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August 13, 2008

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

Re: National Credit Union Administration; 12 CFR Part 723 Member Business Loans; 73 Federal Register 35977, June 25, 2008

Dear Ms. Rupp:

The American Bankers Association (ABA) is responding to the advanced notice of proposed rule (ANPR) published by the National Credit Union Administration (NCUA) concerning possible amendments to its Member Business Loan (MBL) regulations. ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $12.7 trillion in assets and employ over 2 million men and women.

The recent failures of Norlarco Credit Union and Huron River Area Credit Union highlight the inherent risk associated with business lending by credit unions. Congress in 1998 established statutory limits on credit union business lending to ensure credit unions remain focused on their mission of serving individuals and families, especially people of modest means, and to ensure the safety and soundness of the credit union system by limiting its risks. The lowering of equity requirements for construction and land development loans and fleet financing; the expansion of involvement by credit union service organizations (CUSO) in business lending; and greater use of waivers, especially with regard to loan participations, would only increase risks in areas that neither the credit unions nor the NCUA have been constituted to manage effectively.

Moreover, the very proposing of this rule, fraught as it is with significant safety and soundness problems, raises serious doubts about the ability of the NCUA to manage successfully its conflicting roles of being a charterer of financial institutions and the insurer of the deposits of those same institutions. The concerns of an insurer would tend to make a regulator averse to the expansion of financial risks that this proposal presents.

Background

NCUA adopted its first MBL rule in April 1987. In proposing its initial MBL rule in 1986, the NCUA Board (Board) cited that during the prior two years about half of the losses sustained by the National Credit Union Share Insurance Fund (NCUSIF) were directly or indirectly attributed to business lending.[1]

In 1991, NCUA further amended its member business loan rule due to persistent losses to the National Credit Union Share Insurance Fund from business lending. After reviewing the five largest failures in each NCUA region during fiscal year 1990, NCUA found that commercial lending was a factor in 16 of the 30 failures.

Recognizing that business lending by credit unions was inherently riskier, Congress in 1998 placed statutory limits on the aggregate amount of business lending by credit unions to ensure the safety and soundness of credit unions and of the Share Insurance Fund.

However, since the beginning of October 2003, NCUA has substantively amended its member business rule three times making it easier in each instance for credit unions to participate in business lending.

Now, the Board is considering whether to amend its MBL rule again, to clarify or revise current provisions including those related to: loan-to-value (LTV) ratio requirements; collateral and security requirements; credit union service organization involvement in the MBL process; MBL loan participation; and waivers.

ABA's Position

In 1998, Congress made it perfectly clear that credit unions should be focused on consumer lending, not commercial lending. **The clear intent of Congress in enacting Section 203 of the Credit Union Membership Access Act was to establish limitations on the member business loan activities of federally insured credit unions, based upon the belief that (1) credit unions should maintain their focus on consumer lending – especially to persons of modest means; and (2) continued credit union safety and soundness required restrictions in this area.**

The report of the Senate Committee on Banking, Housing & Urban Affairs clearly supports the position that this aggregate limit should be viewed as a limitation on credit union business lending:

> In new section 107(a), the Committee imposed substantial new restrictions on business lending by insured credit unions. Those restrictions are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through an

[1] 51 Federal Register 23234.

> emphasis on consumer rather than business loans. The Committee action will prevent significant amounts of credit union resources from being allocated in the future to large commercial loans that may present additional safety and soundness concerns for credit unions and that potentially increase the risk of taxpayer losses through the National Credit Union Share Insurance Fund….[2]

Additionally, Senator Phil Gramm (R-TX), in his floor statement on July 24, 1998, during the Senate debate on CUMAA, said:

> …the bill, for the first time, begins to put appropriate limits on the amount of business loans that credit unions can make. There are those who believe, and I happen to be one of them, that credit unions were chartered to provide consumer credit to their members as part of a cooperative effort. A dramatic movement of credit unions into commercial lending would circumvent the whole intent of the credit union movement, and in my opinion, it would be a negative factor on the progress of the credit union movement. In this bill, we for the first time set limits on the amount of credit union assets that can go into commercial loans. That is a very positive step.[3]

It is clear from the statutory language and the legislative history that Congress intended for credit union business lending activity to be limited and recognized that business lending carried considerable more risk than consumer lending.

Unlike secure lending to individuals, it is clear that business lending carries inherently more risk. Business loans are typically much larger than consumer loans, requiring more careful underwriting and stringent monitoring due to their potential for greater loss. The risks associated with business lending are compounded when loans are made to out-of-market customers with no prior relationship with or connection to the credit union and in a market that is unfamiliar to the credit union. Moreover, business lending, and particularly losses from business lending, reduce resources available for credit unions to meet their primary mission to serve the financial needs of people of modest income.

Member Business Loan Defaults Are on the Rise

An increasing number of credit unions are reporting financial problems arising from defaulted business loans. For example,

- Spire Federal Credit Union (FCU), formerly Twin City Co-op FCU, is in the process of foreclosing on $13.4 million in loans to Thumper Pond;
- Eastern Financial Florida Credit Union reported a $30 million development loan in default to a luxury condo project; and

[2] *Senate Report* 105-193, pp. 9 - 10.
[3] *Congressional Record*, July 24, 1998, p. S8966.

- Centris FCU has approximately $10 million lent to a water park in bankruptcy.

In fact, the delinquency rate of member business loans (30 days or more past due) at federally-insured credit unions stood at 2.58 percent at the end of the first quarter of 2008 – up by nearly 60 percent from a year ago. Even more disturbingly, the value of delinquent business loans went from $351.7 million in March 2007 to $672.2 million in March 2008 – an increase of 91 percent. In addition, slightly more than $18 million in business loans were charged-off during the first quarter of 2008 in comparison to $2.5 million during the first quarter of last year.

Two Recent High Profile Failures Were Linked to Risky Business Lending

In fact, the recent failures of two mid-sized credit unions – Huron River Area Credit Union (Ann Arbor, Michigan) and Norlarco Credit Union (Fort Collins, Colorado) – demonstrate the reason for congressional concern about the risk posed by business lending to the safety and soundness of credit unions. The failure of these two credit unions can be directly attributed to losses arising from their business loan programs.

According to the news reports, both credit unions were actively involved in making construction and land development loans, the riskiest form of commercial real estate lending, in southwest Florida – well outside each of their local market areas.

Norlarco had 1,035 loans worth $238 million in Lee County, Florida. Huron River was also actively making loans in Lee County. While the dollar volume of these Huron River loans has not been made public, reports suggest them to be in the hundreds of millions of dollars. Huron River posted a $59 million loss during the first six months of 2007 after writing off $62 million related to potentially bad loans.

The ability to monitor out-of-market business loans requires considerable resources, particularly when there is no physical presence in the market. It also requires considerable oversight by regulators to assure adequate compliance with federal and state law regarding underwriting standards, loan monitoring standards, and reporting accuracy. None of these risk management necessities seem to have been envisioned as part of the usual resources of credit unions or of the NCUA.

The ultimate losses experienced by both Norlarco and Huron River Area Credit Unions indicate that their business lending programs exposed them to a high level of risk which was compounded by the fact that these loans were out-of-market and were not adequately underwritten or monitored. Neither do they seem to have been detected by regulatory examination before conditions became critical and losses severe.

Credit Union Resources Ill-Equipped to Manage Business Loan Risk

Credit union regulators, at both the state and federal level, have demonstrated a weak track record of evaluating and managing the type of risks involved in commercial lending. The Government Accountability Office (GAO) warned about this in 2003: "[S]ince member business loans constitute only a small percentage of credit union

lending, most NCUA examiners will not have significant experience looking at this type of lending activity. In contrast, banks and thrifts offer these loans to a much greater extent than credit unions and their regulators do have experience in this area." The GAO was skeptical that NCUA was up to "the challenge to ensuring that it is adequately prepared to monitor" the expansion of credit union business lending.

Specific Comments Related to the ANPR

The following section addresses specific issues raised in the ANPR.

NCUA Should Not Ease the LTV Requirements

NCUA is seeking guidance as to whether it should raise the maximum loan-to-value ratio for construction and land development (CLD) loans and fleet loans made by credit unions. In 2003, the NCUA Board *eased* the equity requirements for CLD loans from 35 percent to 25 percent.

Construction and land development loans are the riskiest form of business lending and were largely responsible for the failure of Norlarco Credit Union and Huron River Area Credit Union. These credit union failures led to large losses to the NCUSIF. In fact, ABA believes NCUA should evaluate what role easing CLD loan equity requirements played in the failure of the two credit unions and subsequent losses to the NCUSIF.

ABA believes that raising the maximum LTV ratio would increase the potential size of losses from CLD loans going forward, particularly to the NCUSIF. As a safety and soundness regulator – and especially as administrator of a federal deposit insurance fund – NCUA would be well-advised to reject arguments to lower the equity requirements for CLD loans.

Additionally, NCUA should not raise the loan-to-value ratio for fleet loans. Fleet loans are more risky than other types of vehicle loans. In 2003, the NCUA Board justified retaining the LTV ratio for fleet loans stating that "when a business requires the use of a fleet of vehicles, it is likely these vehicles will depreciate far more quickly than vehicles used for personal use or a combined personal/business use."[4]

ABA encourages NCUA to work with the other banking agencies under the FFIEC framework in developing consistent standards that can be applied to these type of commercial loans.

CUSO Business Lenders Not Subject to MBL Requirements

NCUA in 2003 authorized CUSOs to originate business loans. During the comment period, ABA objected to allowing CUSOs to originate business loans.

In our 2003 comment letter, ABA wrote that allowing CUSOs to originate business loans undermined congressional intent to limit credit union business lending. When

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[4] 68 Federal Register 56543.

the Credit Union Membership Access Act was debated and the limits imposed on credit union MBLs in 1998, business loan origination was not a permissible activity for CUSOs. ABA believed that permitting CUSOs to originate business loans, coupled with the exclusion from statutory credit union business loan limits of purchasing or participating in non-member business loans, circumvented the limitation imposed by Congress on credit union business lending.

Once NCUA granted FCUs the authority to invest in CUSOs originating business loans, the number of FCUs investing in CUSOs has grown rapidly. At the end of 2004, 27 FCUs had invested in a CUSO whose primary purpose was business lending. By the end of 2007, 97 FCUs had invested in CUSOs whose predominant service was business loan origination.

Additionally, CUSO business lending poses a risk to participating credit unions. CUSOs are not required to comply with the various MBL requirements and limitations in Part 723 when originating business loans. NCUA does not have third-party oversight authority over CUSOs, such as that provided to other federal banking regulators, and the lack of such authority could limit NCUA's effectiveness in ensuring the safety and soundness of credit unions with investments in CUSOs engaging in risky financial activities. As credit unions make greater use of these third-party providers to originate business loans, credit unions subject themselves to operational and reputation risks. NCUA cannot examine third-party providers unless the NCUA obtains the permission of the CUSO.

Although NCUA regulations require a credit union that either invests in or makes a loan to a CUSO to obtain a written agreement permitting NCUA access to the CUSO's records, this has not been the practice. The Government Accountability Office in its 2003 report cited instances where NCUA was either denied access to a third-party vendor or the third-party vendor withheld financial statements from NCUA examiners.

While NCUA does not have the authority to regulate CUSOs originating business loans, it can require that credit unions purchasing business loans from or participating in business loans with CUSOs ensure, as part of their due diligence of third party vendors, that the CUSO complies with MBL regulations, including the requirement of using the services of an individual with at least two years direct experience with the type of business lending in which the credit union will engage.[5] And the NCUA should end the circumvention of statutory restrictions and count all credit union interest in CUSO business loans within the parameters of a CU's limitation on exposure to business lending.

Expanding Loan Participations Waivers Would Widen Loophole

As of March 2008, 575 federally-insured credit unions reported holding nonmember business loans on their books, worth $5.65 billion. At the end of 2004, when NCUA first started gathering data on nonmember business loans, the total value of such loans was $2.04 billion.

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[5] 12 CFR §723.5(a).

In the ANPR, NCUA writes that "it appears some credit unions may not understand or be aware of the waiver process available where nonmember MBL participations may otherwise cause a credit union to exceed the aggregate limit on MBLs." Currently, there are 23 credit unions that have an MBL ratio beneath the aggregate business loan cap, but have a combination of MBLs and nonmember business loans that exceed the aggregate member business loan cap. ABA believes that NCUA is looking to make greater use of the waiver process to circumvent the statutory business loan cap of 12.25 percent of assets.

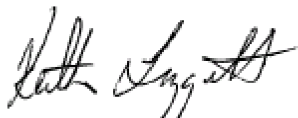
However, this appears to be a reversal of NCUA's position in 2003. At that time, NCUA acknowledged concerns that "the proposed rule would have created a loophole enabling credit unions to escape the limit, the final rule requires Regional Director approval of any transaction that would cause the total of purchased nonmember business loans and nonmember participation interests, when added to the credit union's MBLs, to result in an amount in excess of the credit union's aggregate limit on MBLs."[6] A credit union requesting the waiver must attest to the fact "that the purchase is not being used, in conjunction with one or more credit unions, in a manner that has the effect of trading MBLs that would otherwise exceed the aggregate limit."[7] NCUA believed that its process would ensure that credit unions using the authority were not trading loans to evade the statutory cap. Unfortunately, ABA places little confidence in this attestation process and would urge NCUA not to expand the use of participation waivers—which expansion seems to invite the very evasion that NCUA warned against in 2003.

Also, ABA would request that NCUA disclose all credit unions that have been granted a waiver where nonmember MBL participations otherwise would have caused the credit union to exceed the aggregate MBL limit.

Conclusion

In conclusion, business lending is inherently more risky that consumer lending. Historically, business lending by credit unions has been a major contributor of losses sustained by the NCUSIF. ABA believes that as more credit unions become active business lenders this will pose additional risk to the NCUSIF. The lowering of equity requirements for construction and land development loans and fleet financing; the expansion of CUSO involvement in business lending; and greater use of waivers, especially with regard to loan participations, would only exacerbate those risks. Such an unwarranted expansion of risk is hardly compatible with NCUA's responsibility as the administrator of a federal deposit insurance fund.

Sincerely,



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[6] 68 Federal Register 56544.
[7] Ibid.