SUPPORTING STATEMENT
National Credit Union Administration

Member Business Loans; Commercial Lending, 12 CFR Part 723
OMB No. 3133-0101

A. JUSTIFICATION

1. Necessity of Information Collection

As part of NCUA's Regulatory Modernization Initiative, the NCUA Board (Board) publishes a final rule to amend its member business loan (MBL) rule (Part 723) 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. This amendment to OMB Control Number 3133-0101, Member Business Loans, addresses all of the information collection requirements contained in Part 723.

To modernize the MBL rule and provide reasonable regulatory relief to federally insured credit unions (FICUs), the NCUA Board is altering its overall approach to regulating commercial lending, by shifting from a prescriptive rule to a principles-based rule. Specifically, the final rule eliminates detailed collateral criteria and portfolio limits and instead focuses on broad yet well-defined principles that clarify regulatory expectations for FICUs engaged in commercial lending activities. The approach will eliminate some unintended consequences of the prescriptive approach, such as causing credit unions to manage their lending practices to regulatory restrictions instead of focusing on sound risk management practices. The uniform regulatory prescriptions also inhibit credit unions from considering all relevant risk-mitigating factors in certain borrowing relationships. Under this approach, NCUA supervision will focus on the effectiveness of the credit union's risk management process, which will allow credit unions greater autonomy and flexibility to soundly administer, underwrite, and service commercial loans in a manner that is consistent with regulatory objectives and accepted risk management practices.

The final rule exempts from the requirements of §723.3 (Board of directors and management responsibilities) and §723.4 (Commercial loan policy) credit unions that meet all of the following conditions (qualifying credit unions):

(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. **Purpose and Use of the Information Collection**

Under the final rule, credit unions that are engaged in commercial lending and not exempted from §723.3 and §723.4 may need to revise their commercial loan policies to address various aspects of the commercial lending activity. The commercial loan policy should include identification of the types of business loans the credit union will make, qualifications and experience of personnel, portfolio concentration limits, underwriting standard, loan approval, and other risk management processes. Requiring federally-insured credit unions to maintain commercial loan policies and procedures protects the safety and soundness of credit unions and the National Credit Union Share Insurance Fund (NCUSIF).

The final rule also requires these credit unions to implement a formal credit risk rating system to identify and quantify the level of risk within their commercial loan portfolio. A credit risk rating system is a standard industry practice utilized by commercial lenders, a longstanding NCUA supervisory expectation, and required by other regulators to monitor and quantify risk. As part of the examination process, the review of risk rating process helps prevent losses to credit unions and the NCUSIF.

3. **Consideration Given to Information Technology**

The collection of information does not involve the use of automated, electronic, mechanical or other technological collection techniques.

4. **Duplication**

The information collection is unique to each credit union and is not duplicated in other collection requirements.

5. **Effect on Small Entities**

The final rule alleviates qualifying credit unions which are only occasionally granting a commercial loan(s) from the requirements of §723.3 and §723.4. Small credit unions that do not qualify for the exemption may need to modify their commercial loan policies and enhance their processes to satisfy the new requirements. It is essential for these small credit unions that regularly conduct commercial lending activities to develop and maintain appropriate loan policy/processes to ensure the safety and soundness of the institutions.

6. **Consequences of Not Conducting Collection**

Commercial lending is complex and involves different risks than consumer lending. Credit unions that are lack of appropriate commercial risk management policies and processes may lead to their failures and in some cases, losses to the National Credit Union Share Insurance Fund.

7. **Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)**

There are no special circumstances. This collection is consistent with the guidelines in 5 CFR 1320.5(d)(2).

8. Consultations Outside the Agency

The final rule was publish March 14, 2016, at 81 FR 13530. NCUA received nearly 3,100 comments on the proposed rule. 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.

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.

A significant number of commenters, while generally supportive of the overall rule, also provided substantive input on the specific provisions of the proposed rule. Bank commenters generally expressed opposition to the proposal, in overall concept and principle.

The final rule addresses these public comments and provides the NCUA response in the preamble of the rule. While all the comments received by NCUA were in response to the proposed rule (July 1, 2015, at 80 FR 37898), there was some discussion of PRA issues in the preamble that have been set-out as an attachment for the purpose of this submission. All comments received in response to the proposed rule are posted on NCUA's public website and are available at https://www.ncua.gov/regulation-supervision/Pages/rules/comment-letters/2015/member-business-loans.aspx.

9. Payment or Gift

There is no intent by NCUA to provide payment or gifts for information collected.

10. Confidentiality

Credit union examination reports and any documents related thereto are exempt from the Freedom of Information Act disclosure, pursuant to exemption 8, 5 U.S.C. 552(b)(8).

11. Sensitive Questions

No questions of a sensitive nature are asked. The information collection does not collect any Personally Identifiable Information (PII).

12. Burden of Information Collection

a. **Revising commercial loan policies and procedures.**
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, an estimate of 1,532 FICUs need to revise their policies. For purposes of this analysis, NCUA estimates that it will

take roughly 16 hours for a credit union to meet this requirement. Using these estimates, information collection obligations imposed by this aspect of the rule are analyzed below:

FICUs that are engaged in business lending: 1,532
Frequency of response: .... once
Initial hour burden per response: ....16 hours

16 hours x 1,532 = 24,512

b. **Developing formal risk rating system.**

The final rule also requires credit unions that are engaged in business lending activities and not exempted from §723.3 and §723.4 to develop 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 FICUs 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: .... once
Initial hour burden per response: ....160 hours

160 hours x 139= 22,240

c. Eliminating the waiver requirement – burden relief

The final rule replaces the prescriptive requirements in the current rule with a broad principles-based regulatory approach, the final rule also relieves credit unions from the current requirement to obtain MBL related waivers. Currently, NCUA receives a significant number of MBL-related waiver requests each year. NCUA processed 336 and 225 (an average of 281 per year) 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 relief to credit unions, on an annual basis.

Average MBL related waivers requested by FICUs annually: 281
Frequency of response: ....Annually
Number of hours to prepare 1 waiver request:...(17) hours
Average number of hours (17) hours x 281 = (4,777)

Information Collection Activity	No. Respondent	No. Responses Per Respondent	No. of Responses	Hours Per Response	Total Burden Hours	Cost to Respondent (based on $33.00 hourly wage)
Revising commercial loan policies and procedures	1,532	1	1,532	16	24,512	$808,896
Developing a risk rating system	139	1	139	160	22,240	$733,920
Eliminating Waiver	281	1	(281)	(17)	(4,777)	(157,641)
Totals	1,671		1,671		46,752	1,542,816

13. Capital/Start-up and On-going Operation and Maintenance Cost

NCUA estimates that credit unions will incur a one-time cost of $1,442,232.

14. Costs to Federal Government

There would be a one-time opportunity cost of approximately $1,112,480 for additional training associated with this rule.

15. Changes in Burden

Adjustments are attributed to the removal of the burden hours associated with usual and customary business practices.

Program change are attributed credit unions that are engaged in business lending activities and not exempted from §723.3 and §723.4 that may need to revise their loan policies and procedures. The proposed rule also relieves credit unions from the current requirement to obtain MBL related waivers and prior approval from NCUA 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.

Total burden requested is 46,752 hours.

16. Information Collection Planned for Statistical Purposes

The information collection is not used for statistical purposes.

17. Approval to Omit OMB Expiration Date

The OMB control number and expiration date associated with this PRA submission will be displayed on the Federal government's electronic PRA docket at www.reginfo.gov.

18. Exceptions to Certification for Paperwork Reduction Act Submissions

This collection complies with the requirements in 5 CFR 1320.9.

B. Collection of Information Employing Statistical Methods.

This collection does not employ statistical methods.

The final rule provides 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.

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 became effective 60 days after publication in the *Federal Register*. Implementation of the remaining provisions of this final rule were effective 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 standalone 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.

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, 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.

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 § 723.3and § 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 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 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.

Commercial Loan

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.

§ 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.

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 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 Requirement

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 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. 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 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.

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.

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.

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*.. 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.

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 nonmember 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.

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 nonmember 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.*

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 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.*

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.*

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, nonmember 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 nonmember 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.

§ 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.