

Final Rule Summary: Member Business Loans Rule



Coverage: Federally insured credit unions

Exemption: The final rule provides an exemption from sections 723.3 (board of directors and management responsibilities) and 723.4 (commercial loan policy requirements) for credit unions with less than \$250 million in assets that also (1) have total commercial loans less than 15% of net worth and (2) are not regularly originating and selling or participating out commercial loans.

Agency/Citation: NCUA/12 CFR Part 723

Effective Dates: January 1, 2017; personal guarantee requirement ends May 13, 2016

EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) approved a final member business loans (MBL) rule at the agency's February open Board meeting. The final rule is substantially similar to the 2015 proposed MBL rule.

One significant change is that the final MBL rule eliminates the personal guarantee requirement. The rule has an effective date of January 1, 2017, but the elimination of the personal guarantee requirement will become effective 60 days after publication in the Federal Register.

The final rule eliminates most of the current rule's prescriptive limitations, such as collateral and security requirements, equity requirements and loan limits, and uses with what NCUA calls a "broad principles-based regulatory approach" for safety and soundness. The principles of this approach are predicated on NCUA's expectation that credit unions will maintain prudent risk management processes and sufficient capital commensurate with the risk associated with their commercial lending practices.

The final rule reflects a meaningful shift in regulatory approach and NCUA oversight and supervisory expectations will shift accordingly. NCUA will issue supervisory guidance to examiners that will be shared with credit unions before the final rule takes effect in whole.

The final rule permits credit unions to tailor their member business lending programs to fit their strategic goals and their members' needs. Key changes in the final rule include:

- Giving credit union loan officers the ability, under certain circumstances, to not require a personal guarantee;
- Replacing explicit loan-to-value limits with the principle of appropriate collateral and eliminating the need for a waiver;
- Lifting limits on construction and development loans;
- Exempting credit unions with assets under \$250 million and small commercial loan portfolios from certain requirements; and
- Affirming that non-member loan participations do not count against the statutory member-business lending cap.

DETAILED ANALYSIS

Section 723.1- Purpose and Scope

Section 723.1 provides an exemption for small credit unions with less than \$250 million in assets that also satisfy both of the following conditions:

- The credit union's aggregate amount of outstanding commercial loan balances and unfunded commitments, plus any outstanding commercial loan balances and unfunded commitments sold and serviced by the credit union total less than 15% of the credit union's net worth, **and**
- 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% of the credit union's net worth

This section applies to all federally-insured, natural person credit unions that satisfy the above 2 requirements and does not apply to loans that are (1) made by a corporate credit union; (2) made by a federally insured credit union to another federally insured credit union; (3) made by a federally insured credit union to a CUSO; or (4) fully secured by a lien on a 1-to-4 family residential property that is a member's primary residence.

Section 723.2- Definitions

The final rule modified certain definitions in the current rule, included some new definitions and moved existing definitions to more relevant sections of the rule, as discussed below.

Modified definitions

Associated Borrower

- This term replaces "associated member" and updates the definition to improve clarity and incorporate elements of the combination rules applicable to banks. An

“associated borrower” is “any other person or entity with shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower.”

- There are 3 exceptions that apply to loans involving partnerships, joint ventures, and associations:
 - (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 common enterprise exists, then such other person is not an associated borrower;
 - (2) 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 the partnership, joint venture, or association and the borrower is a limited partner of that other entity, and by the terms of that valid partnership, the borrower is not held generally liable for the debts or actions of that other entity, then such entity is not an associated borrower;
 - (3) 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 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.

Loan to Value Ratio

- The definition was revised to clarify how the LTV ratio should be calculated. The rule clarified that the denominator of the 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. Additionally, the numerator must include all outstanding loan balances plus any unfunded commitments secured by the collateral, including those from other lenders that are senior to the credit union’s lien position.

Net Worth

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

New Definitions

Commercial Loan

- The rule adds a new definition 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 in the FCU Act.
- A “commercial loan” is defined as any credit a credit union extends to a borrower for commercial, industrial, agricultural, and professional purposes, but not for personal expenditure purposes.
- The following types of loans are excluded from the rule and therefore are not considered “commercial loans:”
 - 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 CUSO
 - Loans secured by a 1-to-4 family residential property (regardless of whether it’s the borrower’s primary residence
 - Loans fully secured by shares in the credit union making the extension of credit or deposits in other institutions
 - Loans secured by a vehicle manufactured for household use
 - 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 shared in the credit union to a borrower or an associated borrower, are equal to or less than \$50,000

Common Enterprise

- A definition for this term was added to identify related parties that have direct influence on the overall risk through connected operations and management, while eliminating other borrower relationships where there is only passive investment and involvement.
- Under the new definition, loans should be aggregated for a “common enterprise” when one of the following conditions occurs:
 - (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 may be fully repaid;
 - (2) loans or extensions of credit are made to borrowers who are related directly or indirectly through common control and there is substantial financial interdependence (meaning 50% or more of one borrower’s annual gross receipts or expenditures are derived from transactions with another borrower) between or among borrowers; or
 - (3) separate borrowers obtain loans or extensions of credit to acquire a business enterprise which those borrowers will own more than 50% of the voting securities or voting interests

Control

- Under the new rule, “control” exists when a person or entity directly or indirectly:
 - (1) owns, controls, or has the power to vote 25% or more of any class of voting securities of another person or entity;
 - (2) controls the election of a majority of the directors, trustees, or other persons exercising similar function; or
 - (3) has the power to exercise a controlling influence over the management or policies of another person or entity

Credit Risk Rating System

- “Credit risk rating system” is defined as a formal process to identify and measure risk through the assignment of risk ratings, or credit risk grades, as a standard means for establishing the level of risk associated with a commercial loan and the overall commercial loan portfolio.
- 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 environment factors.
- Non-numerical risk ratings are also acceptable under the rule.

Direct Benefit

- “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 (not limited to real property), goods, or services.

Loan Secured by a 1-to-4 Family Residential Property

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

Loan Secured by a Vehicle Manufactured for Household Use

- Loans secured wholly or substantively by a vehicle manufactured for household use for which the lien is central to the extension of credit are generally not commercial loans for the purposes of the rule.
- “Vehicle manufactured for household use” includes new and used passenger cars, mini-vans, 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 passenger.
- Any vehicle loan that exceeds \$50,000 and is secured by a vehicle used to transport fare-paying customers (e.g., commercial-ride share vehicle like Uber or Lyft) will be considered a commercial loan under the final rule.

Readily Marketable Collateral

- “Readily marketable collateral” is 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.
- Lenders should be clear on what is meant by “readily marketable” and readily marketable collateral should be appropriately discounted by the lender consistent with the lender’s usual practices for making loans secured by such collateral.

Residential Property

- The rule defines “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 clarify that loans secured by a 1-to-4 family residential property are excluded from the definition of commercial loan.
- Recreational-type property such as trailers, campers, and manufactured homes are not residential property for purposes of the rule.

Section 723.3- Board of Directors and Management Responsibilities

Board Responsibility

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

- Approve a written commercial loan policy that complies with Section 723.4
- Review its policy on an annual basis, or prior to any material change in the FICU’s commercial lending program or related organizational structure, or if there is a material change in portfolio performance or economic conditions
- Ensure the FICU appropriately staffs its commercial lending program
- Must understand and remain informed about the nature and level of risk associated with the FICU’s commercial loan portfolio, including potential impact on earnings and net worth

Experience Requirements

The rule eliminates the 2 year experience requirement, but still requires that a credit union have the following experience:

- Senior executive officers—at minimum, a FICU must employ qualified senior executive officers with a comprehensive understanding of the role of commercial lending in the overall business model and establish risk management processes and controls necessary to safely conduct commercial lending.

- Qualified lending personnel—a FICU must employ staff with experience in the following areas:
 - Underwriting and processing for the type(s) of commercial lending in which the credit union is engaged;
 - Overseeing and evaluating the performance of a commercial loan portfolio, including rating and quantifying risk through a credit risk rating system;
 - Conducting collection and loss mitigation activities for the type(s) of commercial lending in which the credit union is engaged.
- Credit unions can satisfy the experience requirements by:
 - Training and developing existing staff;
 - Hiring experienced staff; or
 - Using a third-party such as a CUSO
- With respect to the qualified lending personnel requirement, a third party may only be used if the following conditions are met:
 - The third party has no affiliation with the borrower or any associated borrowers;
 - The decision to grant a loan must reside with the credit union;
 - Qualified credit union staff exercises ongoing oversight over the third party by regularly evaluating any work the third party performs; and
 - The third party arrangement otherwise complies with Section 723.7

Section 723.4- Commercial Loan Policy

The commercial loan policy requirement in the final rule is comparable to the current MBL policy requirements and sets out minimum expectations for risk assessment of the commercial borrower and for active risk management of the commercial loan portfolio.

The policy must provide for ongoing control, measurement, and management of the credit union's commercial lending activities and at a minimum must address each of the following:

- Types of commercial loans permitted
- Trade area
- Maximum amount of assets, in relation to net worth, allowed in secured, unsecured, and unguaranteed commercial loans, and in any given category, to any one borrower or group of associated borrowers
- Qualifications and experience requirements for lending staff
- Loan approval processes, including establishing levels of loan approval authority commensurate with proficiency in evaluating loan risk
- Comprehensive underwriting standards commensurate with the size, scope and complexity of the commercial lending activity and the borrowing relationships contemplated. The rule outlines six requirements that should form the basis of a credit union's underwriting standards.

- Risk management processes commensurate with the size, scope and complexity of the credit union's lending activities and borrowing relationships, including use of loan covenants when appropriate, periodic loan review, credit risk rating system, and a process to identify, report, and monitor loans approved as exceptions to policy.

Section 723.5- Collateral and Security

All of the prescriptive limits in current rule related to collateral have been eliminated in favor of the fundamental principle that commercial loans must be appropriately collateralized. Under the new rule, a credit union must require the borrower to provide collateral that is commensurate with the level of risk associated with the size and type of the commercial loan. Additionally, a 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.

There is also a transitional provision that provides for federally insured credit unions that make member business loans between May 13, 2016 and January 1, 2017 and do not require the full and unconditional personal guarantee from the principal(s) of the borrower as stated above. In such cases, the credit union is not required to seek a waiver from the personal guarantee requirement but it must determine and document in the loan file the mitigating factors that sufficiently offset the relevant risk.

Section 723.6- Construction and Development Loans

The final rule imposes specific requirements for construction and development loans and distinguishes between income-producing property and projects built for commercial purpose. Since construction and development loans present a higher level of risk, the rule requires a credit union that elects to make such loans to ensure that its commercial loan policy includes adequate provisions for determining the collateral value associated with the project. The "collateral value" is the lesser of the project's cost to complete or its prospective market value.

To further safeguard against the risk of commercial and development loans, the rule states that a credit union making these types of loans must also ensure that its commercial loan policy has each of the following:

- qualified personnel reviewing and approving any line item construction budget prior to the loan closing;
- an established credit union-approved requisition and loan disbursement process;
- disbursement of loan funds only after properly documented on-site inspections; and
- loan disbursements that are subject to confirmation that no intervening liens have been filed

Section 723.7- Prohibited Activities

This section of the rule prohibits federally insured credit unions from granting commercial loans to certain parties or when certain conflicts of interest exist. Under the rule, a credit union cannot extend a member business loan to (1) any senior management employee involved in the credit union's commercial loan underwriting, servicing, or collection or to the family members of such persons, (2) any associated borrower, or (3) any compensated director unless the Board of Directors approves granting the loan and the compensated director was recused from the decision-making process.

A credit union may not grant a commercial loan if any of the additional income received by the 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.

The final rule prohibits third party conflicts of interest and adds a provision to clarify what it means to be "independent from the transaction" by stating 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 contingent on the closing of the loan.

Section 723.8- Aggregate Member Business Loan Limit; Exclusions and Exceptions

This section sets out the statutory aggregate limits mandated by Section 107A of the FCU Act. The current rule does now allow most credit unions 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. The new rule has revised this requirement by setting the member business loan limit as 1.75 times the applicable net worth requirement for a credit union to be categorized as well-capitalized under section 1790d(c)(1)(A) of the FCU Act and eliminating the 12.25 percent calculation. As a result, this could lead to a modest increase in the MBL cap for some credit unions.

The definitions of member business loans and commercial loans are also clarified in the rule. The definition of a member business loan is the same as the definition provided in section 723.2 of this part, except the following types of commercial loans are not member business loans and are not counted toward the aggregate MBL limit:

- Any loan in which a federal or state agency fully insures or guarantees repayment, or provides an advance commitment to purchase the loan in full; and
- Any non-member commercial loan or participation interest in a commercial loan made by another lender, as long as the credit union acquired the non-member loans and participation interests in accordance with law and is not trading MBLs to circumvent the aggregate limit.

An exception exists for loans secured by a 1-to-4 family residential property and loans secured by a vehicle manufactured for household use. These types of loans are not commercial loans but are considered member business loans and must be counted towards the aggregate MBL limit.

The rule also provides for statutory exemptions from the MBL limit. Credit unions that have a low-income designation or that participate in the Community Development Financial Institutions program are exempt from the aggregate MBL limit, as are credit unions chartered for the purpose of making commercial loans.

Section 723.9- Transitional Provisions

This section governs circumstances in which after January 1, 2017, a credit union is operating in accordance with a NCUA approved waiver or is subject to any enforcement constraint relative to its commercial lending activities. Any waiver previously issued by NCUA concerning any aspect of the current rule is rendered moot upon the effective date of the final rule, except (1) waivers that were granted for a single borrower or borrowing relationship to exceed the limits set for in section 723.8, or (2) for FICU's in states that have grandfathered rules where NCUA is required to concur with a waiver to the state's rule. However, any previous enforcement constraints imposed on a FICU by NCUA, such as Documents of Resolution, Letters of Understanding and Agreement, and Preliminary Warnings Letters, are unaffected by the new rule.

Section 723.10- State Regulation of Member Business Lending

This section allows federally insured state chartered credit unions to be exempt from part 723 if the state supervisory authority administers a state commercial and MBL that covers all of the provisions of this rule and is no less restrictive, upon determination by NCUA. The final rule also grandfathers the seven states (Connecticut, Illinois, Maryland, Oregon, Texas, Washington, and Wisconsin) that have state rules that NCUA has previously approved.

Section 701.22- Amendments to the Loan Participation Rule

The final rule amends the definition of "associated member" in the current rule to be more consistent with the combination rules applicable to banks by introducing the concepts of direct benefit, common enterprise, and control. NCUA's loan participation rule contains a similar definition of "associated borrower" to track closely with the definition in the MBL rule. In order to maintain consistency, the final rule has adopted parallel amendments in section 701.22 to reflect the final rule's definitions of "associated borrower," "common enterprise," "control," and "direct benefit."