NASCUS
National Association of State Credit Union Supervisors

February 21, 2012

Mary Rupp
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Re: NASCUS Comments on Proposed Rule on Loan Participations

Dear Ms. Rupp:

The National Association of State Credit Union Supervisors (NASCUS)[1] urges NCUA to reconsider its proposed rule on loan participations. NASCUS has carefully reviewed the proposal and thoroughly considered the shared regulatory concerns with the safety and soundness risks presented by loan participations. However we are unable to support this rulemaking in its current form.

NASCUS and NCUA have mutual concerns about the material safety and soundness risk presented by *some* loan participation programs. Regulatory and supervisory scrutiny of loan participation programs are apropos, and it would be insincere to suggest otherwise. For this reason, state regulators fully supported and embraced NCUA's 2008 guidance on loan participation programs.[2] In particular, there is widespread support for emphasizing the need for credit unions to underwrite a loan before purchasing a participation. Likewise, there is support for ensuring that credit union loan participation programs are supported by sufficient third party due diligence, including sound contracts. To the extent NCUA concludes that credit unions in general have inadequately implemented the guidance, state regulators are prepared to work with the agency to focus examination resources on ensuring satisfactory compliance.

With respect to codifying elements of the guidance in a rule of general application, state regulators concur that requiring the underwriting of loans prior to purchase and fundamental elements of loan participation program policies and procedures are reasonable. State regulators would also support rulemaking that establishes risk retention and concentration limits so long as those requirements provide flexibility for state law derivations that provide similar risk mitigation. We also support NCUA's amending §741.8 to allow state-chartered credit unions to participate in loans made by banks without having to obtain prior approval from NCUA. However, as whole, NCUA's proposed rule unnecessarily preempts state authority and threatens to weaken modestly sized credit unions without providing material offsetting benefits to supervision.

[1] NASCUS is the professional association of the nation's state credit union regulatory agencies.
[2] LTCU 08-CU-26, available at http://www.ncua.gov/Resources/Pages/LCU2008-26.aspx

We strongly recommend NCUA work with state regulators to address supervisory concerns regarding loan participations in a manner that does less harm to the dual chartering system, more effectively mitigates material risk, and improves oversight while not unnecessarily burdening credit unions.

In its background to the proposed rule, NCUA asserts "large volumes of participated loans in the system tied to a single originator, borrower, or industry or serviced by a single entity have the potential to impact multiple credit unions if a problem arises."[3] We agree. Our comments are not intended to quibble over any material risk presented by loan participations, but rather to point out that NCUA's rule as proposed fails to make a convincing case that it is the best means to mitigate that risk. NCUA itself has established that benchmark for evaluating its rulemaking.[4]

NCUA's Proposed Rule Weakens Dual Chartering

NCUA's proposal raises serious concerns for NASCUS with respect to the long-term viability of the dual chartering system. Historically, state-chartered federally insured credit unions have looked to state law and regulation to govern their loan participation activities. With this proposal, NCUA is poised to sweep away yet another distinction between state and federal charters and usurp the lawful authority of state chartering agencies. Taken together with NCUA's proposed expansion of credit union service organization (CUSO) rules to cover state-chartered credit unions, this proposed rulemaking would leave very little flexibility for states to authorize distinct powers for their credit unions.[5] The result is a continued homogenization of the natural person credit union system; a homogenization that is more than unfortunate, it is unnecessary and detrimental to the long-term health of *both* the state and federal systems.

A healthy dual chartering system encourages innovation and enhances supervision. Many financial products that are commonplace today arose from innovations in state-chartered financial institutions.[6] NCUA's proliferation of sweeping share insurance rules that preempt state authority diminishes the opportunity for varying state laws to provide flexibility for innovation of new products and services. In addition, the homogenization of credit union regulation also impedes supervision. As the U.S. Treasury Department so aptly observed, diversity of supervision "increases the chances that innovative approaches to public policy problems will emerge...A sole regulator, not subject to challenge from other agencies, might tend to become entrenched, conservative and shortsighted."[7]

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[3] 76 Fed. Reg. 79548 (December 22, 2011).
[4] In a November 7, 2011 letter to the Office of Management and Budget, NCUA Chairman Matz wrote "under my recently announced Regulatory Modernization Initiative, NCUA is publicizing our commitment to *effective*, not excessive, regulation." Emphasis in the original.
[5] See "Credit Union Service Organizations," NCUA Notice of Proposed Rule, 76 Fed. Reg. 44866 (July 26, 2011).
[6] American Bankers Association and Conference of State Bank Supervisors, The Benefits of Charter Choice, The Dual Banking System As A Case Study, June 24, 2005.
[7] Id, citing U.S. Department of the Treasury, Modernizing the Financial System, February 1991, page XiX-6.

NCUA's Case for Preempting State Loan Participation Rules is Unconvincing

After citing the fact that both state and federal credit unions engage in loan participations, NCUA states that "it is important to the safety and soundness of the NCUSIF that *all* federally insured credit unions (FICUs) adhere to the same minimum standards for engaging in loan participations."[8] However, why the standards must be the same as opposed to ensuring that acceptable standards, albeit different, at the state and federal level exist to mitigate risk is never explained. Furthermore, NCUA fails to make a compelling case that the restrictions put forth in the proposal are better than existing state rules for loan participations.

NCUA states that during its examination contacts it has encountered confusion about loan participation regulations. Whether this "confusion" is on behalf of credit unions being examined, or by NCUA's own examiners, the proposal does not say. The proposal also apparently fails to consider that NCUA's organization of its rules, with cross references and references by incorporation, is to blame for confusion rather than the existence of separate state rules.

In the proposal, NCUA recites statistics related to the size and growth of federally insured state-chartered credit union participation loan portfolios.[9] The proposal notes that state-chartered credit unions experience slightly higher delinquency ratios than their federal counterparts, and that out of 123 federally insured credit unions with delinquencies greater than 10%, slightly more are state-chartered (56% or 68 state charters to 58 federal charters). Presumably NCUA included this implicit criticism of the state system and its oversight to justify preempting state loan participation rules. Yet, NCUA's proposal is devoid of any explanation of the losses to the National Credit Union Share Insurance Fund (NCUSIF) in any systemic manner resulting from these patterns. While the NCUA Office of Inspector General (OIG) Capping Report identifies loan participation as a contributing factor to the failures of two credit unions, NCUA's presentation of the data would lead one to believe that more failures are tied primarily to loan participations, but this does not appear to be the case according to the OIG report.

NCUA also fails to provide any nexus between the agency's perceptions of shortcomings in the state system and the specific remedies proposed. As discussed in more detail below, NCUA's proposal lacks meaningful discussion as to why this proposal is the best, or better, approach to redressing loan participation concerns than less intrusive or less preemptive measures. In fact, a close reading of the OIG's investigation of the two credit union failures to which loan participations contributed indicated **management** problems far beyond the scope of this rule. We also note that of the *fifteen* federally insured credit unions liquidated or closed in 2011 (four state-charters and 11 federal charters) loan participations have not been identified as the primary contributing factor to the failures.

Ultimately, NCUA's proposal concludes that "certain requirements should be consistent among all FICUs to minimize systemic risk. Increasing numbers and balances in loan participation portfolios, among both federal credit unions and FISCUs, indicate such a regulatory approach is

[8] 76 Fed. Reg. 79548 (December 22, 2011).
[9] 76 Fed. Reg. 79550 (December 22, 2011).

warranted."[10] That preempting state law and homogenizing the system are the best regulatory response to systemic risk is a dubious proposition, as recent events might attest.

NASCUS Comments on Specific Proposed Provisions

Associated Borrower

NCUA would define an "associated borrower as "any borrower with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower. This includes guarantors, co-signors, major stakeholders, owners, investors, affiliates and other parties who have influence on the management, control, or operations of the borrower." This definition is broad. Taken on its face it would seem as though NCUA considers all members of the same credit union to be associated (for example all the individual churches in a faith-based credit union). It is unclear why the definition of associated borrower for purposes of loan participations is broader than the term's definition under §723.21 for member business loans.[11] At a minimum, the inconsistent definitions will cause the "confusion" NCUA cited as a need for the proposed rule. At worst, the broad definition, coupled with a waiver process NCUA itself cites as being considered unworkable and not viable by credit unions, will prove unnecessarily cumbersome while returning uncertain regulatory benefit.[12]

We are not convinced that it is necessary to dictate a uniform associated borrower limit for all credit unions to protect the insurance fund. From the Fund's perspective, credit unions must demonstrate an awareness of the risks presented by associated borrowers and limits should be addressed in the credit union's policies. Because no evidence is presented that a 15% limit, sans consideration of any other mitigating factors, is anything other than an arbitrary restriction, the rule should allow state regulators to address regulatory requirements for state charters. At a minimum, the definition of associated borrower should be consistent between §723 and the proposed loan participation rule. For state-chartered credit unions, the authority to grant waivers should reside with the state regulator.

Definition of Credit Union Organizations is too Limited

The proposed rule would define a credit union organization for purposes of loan participation regulation as "any credit union service organization meeting the requirements of part 712 of this chapter." In turn, credit union organizations are among the entities that the proposed rule would allow federally insured credit unions to participate in loans. The other entities include any state or federal credit union, generally any bank, and government agencies. The definition as proposed would include all federal credit union service organizations (credit union service organizations or CUSOs) as eligible for participation in loans. However, the definition might exclude many state credit union CUSOs.

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[10] Id.
[11] *Associated member* is any member with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower. 12 C.F.R. 723.21.
[12] 76 Fed. Reg. 79549 (December 22, 2011).

At this time, §712, NCUA's CUSO rule does not apply in full to state credit union CUSOs, CUSOs which in turn would presumably not be eligible to sell participation loans. Given that state credit union CUSOs are regulated by the states, their credit union owners are also regulated by the states and in most cases presumably by NCUA as well, the exclusion of state-chartered credit union CUSOs is arbitrary. Since 2008, NCUA has had access to the books and records of all federally insured credit union CUSOs further making the exclusion of state CUSOs arbitrary.

<u>Definition of Originating Lender is Confusing</u>

The definition of originating lender is confusing. The proposed rule defines an originating lender as a lender "with which the [***member***] initially or originally contracts for a loan and who, thereafter or concurrently with the funding of the loan, sells participations to other lenders."[13] While federal credit unions may be restricted to participating in loans made to members of credit unions, no such rule applies universally to state credit unions. The use of the term "member" therefore presents a completely unnecessary, and avoidable, potential source of confusion. The definition of originating lender should replace "member" with "borrower."

NCUA's proposed §701.22(b) establishes the conditions pursuant to which covered credit unions may participate in loans. Proposed §701.22(b)(1) requires the purchase of a participation in a loan comply with all regulations to the same extent as if the purchasing credit union originated the loan itself. Proposed §701.22(b)(4) requires the borrowers of a loan being participated be a member of one of the credit unions in the transaction. While federal credit unions may be restricted to participating only in loans made to credit union members, state credit unions have no such uniform restriction. In acknowledgement of this fact, NCUA proposes §741.225 in its "Requirements for Insurance" to instruct state-chartered credit unions to comply with §701.22 but exempting them from §701.22(b)(4). We support exempting state credit unions from NCUA's membership requirement and recommend the agency clarify that §701.22(b)(1), limiting credit unions to participating only in loans they could legally make, was not intended to be read as limiting state-chartered credit unions.

In addition, §701.22(b)(1) contains a confusing reference to NCUA's federal credit union limit on loans to one borrower. In citing §701.21(c)(5), it is unclear if NCUA means only for federal credit unions to comply with that provision, or if all federally insured credit unions must now comply with it by cross reference in the loan participation rule.

<u>10% Originator Risk Retention Requirement is Arbitrary</u>

NCUA's proposed requirement that credit unions only participate in loans where the originating entity retains 10% is problematic. While state regulators agree that requiring retention of *some* part of the loan by the originator is a sound practice, there is little justification for mandating that retention be 10%. The proposed rule is silent as to why 10% is the appropriate metric of risk mitigation. While a 10% retention may have been long required for federal credit unions, it is new for state charters and deserving of explanation and discussion.

[13] Ibid. [Emphasis added].

There is ample evidence that a retention level less than 10% might be appropriate. We note that the Federal Deposit Insurance Corporation (FDIC) does not require a 10% risk retention. Furthermore, with respect to securities transactions, Congress considered risk retention requirements in conjunction with the Dodd-Frank Wall Street Reform and Consumer Protection Act. Congress ultimately determined a 5% threshold was sufficient for securitizers to retain. Congress also provided regulators broad leeway to promulgate lesser retention standards so long as the regulations encourage high underwriting standards and appropriate risk management practices.

NCUA's 10% risk retention requirement should not be extended to state credit unions. Absent NCUA identifying a compelling justification for a uniform 10% risk retention requirement, state law or regulation should control for state credit unions.

<u>25% Limit on Originators in the Aggregate of Dubious Regulatory Value</u>

Proposed §701.22(b)(5)(ii) would limit credit unions from participating in loans, in the aggregate, in excess of 25% of their net worth from a single originator. There would be no waiver provision for the 25% limit. The 25% limit would likely have a disproportionate impact on modest sized credit unions. Many credit unions that rely on purchasing loans have developed relationships with specific originators upon whom the purchasing credit union has performed due diligence. We are not convinced that the regulatory benefit of limiting exposure to a single originator outweighs the detrimental impact of disrupting established, effective relationships and forcing purchasing credit unions into the marketplace to contract with unknown entities.

The 25% limit also fails to consider the differences in the types of loans being participated. Large pools of car loans for example represent many multiple streams of repayment, whereas an equal dollar amount of mortgage or commercial loans may rely on a far less diverse stream of repayment. Yet, the proposed rule makes no distinction.

The 25% limit should not apply to state-chartered credit unions. State regulators have adequate tools under state law to ensure that their credit unions do not incur excessive risk in their loan participation relationships.

NASCUS' Recommendations

As we noted at the opening of our comments, state regulators share some of NCUA's concerns with the administration of loan participation programs in *some* credit unions. NASCUS also understands and concurs that supervision should at times be pro-active, addressing concerning trends before significant losses materialize. However, it is also incumbent on regulators to ensure that rules are not unnecessarily burdensome, particularly when regulators act proactively in an anticipatory manner. To mitigate the material risk presented by loan participations in a more efficient manner, we submit the following recommendations:

Proposed rulemaking should focus on underwriting and effective adoption and implementation of policies

Effective risk management of loan participations begins with effective management and due diligence. The risk of a single bad acting originator spreading contagion through the system, or inundating a single credit union, is better mitigated by enforcing underwriting requirements.

State law and regulation should continue to govern loan participations for state credit unions

Dual chartering strengthens the credit union system. NCUA regulations should continue to recognize state authority for state credit union loan participations. Although many credit unions choose to implement programs consistent with NCUA's federal credit union regulations to maximize the loan participation market, the system would benefit from the ability to monitor the effectiveness of state systems with regulations differing from NCUA's regulations. In this way, regulators may evaluate the pros and cons of varying risk retention or concentration limits.

The proposed rulemaking should focus on non-agriculture commercial lending

Different pools of loans carry different risks. At this point, it appears the greatest concern with loan participations are pools of participated commercial loans. If in fact commercial loan participations are of greatest concern, then risk mitigation should be focused there.

Waiver provisions should be meaningful

State-chartered credit unions seeking waivers should be able to rely on their state regulator with notice to NCUA. Differences in assessments of credit unions seeking waivers can be worked out between regulators. In addition, credit unions whose programs demonstrate expertise should be allowed maximum flexibility to vary from various limits by policy or waiver.

Should NCUA insist on requiring its approval for a waiver application by a state-chartered credit union, such approval should be deemed granted if NCUA fails to act within a certain amount of prescribed time.

Loans sold with recourse should be excluded

NCUA must clarify the application of the loan participation rules to loans purchased with recourse. In addition to addressing recourse and non-recourse sales, NCUA must be prepared to address hybrid recourse loan participation products such as the ones being issued by NCUA controlled Western Bridge Corporate Credit Union.[14]

Provisions applicable to state-charters should be incorporated within §741

To address the confusion NCUA cited in its proposal, any parts of the loan participation rule extended to state-chartered credit unions should be included in their entirety within §741. There is simply no rational justification for continuing to require state credit unions to search through

[14] See http://www.wescorp.org/loans/lcommentary.asp?catid=46&cat_typeid=1.

NCUA's federal credit union rules to ensure compliance. Incorporating rules within §741 would seem to be consistent with Chairman Matz's pronounced regulatory modernization initiative.[15] We acknowledge that reorganizing NCUA's rules to retroactively incorporate all insurance rules within a single section is not a simple undertaking. However, the regulatory relief benefits would almost certainly be worth the effort. At a minimum, as NCUA revisits and amends its share insurance rules, those applicable to state charters should be incorporated in their entirety within §741.

In addition to reducing confusion for credit unions, and examiners, as to which rules apply to state-chartered credit unions, incorporating insurance rules within Part 741 in their entirety would also help clarify when NCUA is engaged in rulemaking as a share insurer and when it is engaged in rulemaking as the charterer of federal credit unions.

In closing, we believe the rule as proposed is ill advised and we urge NCUA to reconsider. In particular, NCUA critically underestimates the proposal's potential impact on modestly sized credit unions. As credit unions continue to explore options to replace yield formerly achieved through corporate credit union investment and more robust loan demand, this proposed rule represents a further foreclosing of options.

NASCUS and state regulators remain committed to working with NCUA to mitigate material risk throughout the credit union system, and appreciate the opportunity to submit comments on this proposed rule. NASCUS and state regulators would be pleased to discuss these comments at NCUA's convenience.

Sincerely,

- signature redacted for electronic publication -

Brian Knight
SVP Regulatory Affairs & General Counsel

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[15] We note that the Consumer Financial Protection Bureau has announced its intention to republish all of its inherited rules within a consolidated section of the federal code to ease compliance.