(a) *State rules.* Federally insured state chartered credit unions in a given state are exempted from compliance with this part if the state supervisory authority administers a state commercial and member business loan rule for use by federally insured credit unions chartered in that state, provided the state rule at least covers all the provisions in this part and is no less restrictive, upon determination by NCUA.

(b) *Grandfathering of NCUA-approved state rules.* A state supervisory authority that administers a state commercial and member business loan rule previously approved by NCUA may continue to administer that rule in its current NCUA-approved format. Any modification of that rule must be consistent with this rule, but modification of one part of an existing NCUA-approved state rule will not cause other parts of that rule to lose their grandfathered status.

PART 741—REQUIREMENTS FOR INSURANCE

■ 6. 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—Regulations Codified Elsewhere in NCUA's Regulations as Applying to Federal Credit Unions That Also Apply to Federally Insured State-Chartered Credit Unions

■ 7. 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. Federally insured state chartered credit unions in a given state are exempt from these requirements if the state supervisory authority for that state adopts substantially equivalent regulations as determined by the NCUA Board or, in the case of the commercial lending and member business loan requirements, if the state supervisory authority administers a state commercial and member business loan rule for use by federally insured credit unions chartered in that state that at least covers all the provisions in part 723 of this chapter and is no less restrictive, upon determination by NCUA. In nonexempt states, all required NCUA reviews and approvals will be handled in coordination with the state credit union supervisory authority; and

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