August 19, 2008

Via e-mail regcomments@ncua.gov

Ms. Mary Rupp
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Dear Ms. Rupp:

North Island Credit Union is pleased to comment on NCUA's Notice of Proposed Rulemaking for 12 CFR Part 723 regarding potential changes to the Member Business Loan regulations. We would like to thank the Board for considering changing the current regulations, which we believe are both restrictive and occasionally confusing.

North Island has been active in offering Member Business Loans since 1997. We have gradually expanded our program to include a full range of deposit and service products, which we have made available to our Business Members since 2002. One indication of the viability of our Member Business Services Program is that CUNA's Lending Council recognized us last year with the Inaugural Award for *Excellence in Small Business Lending*. We were told that we received the award, in large part, due to: 1) the breadth of our product offerings, 2) our willingness to share our processes and procedures with other credit unions, and 3) our conservative underwriting practices that derive from the business lending experience level of our staff. (Our 9 loan officers/credit administrators have 302 years of business banking experience.)

We make these points to demonstrate that our comments will be directed primarily towards those changes in the Regulation that would enhance our ability to benefit our members, many of whom came to the credit union after a waive of bank mergers in the mid to late 1990's that had the effect of replacing their trusted community bank loan officer/advisors with the 1-800 number of a much larger bank. North Island entered this line of business as it saw an opportunity to deliver the customary credit union level of service to these dispossessed and often ignored small business owners. This is what we continue to do today and why we believe the changes recommended below are important.

We have arranged our comments in the order of importance to North Island's ability to continue to compete in our primary market.

Increasing the Maximum Loan to Value on Construction and Development Loans. NCUA is requesting comment on changing the maximum loan to value on C&D loans. North Island concurs with NCUA that C&D lending represents one of the highest risk types of MBLs, and that credit unions entering this line of business should possess the required experience to do so. As covered below, we believe that the needed experience level for this particular line of business should be well in excess of the two year requirement contained in the regulation. The primary issue with the current regulation is that it is confusing, primarily because Part 723.3 approaches the question of valuing a construction project strictly as a function of the member's equity injection as a percentage of the total cost of the project, without clearly defining what costs can be considered in this calculation. Accordingly for years, credit unions have had to scour through the somewhat arcane definitions in Part 723 and a decade's worth of old legal opinion letters trying to pick out what can be included and what has to be excluded when calculating the member's required equity injection and the appropriate Loan to Value ratio for construction and development loans. For example, the NCUA's Opinion Letter dated June 7, 2001 (#01-0422), effectively defines Construction/Development Loan to Value as **Loan to Cost**, since the 25% equity injection is measured against the costs (not the value) of the project, which include only: "the appraised value of land owned by the borrower on which the project is to be built, less any

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liens, plus the cost to build the project." What is unclear in this definition is where the entrepreneurial profit and the builder's overhead costs and other non-construction materials related expenses are included in the "cost to build" equation. In an appraiser's valuation, these figures are always spelled out and considered in determining the "As Completed" value of the property. Part 723.3 and the Opinion Letter make no allowance for the appraiser's conclusion. This is unfortunate in that it is a one sided approach that could conceivably increase the risk inherent in the loan transaction. Please allow us to provide a "what if scenario" to illustrate.

If a credit union were to rely solely on the member's equity injection, the following circumstances could apply:

- Using the above definition, it appears to leave open the possibility that a credit union could require their member to provide a cash + equity injection of 25% of the total Project Costs and then finance the remaining 75% of those Costs—regardless of the potential market value of the property to an "arms length" buyer.
- Experience gained in other areas of the financial community has shown us that there are occasional construction projects in which the owners are over improving the property by adding exceedingly expensive tenant improvements or exterior decoration/design features to suit their own tastes or business needs. These are often features that have no value to a future buyer. An appraiser will normally discount the cost of these over-improvements in his or her analysis—instead providing only the value of the property to a prospective buyer.
- So, by adhering to the NCUA's definitions, instead of to the appraised "as completed" value, a credit union could be financing over 75% of the true market value of the property and exposing itself to loss.

The other issue with the existing definitions of equity requirements and the resulting LTVs is that they make all Credit Unions uncompetitive with the other institutional lenders in their marketplace and often unable to grant these loans that benefit their community and members. Many local construction lenders will finance at a minimum 80% of costs, not to exceed 75% of "as completed" value on most commercial projects.

Irrespective of the current situation in which certain credit unions have made unsound lending decisions by paying scant attention to the requirements of the existing Construction/Development Regulations and by lending outside their market area, we believe that most experienced and well capitalized Member Business Lending Credit Unions are capable of properly handling a lower Equity Injection Requirement on their Construction/Development loans. Accordingly, we therefore recommend that the NCUA fashion a more equitable regulation that balances both the minimum Equity Injection Requirement (based on Loan to Cost) and a second requirement for a possible additional Equity Injection (based on the Loan to "As Completed" Value) in evaluating construction lending risk—one that uses the best of both methodologies. So we are suggesting:

- Reduction of the minimum requirement for the Construction/Development Equity Injection to 20%, plus as an additional safeguard:
- Modification of the Regulation to require members to provide an additional equity injection (in excess of the minimum 20%) when it is necessary to reach a Loan to Value, based on the appraiser's "As Completed" value, of no more than 75%.

A final point on this topic: the confusion inherent in the current regulation has twice caused our State Regulator to decline our Waiver Requests because they have been unclear if our requested waiver, as presented above, would conform to how the NCUA desired to monitor and control the construction lending process. In fact, they suggested that it could be easier to change the Regulation to make the definitions and protections clearer than to try to base a waiver on the incomplete information contained in the current Part 723.3 and the body of Opinion Letters.

Applying For Waivers. NCUA is asking whether MBL waivers are understood and pursued by credit unions. We believe that the list of waivers is clearly spelled out and theoretically easily available to credit unions. However, State Chartered Credit Unions often face obstacles in obtaining these waivers because, as mentioned above, their primary regulator has difficulty in interpreting the NCUA's intent when it comes to this specialized area of lending and because there is typically no time limit, similar to the NCUA's, on how long the State Regulator has to respond to the waiver request. The result is often a backlog—with state chartered credit unions waiting many months for a response. In order to expedite this process, we would recommend that the NCUA institute standards, based on Member Business Lending Experience and

Examination Results for those credit unions that wish to take advantage of the available waivers. This would serve a two fold purpose of addressing the safety and soundness issue of providing too much leeway to credit unions without the requisite experience (see next topic) and providing the State Regulators with guidance that would allow them to expedite Waiver Requests based on how the applying credit union matched up with these requirements. A preferable solution, if possible, would be to make the waiver approval timetable and expedited waiver handling standards a Regulatory Requirement—by expressly including them in Part 723.

Two Year Experience Requirement. NCUA is also requesting comment on whether the two year experience requirement is adequate for proper due diligence and underwriting on MBLs. In presentations to other credit unions interested in Member Business Lending, we often use the following overstatement: "If you allow someone with two years experience to run your MBL program, you are turning over the keys to the credit union to the first crook in the door." While two years is enough to warrant certain underwriting authority on very basic MBL transactions, we would recommend that the experience requirement for the person actually running a credit union's In-House MBL Program be set at ten years. Relevant experience should include: lending department management, business loan underwriting, and client relationship management. This ten year prerequisite would still allow credit unions to outsource their MBL underwriting to CUSOs or other consultants that have this level of experience—as long as the client credit union continues to have senior managers, knowledgeable in other areas of lending and finance, review the recommendations of the due diligence provider.

Prepayment Penalties. This is not included in NCUA's Request for Comments but we, along with many of our loan participants, believe it warrants the highest consideration by NCUA for regulatory revision.

Federally chartered credit unions are prohibited by regulation from having a prepayment penalty on any type of loan. While North Island understands the rationale for prepayment penalties to exist in consumer lending, business lending is much more labor intensive than consumer lending. There needs to be a way to recoup the costs of acquiring, underwriting, and processing a loan if the member pays it off within months or even a year or two of origination. Additionally, this regulation imposes a real restriction on the Loan Participation Process. As a State Chartered Credit Union, North Island can charge a prepayment penalty. However, if we participate a portion of such a loan to a Federally Chartered Credit Union, we disclose to our member/borrower that we will not be collecting that credit union's portion of any prepayment penalty that would be charged at a later date. In turn, this reduces the borrower's disincentive against paying the loan off early. For these reasons we respectfully suggest that the NCUA, as part of this regulatory review process, allow loans defined as Member Business Loans under Regulation 723 to be exempt from the prepayment penalty prohibition.

If you have any questions regarding our recommendation or need additional information, please do not hesitate to contact me at the phone number or e-mail address shown below.

Sincerely,

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