IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

DECLARATION OF CHRISTOPHER COLE

In accordance with 28 U.S.C. § 1746, Christopher Cole offers the following declaration:

1. My name is Christopher Cole, and I offer this declaration in response to defendant's motion to dismiss under Fed. R. Civ. P. 12(b)(1). I am employed by the Independent Community Bankers of America ("ICBA") as its Executive Vice President and Senior Regulatory Counsel. As part of my duties, I routinely monitor regulatory developments that may impact ICBA's member community banks across the United States. My duties also include the preparation and submission of comments during the notice and comment period of administrative rulemakings. As part of my job duties, I regularly correspond with ICBA member community banks operating throughout the United States. I also regularly review communications between other ICBA employees and such banks. My testimony herein is based upon my personal knowledge and a review of records kept in the ordinary course of business by ICBA and its member banks.

2. ICBA, which is organized as a not-for-profit corporation, was founded 86 years ago in 1930. ICBA serves as the nation's voice for community banks of all sizes and charter types throughout the United States. Most of the nation's nearly 6,000 community banks are members of ICBA.

3. The mission and purpose of ICBA is to create and promote an environment where community banks flourish. This lawsuit is germane to ICBA's mission because it seeks to protect ICBA's member community banks from excessive and unlawful commercial lending by competing tax-exempt credit unions.

4. Commercial lending is a core component of the operations of ICBA's member community banks. Banks generate revenue from payments made by borrowers on outstanding loans. When a bank makes a commercial loan, that loan is recognized as an asset on the bank's balance sheet.

5. ICBA's member banks regularly compete against credit unions for commercial loans. Indeed, as the National Credit Union Administration (the "NCUA") explained earlier this year, "[o]nce an ancillary product offered by a small number of credit unions, business lending is now becoming a core service offered by many credit unions[.]" Member Business Loans; Commercial Lending, Final Rule, 81 Fed. Reg. 13,530, 13,530 (Mar. 14, 2016).

6. When credit unions compete against ICBA's member banks for commercial loans, they do so on an unlevel playing field. Federal credit unions are exempt from all taxes imposed by the United States or by any state, territorial, or local taxing authority, except for local real or personal property tax.[1] This tax exemption allows credit unions to pay more interest on

[1] Attached as exhibit A is a true and correct copy of an August 2011 Letter of Exemption from Michael J. McKenna, General Counsel of the NCUA, regarding the tax exemptions extended to credit unions. ICBA retrieved this letter from the NCUA website.

deposits, and thereby attract more low-cost funding from consumers, compared to commercial banks. The tax exemption also allows credit unions to offer commercial loans at interest rates significantly lower than rates charged by banks. Similarly, because of the tax exemption and cost advantages it provides, credit unions can offer ancillary services to their commercial loan borrowers for lower fees than banks. Therefore, credit unions have lower operating costs and compete with ICBA's member banks with an operating cost advantage.[2]

7. Because of this uneven position, ICBA members are harmed by competing for commercial loans with tax-exempt credit unions, which have a significant advantage in the terms they can profitably offer. Indeed, credit unions routinely use this inherent cost advantage to convince customers of community banks to borrow instead from the credit unions.

8. ICBA has received information from its members regarding the specific effects of the increased commercial loan activity from tax-exempt credit union competitors. Among other things, ICBA has learned that:

A. An ICBA member bank in Michigan recently lost three commercial lending opportunities, totaling around $3.5 million, to competing credit unions.

B. A second ICBA member bank in Michigan reported multiple instances in which it lost commercial loans, totaling around $4 million, to competing credit unions.

C. An ICBA member bank in Montana reported having lost around $30 million in commercial loans to a competing credit union. The impact to this community bank has been particularly significant since its total gross loan balance is less than $90 million.

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[2] Attached as exhibit B is a true and correct copy of the U.S. Department of the Treasury's Report on Credit Union Member Business Lending. Page 39 of the report observes that credit unions have an "inherent cost advantage" over banks. ICBA retrieved this letter from the website of the Treasury Department.

D. An ICBA member bank in West Virginia reported having lost over $12 million in commercial loans to competing credit unions.

E. An ICBA member bank in South Dakota reported having lost around $2 million in commercial loans to competing credit unions.

F. An ICBA member bank in New Hampshire reported having lost more than $2 million in commercial loans to a competing credit union over the past year.

G. An ICBA member bank in Ohio reported having lost numerous commercial loans to competing credit unions. This member bank also reported a situation in which it had negotiated with a commercial real estate borrower to refinance a million dollar loan and, after the refinancing had been approved, a credit union came in and offered a lower rate. In this case, the bank had to reduce its interest rate by 75 basis-points (nearly one percent) to retain the loan.

9. Each of these loans would qualify as a member business loan ("MBL") under the Federal Credit Union Act, since "the proceeds . . . will be used for a commercial, corporate, or other business investment property or venture, or agricultural purpose." 12 U.S.C. § 1757a(c)(1).

10. Information provided to ICBA by its member banks revealed that credit unions competing for commercial loans often offered rates and terms that deviated from commonly accepted best practices for commercial lending. For example, one ICBA member bank in Michigan reported that it lost a large commercial and industrial loan to a credit union that offered the borrower the opportunity to fund and close the loan prior to engaging in *any* due diligence. In many cases, the credit unions offered fixed-rate loans for longer terms and at lower interest rates than are generally available on commercial loans. In most cases, ICBA's member banks

reported having lost the commercial loans to credit unions because matching the credit union rates was not feasible.

11. Generally, when banks lose commercial loans to competing credit unions, they are unaware of whether the competing credit unions will hold the loans to maturity or participate the loans out to a syndicate of credit unions. Notably, however, multiple ICBA member banks have reported to ICBA that they had learned that commercial loans, which had been lost to competing credit unions, were ultimately financed by credit union syndicates.

12. Since 2003, this harm to ICBA's members has been increasing steadily and significantly, and commercial lending has become a core business for credit unions to the detriment of community banks.[3] In the preamble to the 2016 MBL Rule, NCUA noted that "total business loans including unfunded commitments at federally insured credit unions grew from $13.4 billion in 2004 to $56 billion in September 2015, an annualized growth rate of 14 percent." This rise of commercial lending at credit unions has corresponded to NCUA's historically lax enforcement of the statutory MBL cap,[4] which has since 2003 allowed credit unions to exceed

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[3] Attached as exhibit C is a true and correct copy of slides presented to the 2015 Credit Union National Association ("CUNA") Lending Conference by NCUA's MBL Program Officer, Vincent H. Vieten, in 2015. CUNA is the credit union industry's primary trade association and lobbying group. Slide three charts the ten-year growth of MBLs in the credit union system. ICBA identified the presentation with a standard Internet search, and retrieved the slides from the website of CUNA.

Attached as exhibit D is a true and correct copy of NCUA's 2008 Supervisory Letter titled "Evaluating Loan Participation Programs." On the first page, the letter states that "[o]utstanding loan participations more than doubled between 2003 and 2008." ICBA retrieved this letter from the NCUA website.

[4] *See* Ex. B at 5 ("[In 2001, the Treasury Department] reviewed NCUA's enforcement of its member business lending regulations[.] Overall, [Treasury] found it difficult to determine whether credit unions were in full, partial, or non-compliance with Part 723 because the information contained in the examination reports did not consistently show whether the examiners tested for compliance.").

the cap through limited, incremental waivers, including by facilitating credit unions to aggregate their commercial lending through participation syndicates that rely on waivers from NCUA.

13. The previous rule was not enough for credit unions. For years, credit union trade groups have tried unsuccessfully to lobby Congress to increase the MBL cap. In 2011, under the previous waiver approval scheme, the President & CEO of CUNA testified to Congress that over 500 credit unions across the United States were being constrained by, and would soon be "bumping up against," the MBL cap.[5] The credit union industry has described the cumbersome 2003 system, which included a waiver pre-approval process, as a "barrier to entry" for credit unions wishing to increase their commercial lending even more in competition with community banks.[6]

14. ICBA has opposed these efforts to expand the MBL cap because of the concrete harm to ICBA's members as a result of commercial lending from credit unions. In 2011, the President of an ICBA member bank in Minnesota testified to Congress that "[f]or [his] bank, credit union business lending represents an immediate threat." This ICBA member explained

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[5] Attached as exhibit E is a true and correct copy of a letter from O. William Cheney, President and CEO of CUNA, to the Representative Shelley Moore Capito, Chairman of the Subcommittee on Financial Institutions and Consumer Credit, Committee on Financial Services, U.S. House of Representatives. On pages five and six, Mr. Cheney provides a detailed basis for why he believes Congress should raise the MBL Cap, including that, in 2011, over 500 credit unions would soon be "bumping up against" the MBL cap. ICBA retrieved this letter from the website of the U.S. House of Representatives Committee on Financial Services.

[6] Attached as exhibit F is a true and correct copy of slides presented to the CUNA Lending Council's 2015 MBL Lenders Roundtable Discussion by Bob Stowell, Senior Vice-President/Chief Strategy Officer, US Federal Credit Union. On slide three, Mr. Stowell describes the purpose of the presentation as a chance "for experienced MBL lenders to explore their most critical issues." On slide eight, Mr. Stowell describes the MBL cap as "a barrier to entry into offering MBL services." ICBA identified the presentation with a standard Internet search, and retrieved the slides from the website of CUNA.

that, "[o]n countless occasions, [the bank] lost business lending opportunities with established customers to credit unions who underpriced [the bank's] competitive rates."[7]

15. After failing to persuade Congress to change the law, CUNA turned its attention to NCUA and has lobbied the regulator to loosen the commercial lending restriction even further.[8]

16. In the current rulemaking, NCUA undertook a comprehensive reconsideration of all aspects of its regulation of commercial lending by credit unions, sought and received comments from all interested parties on all relevant issues, including its interpretation and enforcement of the statutory MBL cap. 81 Fed. Reg. at 13,548.

17. NCUA has now issued an entirely new rule that abolishes the waiver approval process and replaces it with a new provision that declares a categorical exclusion from the definition of MBLs for commercial loan interests that were previously subject to the waiver approval requirement so that credit unions now have much "greater flexibility and individual autonomy" to engage in commercial lending to the detriment of community banks. Indeed, when NCUA's MBL Program Officer presented to the CUNA Lending Conference in 2015, his slides described the coming changes to the agency's treatment of "non-member business loan participations." Under the heading of "Current Rule," NCUA's slide states that "Non-member business loan participations [are] included in the cap unless waiver is granted." Under the

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[7] Attached as exhibit G is a true and correct copy of the June 16, 2011 testimony of Noah Wilcox, President and CEO of Grand Rapids State Bank, on behalf of ICBA, to the United States Senate Committee on Banking, Housing, and Urban Affairs. ICBA maintains a copy of this testimony on its publicly available website.

[8] Attached as exhibit H is a true and correct copy of an August 2013 letter from Mary Mitchell Dunn, Deputy General Counsel and Senior Vice President of CUNA to Michael J. McKenna, General Counsel of NCUA. ICBA identified the presentation with a standard Internet search, and retrieved the slides from the website of CUNA.

heading of "Proposed Rule," NCUA's slide states that its proposed rule "Removed non-member business loans from the calculation against the cap" and "No longer requires waivers." Ex. C at 17.

18. The 2016 MBL Rule makes it much easier for credit unions to combine their lending capacities through participation syndicates. In the commercial lending market, credit unions frequently form lending syndicates to make commercial loans. In these syndicates, each credit union participant takes an interest in the loan and the borrower receives loan proceeds equal to the total amount contributed by each participating credit union. This process is often accomplished and facilitated through special purpose entities set-up by credit unions, known as credit union service organizations ("CUSOs"). Depending on the status of the originating credit union, the originator may participate out 90 to 95 percent of the commercial loan. ***Under the 2016 MBL Rule, only the credit union to which the borrower actually belongs must count its portion of the commercial loan toward its MBL cap.*** Moreover, in certain cases, such as where the originating credit union is a "low income credit union," up to 100 percent of the MBL may be exempt from the MBL cap. In other words, the new structure creates a situation where many new commercial loans will be made by credit unions and where between 90 percent and 100 percent of the same loans will not count towards the MBL cap of any credit union.

19. As a result, the 2016 MBL Rule creates a significant new capacity for commercial lending in the credit union system. Credit unions will be freed to engage in increased commercial lending without having to go through the waiver pre-approval process—a change that will stimulate significantly more active and larger commercial lending by credit unions through multi-credit union participation syndicates. This change will immediately expand the market for commercial loans against which ICBA's member banks will have to compete.

20. Statements from the credit union industry have made clear that, as early as 2011, there were more than 500 credit unions across the country being constrained by the MBL cap. Reports from NCUA also make clear that MBL activity by credit unions has risen significantly since even 2011. The fact that credit unions have been "bumping up against the cap" for years and have a pent-up desire to make commercial loans beyond the statutory limit shows that the increase in regulatory capacity for commercial lending resulting from the 2016 MBL Rule's categorical exclusion will produce an immediate increase in this lending activity by previously constrained credit unions.

21. Because ICBA's members will compete with this influx of new commercial loan capital from credit unions, and because credit unions have an inherent cost advantage from their tax exemptions, it is certain and without question that ICBA's members will suffer additional harm beginning in January 2017 when the 2016 MBL Rule, and its categorical exclusion, goes into effect.

22. Beyond the current and imminent competitive harm described above, the announcement of NCUA's adoption of the categorical exclusion in the 2016 MBL Rule and the expectation in the markets that the exclusion is about to go into effect are already having an actual, current adverse effect on the franchise value of community banks. As a result, member banks are less attractive to investors and it is more difficult for them to obtain additional capital on reasonable terms.

23. For example, one ICBA member bank in Montana reported that its value has declined in light of the finalization of the 2016 MBL Rule because (i) it often competes for commercial loans with a large, aggressive credit union in its local market, (ii) the member bank often loses loans to the credit union where the borrower is price sensitive, (iii) the 2016 MBL

Rule eases restrictions on what counts towards the MBL cap (*i.e.*, allowing credit unions to exclude certain acquired commercial loans from the MBL cap), thereby increasing the capacity for commercial lending by credit unions, and (iv) the immediate impact of the ICBA member bank's commercial lending prospects has reduced its overall present value.

24. Another ICBA member bank in Ohio reported that the imminent effectiveness of the 2016 MBL Rule will drive down rates on commercial loans in its market, given the increased capacity for commercial lending in the credit union system and this bank's previous experiences with competing against credit unions that routinely price commercial loans at below-market interest rates. As a result, this member bank reports that it likely will be forced to exit the market for small business loans, thereby leading to a decline in the bank's profitability. A decline in the bank's future profitability has resulted in an immediate decline in the bank's value.

25. Thus, the member banks of ICBA have reported suffering direct economic injuries caused by the finalization of the 2016 MBL Rule, and they imminently will suffer greater financial and competitive harm when the rule becomes fully effective in January 2017.

26. The above experiences represent only a sampling of the reports that ICBA has received from member banks across the United States reporting varying degrees of harm from 2016 MBL Rule. Further, ICBA's members have reported that additional harm is imminent and will occur when the 2016 MBL Rule becomes effective on January 1, 2017.

27. ICBA has a long history of efficiently and effectively coordinating with its thousands of member community banks across the United States. As a result, ICBA is the best party to represent the interests of community banks in a challenge to the 2016 MBL Rule. Indeed, with its well-established network of member community banks, ICBA is in a better position than any single bank to present to the Court the full effects and implications of the 2016

MBL Rule. Moreover, it would be impractical for any single impacted member bank to challenge this rule because ICBA member banks are small, locally owned and locally operated lending institutions with limited resources. Further, if each ICBA member bank that has been already, or will be imminently, impacted by the increase in commercial lending competition from credit unions brought its own individual challenge to the 2016 MBL Rule, they would need to pursue a slew of lawsuits in various jurisdictions across the United States, each challenging the same aspect of this NCUA regulation.

28. Attached as exhibits I, J, and K are declarations from members of ICBA describing the impact on them of NCUA's regulatory policy permitting increased commercial lending by credit unions and the 2016 MBL Rule. These declarations are a small, representative sample of the many comments we have received from our member community banks all across the country.

I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct.

Executed on November 15, 2016.

Christopher Cole

Christopher Cole
Executive Vice President/Senior Regulatory Counsel
Independent Community Bankers of America

EXHIBIT A

National Credit Union Administration

Credit Union: _____

Charter Number: _____

LETTER OF EXEMPTION

This Letter of Exemption certifies that federal credit unions are exempt from all taxes imposed by the United States or by any state, territorial, or local taxing authority, except for local real or personal property tax. Section 122 of the Federal Credit Union Act (12 U.S.C. § 1768) states in relevant part:

> *The Federal credit unions organized hereunder, their property, their franchises, capital reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority: except that any real property and any tangible personal property of Federal Credit unions shall be subject to Federal, State, Territorial and local taxation to the same extent as other similar property is taxed.*

This exemption from taxation includes, but is not limited to, state or local sales taxes for direct purchases of goods or services by a federal credit union, and hotel occupancy taxes on lodging or meals for employees traveling on official federal credit union business. The exemption applies in instances where the obligation of paying the tax falls on the federal credit union, and payment is made by the federal credit union via direct billing or use of a credit card in the name of the federal credit union.

For a more detailed explanation of the tax exemption please visit the agency's website at: http://www.ncua.gov/GenInfo/GuidesManuals/Tax_Exempt/ExemptExplanation.htm

Sincerely,

Michael J. McKenna
General Counsel

(Revised 8/2011)

EXHIBIT B

Credit Union Member Business Lending

UNITED STATES DEPARTMENT OF THE TREASURY

January 2001

The Honorable Paul S. Sarbanes
Chairman
Committee on Banking, Housing,
and Urban Affairs
U.S. Senate
Washington, D.C. 20510-6075

Dear Mr. Chairman:

I am pleased to transmit the Department of the Treasury's report on credit union member business lending. We prepared this report as required by section 203 of the Credit Union Membership Access Act of 1998.

In preparing this report, we directly surveyed all 1,514 credit unions that carried member business loans on their books as of June 30, 1999. The survey produced detailed information on credit union member business lending, including the types and sizes of businesses that receive such loans, and the collateral used to secure those loans. The survey data reported here fills an information void about credit union member business lending and should inform any future policy discussions about such lending.

We also report our findings as to the effectiveness and enforcement of the National Credit Union Administration's regulations applicable to member business lending; whether business lending could affect credit unions' safety and soundness; the extent to which member business lending assists low- and moderate-income individuals; whether credit unions have a competitive advantage in making business loans; and the effect of the Credit Union Membership Access Act on the future growth of credit union member business lending.

Sincerely,

Lawrence H. Summers

Enclosure

[Identical letter sent to the Honorable Phil Gramm]

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515-6050

Dear Mr. Chairman:

I am pleased to transmit the Department of the Treasury's report on credit union member business lending. We prepared this report as required by section 203 the Credit Union Membership Access Act of 1998.

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Sincerely,

Lawrence H. Summers

Enclosure

[Identical letter sent to the Honorable John LaFalce]

EXECUTIVE SUMMARY

As depository institutions, most credit unions are small, retail-oriented operations that focus primarily on providing consumer credit to their members. However, credit unions may also make business loans to their members. As of June 30, 2000, federally insured credit unions had $4.3 billion in member business loans outstanding. About 14 percent of federally insured credit unions had member business loans outstanding on that date.

The NCUA defines a credit union member business loan as any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for the following purposes: commercial, corporate, other business investment property or venture, or agricultural. The NCUA further exempts certain loans, including loans fully secured by a primary, 1-4 family residence and loans the total of which to an individual is less than $50,000. In 1998 Congress codified the definition and limited a credit union's member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets. The NCUA subsequently incorporated these limits and certain exceptions into their member business lending regulations.

Larger credit unions are more likely to offer member business loans than are smaller institutions. As of mid-year 2000, over half (53 percent) of the 338 federally insured credit unions with more than $250 million in total assets offered member business loans. At the same time, less than five percent of the smallest credit unions (under $10 million in total assets) offered this product.

Few credit unions are active business lenders. As of June 30, 2000, only 92 of 10,477 credit unions had total member business loans outstanding exceeding their net worth. While this group comprises less than one percent of all credit unions, they account for over 46 percent of total member business loans outstanding.

Four characteristics distinguish credit union member business loans from commercial lending done by banks:

the loans can only be made to credit union members;
the loans generally require the personal guarantee of the borrower;
the loans generally must be fully collateralized; and
total member business lending is generally subject to a portfolio limitation of 12.25 percent of total assets.

We prepared this study pursuant to section 203 of the Credit Union Membership Access Act of 1998. Congress directed us to investigate six specific issues pertaining to credit union member business lending. Our findings with respect to each of these issues are summarized below.

The Effectiveness and Enforcement of NCUA's Member Business Lending Regulations

Congress asked us to study the effectiveness and enforcement of the National Credit Union Administration's (NCUA) regulations applicable to member business lending.

Part 723 of the NCUA's regulations sets forth the written policies a credit union must have in place in order to make member business loans, and it establishes additional limitations and requirements on these loans. These limitations and requirements are intended to limit excessive risk taking in credit unions' member business lending portfolios. Overall, the regulations appear to be quite effective at limiting the credit risk associated with member business loans. The requirements for formal board policies, portfolio limits, and collateral requirements are much more stringent than those faced by banks and thrifts.

We reviewed the NCUA's enforcement of its member business lending regulations by looking at recent examination reports of credit unions that are actively engaged in this type of lending. Overall, we found it difficult to determine whether credit unions were in full, partial, or non-compliance with Part 723 because the information contained in the examination reports did not consistently show whether the examiners tested for compliance. NCUA staff told us that examiners need not document an area of review where no specific and material concerns were identified. We also had difficulty assessing the degree of compliance-testing undertaken in state-chartered credit unions. We identified several steps that the NCUA might take to improve its enforcement of Part 723, including monitoring Call Report data for credit unions that exceed the statutory limits; ensuring that credit unions are in compliance with other applicable regulatory requirements before granting a waiver to a member business lending limit; and updating its examination reports to reflect the current regulatory requirements.

Member Business Lending over $500,000 and Under $50,000

Congress asked us to examine member business lending over $500,000 and under $50,000, and to break down the data by types and sizes of businesses that received member business loans.

To collect the data requested by Congress on member business loans, we directly surveyed all 1,514 federally insured credit unions reporting member business loans outstanding on their June 30, 1999 Call Report. The survey asked credit unions to provide detailed information about their member business loan portfolio, including:

the size of member business loans;
the types of collateral used to secure member business loans;
the types and sizes of businesses that receive member business loans; and
the household income of members receiving member business loans.

A copy of the survey and the aggregated responses are provided in the Appendix. After inputting and error-checking the data, we had 1,030 survey responses -- 68 percent of all credit unions reporting member business loans -- that could be used in our analysis.

The survey data showed that 59 percent of member business loans had balances less than $50,000 and 2 percent had balances greater than $500,000. These loans amounted to 14 percent

and 17 percent, respectively, of the total outstanding principal balance of all the loans reported to us by survey respondents. For all reported loans, over half were collateralized with non-agricultural real estate, and another 23 percent were collateralized with taxicab medallions. Agricultural collateral backed 12 percent of the loans.

Over 50 percent of the loans reported to us by survey respondents were made for businesses with assets under $100,000 and about 86 percent of those made were to businesses with total assets less than $500,000. Loans to service-oriented businesses and for rental property made up nearly 55 percent of the total number of loans. In addition, 29 percent of member business loans were to agriculture-related business and 12 percent to "other business type."

Looking at the total dollar value of member business loans outstanding, the survey showed that over 70 percent went either to service providers (38.8 percent) or for rental properties (32.9 percent). It appears that the figures for service providers largely reflect the loans made for taxicab medallions. Nearly half of the unpaid principal balance of member business loans outstanding was to businesses with total assets between $100,000 and $500,000. Cumulatively, almost 70 percent of the value of member business loans was made to businesses with total assets less than $500,000.

Meeting the Needs of Low- and Moderate-Income Individuals

Congress asked us to study the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals within the field of membership of insured credit unions.

We solicited information from credit unions about the member household income level for each of their member business loans based on several income categories. Overall, these data were difficult to obtain and the information that we did receive may suffer from accuracy problems. Thus, our survey data should be interpreted cautiously.

Our survey results showed that 25 percent of member business loans were made to members with household income of less than $30,000 -- and that these loans totaled 13 percent of the outstanding member business lending balances. Another 20 percent of the loans (with 15 percent of the outstanding loan balance) went to households with incomes reported to be between $30,000 and $50,000.

The Effect of the Act on the Number of Credit Unions Engaged in Member Business Lending and the Overall Amount of this Lending

Congress asked us to study the effect of the 1998 Act on the number of insured credit unions involved in member business lending and the overall amount of commercial lending.

Overall, we expect the volume of credit union business lending to continue to increase. Certain provisions in the Credit Union Membership Access Act will tend to aid this growth, while others will serve to hinder it.

We expect that changes to the credit union membership restrictions in the Act will increase member business lending for two reasons. First, the expanded membership opportunities established in the Act will likely spur credit union growth, and larger credit unions tend to be more active member business lenders. Second, more credit unions are converting to community charters, which allow businesses to be credit union members.

On the other hand, the member business lending restrictions contained in the Act, coupled with risk-based net worth requirements issued by the NCUA, should temper this expected growth. The statutory limit on member business loans to 12.25 percent of assets serves as a binding constraint on long-term growth in this product market for credit unions not otherwise exempt from this limit. Also, marginal net worth requirements on member business loans that do exceed the 12.25 percent limit could also temper loan growth.

As for the competitive implications of the Act's membership and business lending provisions, it is reasonable to expect that some of these additional business loans will be new, while others will have been competed away from other depository institutions. Over the next few years, the total effect on other depository institutions should be modest -- especially given credit unions' relatively minor role in serving commercial borrowers. At the same time, there likely will be an increasing incidence of credit unions competing commercial loans away from other depositories in specific local markets.

Member Business Lending and the Safety and Soundness of Credit Unions and the Share Insurance Fund

Congress asked us whether member business lending by credit unions could affect the safety and soundness of credit unions or the National Credit Union Share Insurance Fund.

In the 1980s and early 1990s, member business lending was a factor in a number of credit union failures, and it contributed to losses to the Share Insurance Fund. In response, the NCUA established regulations governing member business loans in 1987, and strengthened those regulations in 1991.

Today, member business loans are generally less risky than commercial loans made by banks and thrifts because they generally require the personal guarantee of the borrower and the loans generally must be fully collateralized. Ongoing delinquencies -- for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due -- are lower for credit unions than for banks and thrifts. Credit unions' mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent).

We assessed the risk to the Share Insurance Fund from member business lending by running several simple stress tests whereby some portion of credit unions' outstanding member business loans were assumed to default at a total loss to the credit unions. No other sources of loss were included in the tests. These stress tests are hypothetical and do not represent a judgement that the outcomes are likely. Rather, the tests seek to gauge the Share Insurance Fund's ability to withstand a negative shock to credit unions' member business loan portfolios. If every credit

union member business loan outstanding as of December 31, 1999, defaulted at a total loss to the credit union, and the credit unions suffered no other losses, the Share Insurance Fund would have remained solvent by $3.1 billion. We conclude that, at this time, member business lending alone does not pose material risk to the Share Insurance Fund.

Do Credit Unions Have a Competitive Advantage? Could this Advantage Affect the Viability and Profitability of Other Federally Insured Depository Institutions?

Congress asked us to study whether credit unions that engage in member business lending have a competitive advantage over other insured depository institutions, and if any such advantage could affect the viability and profitability of such other insured depository institutions.

Credit unions have advantages over other depository institutions in that some receive sponsor subsidies, while all are exempt from the federal corporate income tax. However, credit unions do face certain constraints, in the form of limitations on the eligibility to receive such loans and on the loans themselves, that banks and thrifts do not have. Overall, we cannot discern whether credit unions have a competitive advantage.

Business lending is a niche market for credit unions. Overall, credit unions are not a threat to the viability and profitability of other insured depository institutions. In certain instances, however, credit unions that engage in member business lending may be an important source of competition for small banks and thrifts operating in the same geographic areas.

MEMBER BUSINESS LENDING

Introduction

Credit unions are depository institutions. Most are small, retail-oriented operations that focus primarily on providing consumer credit to their members. However, credit unions may also make business loans to their members. Credit unions are generally not active commercial lenders, but certain credit unions serve as an exception to this rule. As of June 30, 2000, federally insured credit unions had $4.3 billion in member business loans outstanding.

This section defines member business lending, sets forth the statutory requirements for this study, describes the methodology used, and outlines the structure of the study.

A. Member Business Lending is Distinct and Limited

A member business loan is a commercial loan, like those made by banks. However, four legal constraints on credit union member business loans distinguish them from commercial lending by banks:

the loans can only be made to credit union members;
the loans generally require the personal guarantee of the borrower;
the loans generally must be fully collateralized; and

total member business lending is generally subject to a portfolio limitation of 12.25 percent of total assets.

Relative to other depository institutions, credit unions are not active commercial lenders. Federally insured credit unions reported $4.3 billion in member business loans outstanding as of mid-year 2000, or about one percent of their total assets. Moreover, only about 14 percent of federally insured credit unions had any member business loans outstanding on that date. In contrast, banks and thrifts reported $1 trillion in commercial loans outstanding as of mid-year 2000, or about 15 percent of their total assets.

Larger credit unions are more likely to offer member business loans than are smaller institutions. As of mid-year 2000, over half (53 percent) of the 338 federally insured credit unions with more than $250 million in total assets offered member business loans. At the same time, less than five percent of the smallest credit unions (under $10 million in total assets) offered this product.

Few credit unions are active business lenders. As of June 30, 2000, only 92 of 10,477 credit unions had total member business loans outstanding exceeding their net worth. While this group comprises less than one percent of credit unions, they account for over 46 percent of the unpaid principal balance of all member business loans. These credit unions may provide important competition for the small banks and thrifts that operate in the same geographic areas.

B. Study Requirements, Methodology, and Design

Requirements

The Treasury performed this study pursuant to section 203 of the Credit Union Membership Access Act of 1998, which President Clinton signed into law on August 7, 1998. 1 That section required the Treasury to conduct a study of member business lending by federally insured credit unions, including:

an examination of member business lending over $500,000 and under $50,000, and a breakdown of the types and sizes of businesses that receive member business loans;
a review of the effectiveness and enforcement of regulations applicable to member business lending;
whether member business lending could affect the safety and soundness of credit unions and the National Credit Union Share Insurance Fund;
the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals within the field of membership of insured credit unions;
whether insured credit unions that engage in member business lending have a competitive advantage over other insured depository institutions, and if any such advantage could affect the viability and profitability of such other insured depository institutions; and

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1 Pub. L. No. 105-219, § 203, 112 Stat. 913, 922.

the effect of enactment of the Credit Union Membership Access Act on the number of credit unions involved in member business lending and the overall amount of commercial lending.

Methodology

Because of the paucity of data on credit union member business lending, the Treasury Department directly surveyed individual credit unions to gather information on the types and sizes of businesses receiving member business loans, the collateral used to secure such loans, and the household income levels of the borrowers. The survey was sent to all 1,514 federally insured credit unions reporting member business loans outstanding on their June 30, 1999 Call Report. 2 Some 1,030 credit unions -- an unusually large response rate of 68 percent -- submitted usable responses.

Before issuing the member business lending survey, we met with the National Credit Union Administration (NCUA) and representatives of credit union and bank trade associations. These parties assisted in the construction of the survey by providing insight into appropriate categories, terminology, phrasing, and formatting. The NCUA also provided sampling services based on our specifications and generated an electronic mailing list and labels for us. Three credit union organizations (Credit Union National Association, National Association of Federal Credit Unions, and National Association of State Credit Union Supervisors) all pre-tested the survey instrument with certain members and publicized the survey on their respective web-sites.

To review the NCUA's enforcement of its member business lending regulations, we analyzed appropriate portions of NCUA examination reports on credit unions actively engaged in member business lending and we conferred with NCUA staff about the structure of their member business lending reviews.

3. Overview

Section II outlines the legal framework under which credit unions engage in member business lending – including an analysis of the effectiveness and enforcement of federal regulations. Section III provides comprehensive data on the types and sizes of businesses and the income characteristics of credit union members that receive member business loans. Section IV assesses the effect of the Credit Union Membership Access Act on the number of credit unions engaged in member business lending and the overall amount of commercial lending. Section V examines the effect of member business lending on credit union safety and soundness and on the Share Insurance Fund. Section VI considers whether credit unions have a competitive advantage in making business loans. Section VII summarizes the report's findings.

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2 The NCUA's Call Report is a financial disclosure report filed by each credit union. Specifically, the Call Report includes information about the credit union's balance sheet (assets, liabilities, and equity) and income statement (revenues and expenses). The Call Report is filed quarterly by large credit unions (those with greater than $50 million in total assets) and semi-annually by small credit unions (those with less than $50 million in total assets).

Legal Framework for Member Business Lending

Some credit unions have always made commercial credit available to their members. However, not until 1987 were credit unions subject to federal member business lending regulations. Overall, these regulations appear to be quite effective at limiting the risks associated with member business lending. We identified a few steps that the NCUA could take to strengthen its enforcement of these regulations.

Brief History of Credit Union Business Lending

Since their inception, credit unions have offered business-related loans to their members. It was not until 1987, however, following several credit union failures due to business lending, that the NCUA promulgated regulations specifically targeted at this type of lending. At that time, the NCUA reported that half of the losses accruing to the National Credit Union Share Insurance Fund ($20-$30 million) in the two previous years (1985 and 1986) were directly or indirectly the result of member business lending. 3

Even after the NCUA issued its member business lending regulations in 1987, poorly managed business lending programs continued to result in credit union failures. The NCUA's analysis of the five largest failures in each of its six regions during the 1987-1991 period found that "commercial lending was a factor" in 16 of the 30 credit union failures. These 16 failures cost the Share Insurance Fund about $100 million. 4 The NCUA also found that problem credit unions in 1991 had a "disproportionately higher level of member business loans than other credit unions." The NCUA concluded that, at that time, "credit unions with the poorest overall condition and poorest ability to withstand losses tend to have the greatest involvement with member business loans." 5 The NCUA responded by revising its member business lending regulations in September 1991.

Following the 1991 regulatory revisions and the vastly improved macroeconomic environment, the quality of credit unions ' member business lending portfolios grew stronger through the 1990s. As of June 30, 2000, member business lending delinquencies stood at 1.84 percent -- compared to 8.20 percent as of year-end 1993.

B. Current NCUA Regulations

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3 51 Fed. Reg. 23,234 (June 26, 1986).

4 56 Fed. Reg. 2,723 (Jan. 24, 1991).

5 56 Fed. Reg. 48,421 (Sept. 25, 1991).

The NCUA defines a credit union member business loan as any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for the following purposes: commercial, corporate, other business investment property or venture, or agricultural. 6 The NCUA further exempts loans having certain characteristics, even if the proceeds are used for commercial purposes. Exempt loans include those:

fully secured by a primary, 1-4 family residence;
fully secured by shares in the credit union making the loan or deposits in another financial institution;
the total of which to an individual is less than $50,000;
fully insured, or fully guaranteed, or where there is an advance commitment to p urchase in full by any agency of federal, state, or local government; or
granted by a corporate credit union to another credit union. 7

Congress codified the NCUA's member business lending definition, including the exemptions, in the Credit Union Membership Access Act of 1998. 8 At that time, Congress also limited a credit union's member business lending to the lesser of either 1.75 times net worth or 12.25 percent of total assets. 9 The NCUA subsequently incorporated these limits and certain exceptions into their member business lending regulations. 10 (Section V discusses the effect of the Act on member business lending.)

Part 723 of the NCUA's regulations requires that credit unions engaging in member business lending must have written policies that address the following issues:

the types of loans to be made;
the trade area to be serviced;
the maximum amount of assets (in relation to net worth) that will be invested in business loans;
the maximum amount of assets (in relation to net worth) that will be invested in any category of business loans;
the maximum amount of assets (in relation to net worth) that will be loaned to one member (or associated group of members);
the qualifications and experience of the personnel involved in making these loans (these individuals are to have at least two years experience with this type of lending);
a requirement to analyze and document the ability of the borrower to repay the loan;

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6 12 C.F.R. § 723.1(a).

7 12 C.F.R. § 723.1(b).

8 12 U.S.C. § 1757a(c)(1).

9 12 U.S.C. §§ 1757a(a), 1790d.

10 12 C.F.R. §§ 723.16, 723.17.

documentation supporting each loan application (i.e., balance sheet, income statement, cash flow, etc.);
collateral requirements (including loan-to-value ratios, appraisals, title search and insurance requirements, marketability, etc.);
appropriate interest rates and maturities;
loan monitoring and servicing procedures; and
identification of individuals ineligible to receive member business loans. 11

Part 723 also outlines the following minimum limits and policies:

unless approved by the NCUA, member business loans may only be granted on a fully secured basis by second liens up to 80 percent loan-to-value (LTV) and first liens up to 80 percent LTV (first liens between 80-95 percent LTV may be acceptable when the amount exceeding 80 percent is fully insured by a private mortgage insurer);
unless approved by the NCUA, loans may not be granted without the personal liability and guarantees of the principals (loans to non-profits are exempt from this requirement);
unless approved by the NCUA, loans to one borrower (or group of associated borrowers) may not exceed 15 percent of a credit union's net worth or $100,000 -- whichever is larger (any portion of such loans secured by government guarantees or shares in the credit union are not included in this calculation);
member business loans should be granted for periods consistent with the purpose, security, creditworthiness of the borrower, and sound lending practices; and
"allowance for loan losses" are to be reserved at 100 percent of the outstanding loan amount for actual losses, 50 percent for "doubtful loans," and 10 percent for "substandard loans."

Also, with regard to credit unions implementing a member business loan program, the credit union's board of directors must adopt specific business loan policies and review them at least annually.

Unless waived by the NCUA, construction and development loans are subject to the following additional requirements:

the aggregate amount of these loans must not exceed 15 percent of net worth (net of any amounts guaranteed by the government or secured by shares);
the borrower must have at least a 35 percent equity interest in the property; and
on-site, written inspections must be prepared by qualified personnel prior to release of funds.

Part 723 is intended to limit excessive risk taking in credit unions' member business lending portfolios. The NCUA thus seeks to maintain the financial safety and soundness of credit unions and the Share Insurance Fund. In the next two sections, we analyze the effectiveness and enforcement of Part 723.

C. Effectiveness of NCUA's Member Business Lending Regulations

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11 12 C.F.R. § 723.6.

Congress asked us to determine the effectiveness of the NCUA's member business lending regulations. We understood this to mean determining how effective Part 723 is at reducing credit risk.

> We focused on the regulatory definition of a business loan, the required written policies governing business lending, collateral and security requirements, and limitations on member business lending generally and construction and development lending in particular. We also compared Part 723 to commercial lending regulations applicable to federally chartered banks and thrifts. Our analysis resulted in five principal findings.

First, our survey results show that a large percentage of member business loans are financing 1-4 family residential rental properties (see Section III for details). According to the NCUA, these often are second or third homes that a credit union member rents to others. Rental properties typically have greater credit risk than owner-occupied properties. The Federal Credit Union Act requires that a non-owner occupied 1-4 family residential mortgage be classified as a member business loan unless it is the borrower's future primary residence. We believe that these loans should be reported as a subset of member business lending and identified as "non-owner occupied 1-4 family mortgages."

Second, the NCUA requires the boards of directors of credit unions engaged in commercial lending to meet certain requirements that are not applicable to national banks or federal savings associations. Specifically, credit union boards must establish a member business loan policy identifying the types of business loans it will make, its trade area, the qualifications and experience of its business lending personnel, and those individuals ineligible to receive such loans. 12 In addition, the credit union must limit the amount it will dedicate to aggregate member business lending, as well as to any given type of member business lending. 13

Third, NCUA collateral and security requirements serve to differentiate credit union member business lending from commercial lending by other depository institutions. Except for commercial credit card programs, the NCUA requires collateral for all credit union member business loans. By contrast, banks and thrifts generally are not required to take a security interest in a commercial loan borrower's assets.14 Because collateral serves to better align the incentives of the borrower with the lender, collateral requirements generally result in smaller, less risky loans and hence less overall credit risk.

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12 12 C.F.R. §§ 723.5, 723.6(a), (b), (f), and (m).

13 12 C.F.R. § 723.6(c), (d).

14 All national banks and federal savings associations, however, must establish and maintain prudent underwriting practices. 12 C.F.R. § 30, Appendix A § II.D; 12 C.F.R. § 560.100 *et seq*.

Fourth, the Credit Union Membership Access Act limits a credit union's business lending activity to the lesser of 1.75 times net worth or 12.25 percent of total assets. 15 Similarly, federal savings associations are limited in their commercial lending to 20 percent of total assets, provided that any amount over 10 percent of total assets consists of small business loans. 16 National banks, by contrast, may make commercial loans without specific limitation. 17

Fifth, limitations on credit union construction and development lending (i.e., 15 percent of net worth) are stricter than for banks and thrifts. 18 For example, federal savings associations are limited in their unsecured construction lending to the greater of total capital or five percent of total assets. 19 Federal savings associations are also limited in their lending secured by non-residential real estate up to 400 percent of capital. 20 National banks, by contrast, may make construction and development loans without specific limitation. 21

Overall, the NCUA's member business lending regulations appear to be quite effective at limiting the credit risk associated with these loans. Indeed, the NCUA's formal board policy requirement, portfolio limits, and collateral requirements are much more stringent than those faced by banks and thrifts.

D. Enforcement of NCUA's Member Business Lending Regulations

We reviewed the NCUA's enforcement of its member business lending regulations by looking at recent examinati on reports of credit unions that are actively engaged in this type of lending.

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15 12 U.S.C. § 1757a(a); 12 C.F.R. § 723.16.

16 12 U.S.C. § 1464(c)(2)(A); 12 C.F.R. 560.30.

17 12 U.S.C. § 24(seventh).

18 12 C.F.R. § 723.3(a).

19 12 U.S.C. § 1464(c)(3)(C); 12 C.F.R. 560.30.

20 12 U.S.C. § 1464(c)(2)(B); 12 C.F.R. 560.30.

21 12 U.S.C. § 371(a).

Review of Examination Reports

We limited our review of examination reports to those credit unions that reported on their year-end 1999 Call Report having either member business loans exceeding the lesser of 1.75 times net worth or 12.25 percent of total assets, or construction and development loans outstanding exceeding 15 percent of net worth. This approach directed our review of NCUA's enforcement of Part 723 to those credit unions that, by their own reporting, exceeded the standard limits on member business lending. As a result, we established a sufficiently large sample from which to draw conclusions and we directed our resources to cases where we would expect to find that the NCUA had either taken enforcement action or granted waivers to its regulations.

Looking at year-end 1999 Call Report data, we identified 90 credit unions with member business loans in excess of the regulatory ceilings. 22 Of these, 78 credit unions had member business loans outstanding exceeding the aggregate member business lending limit and 15 credit unions exceeded the construction and development lending limit. Three credit unions exceeded both limits. Of these 90 credit unions, two had recently been liquidated and an examination report for another was not available. Consequently, we reviewed electronic examination reports for 87 credit unions using the NCUA's Automated Integrated Regulatory Examination System (AIRES) program. 23

Findings

In reviewing examination reports for the 87 credit unions, we evaluated whether:

the credit union had obtained the appropriate waiver for the lending limits it exceeded;
examiners systematically tested for compliance with the requirements of Part 723; and
credit unions corrected compliance problems identified by examiners.

a. Waivers

As noted above, all 87 credit unions in our sample had member business loans in excess of the regulatory limits. The NCUA's regulations permit credit unions to exceed those limits if they meet certain criteria. Specifically, a credit union may exceed the aggregate limit on outstanding member business loans if it applies for and receives an exception to the limit, pursuant to the

22 As of June 30, 2000, 103 credit unions exceeded at least one of the regulatory ceilings.

23 The AIRES program was designed by the NCUA and is now used by both them and state credit union supervisors. The NCUA provides AIRES (and laptop computers) to credit union examiners in 49 states (Utah excluded).

standards set forth in Part 723. 24 A credit union also may apply for a waiver of the aggregate limit on construction and development loans pursuant to procedures in Part 723.25

Of the 78 credit unions that exceeded the aggregate member business lending limit, six did not have the appropriate exception. According to the NCUA, four of these credit unions are under moratoria to stop their member business lending production until they attain a level below 12.25 percent of total assets. One did not seek a waiver because it only temporarily exceeded the member business lending threshold, and one only appeared to exceed the limit because it had filed an incorrect Call Report.

Of the 15 credit unions with construction and development loans exceeding 15 percent of their net worth, only two had the appropriate waiver. According to the NCUA, 10 of the 15 credit unions had filed incorrect Call Reports.

In 12 instances, we found that the NCUA had issued an exception or a waiver to a credit union that it found to be in noncompliance with other aspects of Part 723. It appears that the NCUA does not require that a credit union otherwise be in compliance with Part 723 before granting a waiver from the lending limits.

b. Compliance Testing

The NCUA's examiner guidance manual states that examiners should test every credit union with member business loans for compliance with Part 723. We assessed examiners' conformance with this requirement by reviewing the most recent two or three examination reports completed for each of the 87 credit unions in our sample. For state-chartered credit unions, we also looked at a checklist prepared by NCUA examiners that documents their own review of the state examination. Since all of the credit unions in our sample exceed certain regulatory limits for member business lending, they are all materially involved in such lending. Consequently, one would expect that the review of member business loan portfolios would be a material aspect of any full regulatory examination of these credit unions.

Overall, we found it difficult to determine whether any in our sample of 87 credit unions was in full, partial, or non-compliance with Part 723. As noted above, both NCUA and state credit union examiners use the AIRES program to document their on-site visits to credit unions. However, the member business lending questionnaire contained on AIRES is limited in that it focuses exclusively on board policies. Thus, it omits the other requirements under Part 723, such as loan-to-value ratios below 80 percent, personal guarantees, and loan loss reserving requirements. In short, the member business lending questionnaire in AIRES is not set up in a way that requires the examiner to attest to a credit union's compliance with all aspects of Part 723.

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24 12 C.F.R. §§ 723.17, 723.18.

25 12 C.F.R. §§ 723.10(c); 723.11.

We tested whether examiners completed the limited member business lending questionnaire for the 87 credit unions in our sample. The information contained in the examination reports did not consistently show whether the examiners tested for compliance. NCUA staff told us that examiners need not document an area of review where no specific and material concerns were identified. We also had difficulty assessing the degree of compliance-testing undertaken in state-chartered credit unions.

In 19 cases (22 percent), examiners systematically reviewed (and documented their review of) credit union board policies regarding member business lending. In another 33 cases, examiners indicated in their work papers that they had looked at some aspect of the credit union's compliance with Part 723. These work paper comments were either that a credit union violated a regulatory provision concerning member business lending or that it had recently corrected problems identified in previous examinations. Thus, in at least some of the cases where the examiner did not complete the member business lending questionnaire, the examiner did undertake some amount of review in this area. In the remaining 35 credit unions, however, we found no evidence that examiners tested for compliance with Part 723.

We had particular difficulty assessing the degree of compliance testing undertaken in state-chartered credit unions. NCUA examiners do not typically examine state-chartered credit unions. Instead, state examiners use the AIRES program and then forward their examinations to the NCUA. NCUA examiners then review this report and complete a checklist that assesses whether the state exam covered key risk areas. These reports, however, are not uniform across NCUA regions. For example, not all regions have a question concerning compliance with member business lending regulations and when they do, the question refers to Part 701.21(h) of NCUA's Rules and Regulations.26 Also, NCUA examiners reviewing AIRES examination data submitted by state examiners face the same limitations we encountered and have noted above. Thus the NCUA has little direct knowledge, and only limited indirect knowledge, of the compliance of state-chartered credit unions with the requirements of Part 723.

The NCUA's policy is to conduct on-site safety and soundness examinations at state-chartered, federally insured credit unions only if the NCUA has an "insurance concern" 27 or observes negative trends in a state credit union or group of state credit unions. As a result, many years may pass in between examinations by the NCUA of a state-chartered credit union. The NCUA's approach differs from that taken by the federal banking agencies, which are required by law to examine state-chartered banks and thrifts under their jurisdiction at least every two years. 28

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26 This section was replaced by Part 723 in May 1999. 64 Fed. Reg. 28721 (May 27, 1999).

27 Determination that a state-chartered credit union is an "insurance concern" is a judgment left to each NCUA regional office and is not guided by a formal regulation or policy guidance.

28 The federal banking agencies are the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

From our limited review, we could not attest to the NCUA's testing for compliance with restrictions on construction and development lending. For all construction and development loans, Part 723 requires that: (1) borrowers have at least a 35 percent equity stake in the properties (projects); and (2) on-site, written inspections by qualified personnel have been conducted prior to the release of the loan funds. For the 15 credit unions reporting construction and development lending exceeding 15 percent of net worth, none of the examination reports we reviewed documented whether those credit unions had been examined for compliance with these requirements.

c. Correcting Compliance Problems

We also reviewed past examination reports for the 87 credit unions in our sample to see whether compliance problems identified by an examiner were cured before the next examination. Specifically, we looked at cases in which an examination report recorded a formal agreement (such as a "Document of Resolution" or "Letter of Understanding and Agreement") or an oral directive to a credit union to correct a lack of compliance with Part 723. Overall, based on the information available to us in the examination files, we could not usually determine a credit union's compliance with a "Document of Resolution" or "Letter of Understanding and Agreement." We worked under the assumption that if the subsequent examination did not mention the earlier problems, the credit union had corrected them.

We found that when NCUA examiners identified compliance problems, the credit unions did not always correct all of the problems by the next examination. In six cases, we found at least one member business lending-related problem that still existed at the time of the next examination. Each of these six credit unions was located in NCUA Region 5 and participated in that region's special agricultural review program, 29 and five of these six credit unions were state chartered.

d. Farm Service Agency Guarantees for Agricultural Member Business Loans

NCUA Region 5 has encouraged some credit unions to seek federal loan guarantees provided by the Farm Service Agency (FSA) for troubled agricultural borrowers. Based on its agricultural review work papers, it seems that Region 5 encourages credit unions to obtain such guarantees for their agriculture loans. While this is not a problem per se, we identified two concerns with this policy. First, Region 5 was encouraging credit unions to seek guarantees on loans that were already not performing (thereby shifting the credit union's credit risk to a federal agency). Second, some credit unions had difficulty meeting the FSA servicing requirements – potentially resulting in loss of the FSA guarantee.

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29 The NCUA established its agriculture review program to review the financial condition and administrative operations of credit unions engaged in agricultural lending. This program uses examiners that specialize in reviewing agricultural lending to tailor corrective actions in response to a credit union's operational and financial difficulties arising from agricultural lending.

2. Improving the NCUA's Enforcement of Part 723

Based on our review, we believe that the NCUA can improve its enforcement of Part 723 in four ways:

Regularly monitor Call Report data to identify those credit unions exceeding the member business lending limits. When those credit unions are identified, the NCUA should quickly determine whether the data are accurate and, if so, whether a credit union qualifies for a waiver or exception under Part 723 or whether other action is appropriate.

Ensure that a credit union is in compliance with other applicable regulatory requirements before issuing a waiver to a member business lending limit.

Update both the member business lending questionnaire and the Code 26 report (for reviewing the examinations of state-chartered credit unions) to reflect the current requirements of Part 723. In addition, the NCUA examiners should ensure that examiners follow the examiner's guidance in reviewing compliance with Part 723 and properly documenting that review.

Test for compliance with the 35 percent equity requirement and the on-site inspection requirement for construction and development lending in Part 723.

Member Business Lending Survey

Congress asked us to provide it with detailed information about: (1) credit union member business lending over $500,000 and under $50,000; (2) the types and sizes of businesses that receive member business loans; and (3) the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals. Because neither the NCUA nor national credit union trade associations had previously collected this information, we constructed a survey to obtain these data.

Survey Methodology and Response

1. Member Business Loans and Business Purpose Loans

When the NCUA first promulgated its member business lending regulations in 1987, it required credit unions to report all business loans on their Call Reports. At the same time, however, only loans to a single borrower with aggregate original amounts greater than $25,000 were subject to the member business lending regulation. In an effort to reduce regulatory burden, in 1993 the NCUA raised the regulatory threshold to $50,000 and eliminated the reporting requirement for loans under this amount. 30 Since then, credit union business loans made for business purposes, but that aggregate to less than $50,000 for a particular borrower have generally been reported as either consumer loans, mortgage loans, or "other" loans. NCUA refers to these as "business

30 58 Fed. Reg. 40,040 (July 27, 1993).

purpose loans" but does not require credit unions to report them in a separate category. Nor do credit unions have to adhere to any of the NCUA's member business lending requirements in making business purpose loans.

Since Congress asked us to provide data on "member business lending over $500,000 and under $50,000" the distinction between member business loans and business purpose loans is an important one. In order to avoid confusion among credit unions in collecting the data requested by Congress, we followed the NCUA's conventions and terminology. There are two ways in which a credit union may have a member business loan less than $50,000. First, the loan is one of a group of business loans to a single borrower that, when added together, amount to more than $50,000. Second, the original principal amount of the member business loan exceeded $50,000 but enough of the principal had been repaid so as to make the remaining principal balance less than $50,000.

Since Congress asked for data on member business loans less than $50,000, we took the additional step of asking credit unions for data on their business purpose loans. While these loans do not meet the NCUA's definition of a member business loan, they are loans less than $50,000 where the loan proceeds went to finance a business, rather than a consumer, purpose.

Thus, in our survey we separately asked credit unions about their member business loans and their business purpose loans. Based on current regulations and on our discussions with the NCUA, credit union trade associations, and individual credit union managers prior to issuing our survey, we understood that there was no reason for credit unions to maintain readily identifiable loan files on business purpose loans. Nor was there any reason to expect that they maintained the sort of detailed data on these loans that they must have for their member business loans. Consequently, we asked credit unions to estimate the number and dollar value of business purpose loans on their books, but we did not ask them to provide more detailed data on these loans. As described below, we found that some credit unions are not clear about the distinction between business purpose loans and member business loans.

2. Survey Design and Response Rate

To collect the data requested by Congress on member business loans, we directly surveyed all 1,514 federally insured credit unions reporting member business loans outstanding on their June 30, 1999 Call Report. The survey asked credit unions to provide detailed information about their member business loan portfolio, including:

the size of member business loans;
the types of collateral used to secure member business loans;
the types and sizes of businesses that receive member business loans;
the household income of members receiving member business loans;
the size and duration of loan delinquencies; and
the extent to which loan participations were used to share the credit risk associated with member business loans.

A copy of the survey and the aggregated responses are provided in the Appendix.

> We received 1,118 survey responses (73.8 percent). After inputting and error-checking the data, we found that 88 of these credit unions reported on their survey that they had no member business loans. Because these responses directly conflicted with their mid-year 1999 Call Report filings, we removed these credit unions from the analysis. As a result, we received 1,030 surveys -- 68 percent of all credit unions reporting member business loans -- that could be used in our analysis.

In order to gather information about business purpose loans, we elected to survey both credit unions that did and did not have member business loans. Specifically, we asked a stratified random sample of 811 credit unions that did not report member business loans outstanding as of June 30, 1999 about any business purpose loans they may have. 31 This survey asked the respondents to estimate the number and unpaid principal balances of any business purpose loans that they may have had on their books as of June 30, 1999. Overall, we received 648 responses to this survey (80.0 percent). Five of these contained incomplete data, resulting in 643 responses in our analysis. We also asked all of the credit unions that did report having member business loans to separately provide us with an estimate of the number and unpaid principal balances of any business purpose loans that they may have had on their books as of June 30, 1999. A copy of the survey on business purpose loans and the aggregated responses are also provided in the Appendix.

B. Data Limitations

In order to ensure that the 1,030 credit unions that returned completed member business loan surveys were representative of all 1,514 credit unions with member business loans, we conducted a statistical test. 32 The results indicated that the total assets and the ratio of member business loans-to-total assets of the responding credit unions were not statistically different from those of the non-responding credit unions.

To test the accuracy of the survey responses, we compared the total dollar volume of member business lending for each credit union as reported on both the Call Report and our survey for June 30, 1999. Even after allowing for errors up to $1,000, we found that 194 of the credit unions responding to our survey (19 percent) had reporting discrepancies. These discrepancies

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31 The sample was stratified based on total assets. The stratification categories were: under $2 million, $2-10 million, $10-50 million, $50-250 million, and over $250 million. Sample sizes in each strata were determined assuming a 50 percent response rate and 90 percent confidence interval.

32 We conducted t-tests of the differences in the means of both total assets and the ratio of member business loans to total assets based on Call Report data as of June 30, 1999. Both tests accepted the null hypothesis of no statistical difference between responding and non-responding credit unions.

arose despite the explicit guidance on the survey form that the total loan volume reported on the survey should be identical to the total reported on the Call Report. 33

In an attempt to resolve these discrepancies, we contacted more than 100 survey respondents. Based on our review of the surveys and the numerous discussions we had with survey respondents, we believe that some credit unions were confused about the NCUA's definition of a member business loan. This confusion sometimes caused credit unions to report business purpose loans as being member business loans on their Call Report or on our survey. The confusion among some credit unions as to what constitutes a member business loan raises some question as to the reliability of Call Report data on member business loans.

C. Survey Results

1. Member Business Loans

The following data on credit union member business loans are from the 1,030 usable responses to the Treasury survey. The data are as of June 30, 1999.

Our survey results show that member business loans served as financing primarily for service businesses, agricultural businesses, and rental properties. Furthermore, borrowers collateralized most member business loans with non-agricultural real estate. Credit unions also reported that 25 percent of member business loans were issued to members of low- and moderate-income households. As described below, the survey results are limited in that: (1) some credit unions appear to be confused about the definition of member business loans; and (2) borrower information, such as business size and household income, often reflected information from the time of loan origination, which could have been several years or more in the past.

a. Collateral Type

As previously noted, NCUA regulations require that almost all member business loans be fully collateralized. Table 1 shows that non-agricultural real estate (55.7 percent) and taxicab medallions (22.7 percent) collateralized most of the unpaid principal balance of member business loans. Agricultural-related assets (real estate, equipment, crops, or livestock) secured another 12.4 percent of member business loan balances. Together, these three types collateral backed 91 percent of the unpaid principal balance of all member business loans.

Loans under $100,000 constituted about one-third of the outstanding unpaid principal balance of member business loans. While non-agricultural real estate collateralized 16 percent of these loan balances, the remainder was tied to a variety of assets (e.g., inventory and equipment). Another one-half of the unpaid principal balances on member business loans were for loans between $100,000 and $500,000. Non-agricultural real estate and taxicab medallions (i.e., higher value assets) primarily backed these loans. Another 17 percent of unpaid principal balances on

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33 The survey included specific schedule and line number information indicating what data on the credit union's June 30, 1999 Call Report should match what data reported in the survey.

member business loans were for loans over $500,000. These loans were (almost exclusively) secured by non-agricultural real estate.

Table 1: Distribution of Unpaid Principal Balance of Member Business Loans
By Collateral Type and Loan Size
(As of June 30, 1999)

Collateral Type	Loan Size				
	Under $50,000	$50,000 – $100,000	$100,001- $500,000	Over $500,000	Total
Agricultural Real Estate	1.0%	1.5%	2.7%	0.1%	5.2%
Agricultural Equipment	1.9%	1.0%	0.9%	0.0%	3.8%
Crops and Livestock	1.2%	1.0%	1.1%	0.0%	3.4%
Non-Ag Real Estate	5.6%	10.5%	23.5%	16.1%	55.7%
Non-Ag Equipment	1.6%	1.2%	1.6%	0.4%	4.7%
Accounts Receivable	0.1%	0.0%	0.1%	0.0%	0.2%
Inventory	0.1%	0.1%	0.3%	0.0%	0.5%
Taxicab Medallions	1.3%	2.4%	18.7%	0.3%	22.7%
Other Collateral	1.2%	1.0%	0.9%	0.1%	3.1%
No Collateral	0.3%	0.1%	0.1%	0.0%	0.6%
Total	14.3%	18.8%	49.9%	17.0%	100.0%

For the number of loans by collateral type and loan size, Table 2 shows that non-agricultural real estate and taxicab medallions secured 47.5 percent of all member business loans. The fact that loans secured by such collateral account for 78.4 percent of the total unpaid principal balance reported in Table 1 indicates that these loans tend to be larger than member business loans secured with other collateral. The remainder of the member business loan portfolio generally included much smaller loans that were secured by a variety of collateral types. Nearly 60 percent of member business loans had remaining unpaid principal balances less than $50,000 and almost 78 percent were less than $100,000. Fewer than 2 percent of member business loans outstanding were for more than $500,000.

Table 2: Distribution of Member Business Loans by Collateral Type and Loan Size
(As of June 30, 1999)

Collateral Type	Loan Size				
	Under $50,000	$50,000 – $100,000	$100,000- $500,000	Over $500,000	Total

Agricultural Real Estate	2.6%	1.5%	1.1%	0.0%	5.2%
Agricultural Equipment	10.7%	1.1%	0.4%	0.0%	12.3%
Crops and Livestock	6.9%	1.3%	0.7%	0.0%	9.0%
Non-Ag Real Estate	13.6%	9.6%	8.7%	1.7%	33.5%
Non-Ag Equipment	6.8%	1.4%	1.2%	0.1%	9.6%
Accounts Receivable	0.5%	0.1%	0.0%	0.0%	0.6%
Inventory	0.4%	0.1%	0.2%	0.2%	0.9%
Taxicab Medallions	4.3%	2.4%	7.3%	0.0%	14.0%
Other Collateral	4.8%	1.3%	0.4%	0.0%	6.6%
No Collateral	8.0%	0.2%	0.1%	0.0%	8.3%
Total	58.6%	19.0%	20.2%	2.2%	100.0%

b. Business Type and Size[34]

Looking at the distribution of member business loans by business type, we once again found that the data were clustered into two groups. Table 3 shows that, based on the total dollar value of loans outstanding, over 70 percent of member business loans were made to either service providers (38.8 percent) or for rental properties (32.9 percent). Given that Table 1 shows that 22.7 percent of the value of member business loans was secured by taxicab medallions, it would seem that the figures for service providers largely reflect the loans made for taxicab medallions.

Table 3 also shows that nearly half of the unpaid principal balance of member business loans outstanding is to businesses with total assets between $100,000 and $500,000. Cumulatively, almost 70 percent of the value of member business loans is made to businesses with total assets less than $500,000.

Table 3: Distribution of Unpaid Principal Balance of Member Business Loans by Business Type and Size
(As of June 30, 1999)

Business Type	Business Size (As Measured by Total Assets)

[34] Some credit unions reporting information about the collateral type used to secure their loans did not provide complete information for the subsequent tables. We found that 42 credit unions provided no subsequent information, while another 76 provided limited amounts (e.g., provided information about half of their member business loans). Therefore, the total dollar amount of member business loans used for our analysis of "business type" was about $551 million lower than the amount used for collateral type -- reflecting a lack of data on about 3,700 loans.

	Under $100,000	$100,000 $500,000	$500,001 $1 Million	Over $1 Million	Total
Manufacturing	0.3%	0.4%	0.2%	0.2%	1.2%
Service	3.6%	18.8%	14.9%	1.4%	38.8%
Agriculture	6.6%	5.5%	1.4%	0.7%	14.3%
Real Estate Construction and Development	0.4%	2.0%	0.8%	1.2%	4.3%
Rental Property	10.1%	14.8%	5.0%	3.0%	32.9%
Religious Organization	0.1%	0.5%	0.6%	0.5%	1.7%
Other Fraternal Org	0.1%	0.1%	0.0%	0.0%	0.2%
Other Business Type	2.2%	2.5%	0.9%	1.1%	6.7%
Total	23.5%	44.6%	23.9%	8.0%	100.0%

Table 4 shows that the distribution of the number of loans by business type and size is different from the distribution of unpaid principal balances. Over 50 percent of the number of loans made are for businesses with assets under $100,000 and about 86 percent of those made are to businesses with total assets less than $500,000. Loans to service-oriented businesses and for rental property make up nearly 55 percent of the total number of loans. In addition, 29 percent of member business loans were to agriculture-related business and 12 percent to "other business type."

Table 4: Distribution of Member Business Loans by Business Type and Size
(As of June 30, 1999)

Business Type	Business Size (Measured by Total Assets)				
	Under $100,000	$100,000 $500,000	$500,001 $1 Million	Over $1 Million	Total
Manufacturing	0.7%	0.2%	0.1%	0.2%	1.3%
Service	9.1%	14.0%	5.8%	1.1%	29.9%
Agriculture	19.5%	7.1%	1.4%	0.5%	28.6%
Real Estate Construction and Development	0.4%	0.7%	0.2%	0.3%	1.6%
Rental Property	14.7%	7.9%	1.4%	0.8%	24.9%
Religious Organization	0.2%	0.3%	0.1%	0.9%	1.4%
Other Fraternal Org	0.1%	0.1%	0.0%	0.0%	0.2%
Other Business Type	8.7%	2.1%	0.9%	0.5%	12.2%
Total	53.5%	32.3%	9.9%	4.3%	100.0%

c. Household Income

Congress asked us to study the extent to which member business lending helps to meet the financial services needs of low- and moderate-income individuals. To this end, we asked credit unions to report the member household income level of their member business loan borrowers. We defined the following income categories: under $30,000, $30,000-50,000, $50,000-100,000, $100,000-250,000, and over $250,000. Credit unions also had the option to classify the loan as being made directly to a business.

Overall, we had difficulty obtaining the household income data from credit unions and the information that we did receive may be inaccurate. First, 80 credit unions (7.8 percent of those responding to the survey) did not provide any data at all. Since these credit unions tended to have the largest member business loan portfolios, the survey produced household income data on only 65.4 percent of all the member business loans reported in the survey. Second, credit unions may have had only dated information about the borrower's household income that did not reflect the borrowers current income situation. 35 Third, some credit unions may not have reported household income, but rather borrower income, on the survey. As a result of the latter two reporting problems, reported household income may tend to be below actual household income. Consequently, we believe that the results reported below should be interpreted cautiously.

Table 5 shows the number and outstanding balance of loans made to borrowers in the various household income categories for those credit unions that provided these data. The survey results show that 25.3 percent of member business loans were made to members with household income of less than $30,000. These loans totaled 13.2 percent of the outstanding member business lending balances. Another 20 percent of the loans (with 15 percent of the outstanding loan balances) went to households with incomes reported to be between $30,000 and $50,000.

Credit unions reported that 21.4 percent of their member business loans -- amounting to 23.5 percent of unpaid principal balances -- were made directly to businesses. Follow-up conversations with credit unions suggest that many institutions reported "borrower is a business" because they either thought of these loans that way (even though they are truly made to the member) or because they didn't have the household income data available. However, only not-for-profits and business members of community credit unions are eligible to directly receive member business loans. Thus, we question whether these survey results are reliable.

As an alternative measure of member business lending to low- and moderate-income households, we examined Call Report data for the 541 "low-income" credit unions operating as of year-end 1999. These credit unions had $293 million in member business loans outstanding as of that date. Of course, the Call Report does not distinguish member business loans by household

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35 For example, as noted above, many member business loans are for non-owner occupied rental properties with long-term mortgages. In this case, the credit union may have only had income data (household or personal) as of loan origination, which could have been years before the time of our survey.

income. Some low-income credit unions may make loans to non-low-income households, and non-low-income credit unions may make loans to low-income households.

Table 5: Distribution of Member Business Loans by Member Household Income
(As of June 30, 1999)

Member Household Income	Distribution of Dollar Value of Loans Outstanding	Distribution of Number of Loans Outstanding
Under $30,000	13.2%	25.3%
$30,001-$50,000	15.1%	20.1%
$50,001-$100,000	26.3%	23.6%
$100,001-$250000	16.1%	8.4%
Over $250,000	5.8%	1.3%
Borrower is Business	23.5%	21.4%
Total	100.0%	100.0%

d. Additional Analysis

For each of the credit unions that responded to our survey, we identified its NCUA region, and its common bond and charter type. [36] This subsection provides additional details on the survey results to show how member business lending varied by region, common bond, and charter of the responding credit unions.

Table 6 reports the survey results for member business loans by collateral type and NCUA Region. The geographical differences are pronounced. First, taxicab medallions secured 64 percent of the member business loans in the Albany region, whereas non-agricultural real estate secured 85 percent or more of the member business loans in the Atlanta, Capital, and Pacific districts. The remaining two districts -- Austin and Chicago -- make almost all of the credit union member business loans backed by some type of agricultural collateral, either real estate, equipment, or crops and livestock.

Table 6: Distribution of Member Business Loans by Collateral Type
and NCUA Region

36 The six NCUA Regions are: Albany NY, Atlanta GA, Chicago (Lisle, IL), Pacific (Concord, CA), Capital (Alexandria, VA), and Austin TX.

(As of June 30, 1999)

Collateral Type	NCUA Region					
	Albany	Atlanta	Austin	Capital	Chicago	Pacific
Agricultural Real Estate	0.1%	0.8%	20.7%	3.4%	12.4%	0.62%
1Agricultural Equipment	0.0%	0.9%	16.9%	0.7%	7.6%	0.17%
Crops and Livestock	0.0%	0.0%	19.1%	0.1%	1.3%	0.80%
Non-Ag Real Estate	28.8%	92.3%	27.2%	84.9%	62.8%	92.28%
Non-Ag Equipment	2.2%	2.1%	10.3%	3.0%	10.2%	3.07%
Accounts Receivable	0.1%	0.0%	0.9%	0.7%	0.2%	0.08%
Inventory	0.3%	0.3%	1.3%	0.2%	0.5%	0.24%
Taxicab Medallions	64.4%	0.0%	0.0%	2.6%	0.0%	0.03%
Other Collateral	3.9%	3.1%	3.3%	2.2%	3.5%	1.96%
No Collateral	0.1%	0.4%	0.3%	2.2%	1.6%	0.76%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.00%

Table 7 reports survey results on the differences in member business loans among the various common bond types: occupational, association, community, or other. 37 Community credit unions had the most diversity in collateral backing member business loans. Associational credit unions, by contrast, used non-agricultural real estate as collateral for over 90 percent of their member business loans. Taxicab medallions secured nearly half of the member business loans made to individuals in occupational credit unions. 38 Another 41 percent of member business loans made by occupational credit unions was secured by non-agricultural real estate.

Table 7: Distribution of Member Business Loans by Collateral Type
and Common Bond Type
(As of June 30, 1999)

Collateral Type	Common Bond Type

37 In our analysis, "occupational" credit unions include both those identified as single-common-bond occupational credit unions and multiple common bond credit unions where the primary membership group was an occupation or employer. We defined associational and community common bond credit unions to have a single membership group. Credit unions in the "other" common bond category include: (1) a small number of single-common bond credit unions not otherwise defined; and (2) a larger collection of multiple common bond credit unions that have no primary occupational group, have multiple associational groups, or have both occupational and associational groups in their field of membership.

38 According to the NCUA, eight credit unions -- three federal credit unions and five state credit unions -- have been chartered for the principal purpose of making loans to taxi drivers.

	Community	Association	Occupational	Other
Agricultural Real Estate	8.1%	3.8%	1.9%	11.1%
Agricultural Equipment	5.4%	1.0%	1.8%	9.2%
Crops and Livestock	2.4%	0.1%	2.1%	9.9%
Non-Ag Real Estate	65.7%	90.2%	40.6%	51.4%
Non-Ag Equipment	10.5%	2.0%	2.1%	7.9%
Accounts Receivable	0.2%	0.1%	0.1%	0.6%
Inventory	1.0%	0.0%	0.2%	1.0%
Taxicab Medallions	0.4%	0.0%	47.6%	6.2%
Other Collateral	5.1%	1.6%	3.3%	2.5%
No Collateral	1.2%	1.1%	0.3%	0.2%
Total	100.0%	100.0%	100.0%	100.0%

Finally, we measured the differences in our survey results between federally chartered credit unions and state chartered credit unions. While 55 percent of our survey respondents had federal charters, state-chartered credit unions accounted for 74 percent of the member business loans reported in response to our survey. Table 8 shows that federally chartered credit unions relied on non-agricultural real estate as collateral for more than half of their member business loans, while state-chartered credit unions relied more on agriculture-related collateral and taxicab medallions.

Table 8: Distribution of Member Business Loans by Collateral Type and Charter Type (As of June 30, 1999)

Collateral Type	Charter Type	
	Federal	State
Agricultural Real Estate	2.3%	6.2%
Agricultural Equipment	8.1%	13.7%
Crops and Livestock	4.9%	10.4%
Non-Ag Real Estate	55.2%	25.8%
Non-Ag Equipment	10.6%	9.3%
Accounts Receivable	0.4%	0.7%
Inventory	0.8%	1.0%
Taxicab Medallions	4.7%	17.3%
Other Collateral	8.5%	5.9%
No Collateral	4.5%	9.6%

Total	100.0%	100.0%

2. Business Purpose Loans

As noted in the earlier section on survey methodology and response, we chose to ask credit unions about their business purpose loans. As previously noted, business purpose loans do not meet the NCUA's definition of a member business loan but they are loans of less than $50,000 made to a credit union member for a business purpose. We asked credit unions to estimate the number and dollar value of their business purpose loans.

For those credit unions that make member business loans, we found that many were confused by the difference between business purpose loans and member business loans. While we were careful in the survey structure and survey instructions to differentiate between these two categories of loans, 35 percent of the credit unions responding to our member business lending survey reported the same dollar amount for both categories. Consequently, we believe that the distinction between the two concepts is not clear and that our survey results on business purpose loans should be interpreted with caution.

For the 658 credit unions that did not report the same figure for both business purpose loans and member business loans, 394 (60 percent) reported having business purpose loans on their books. These 394 credit unions estimated that they had 20,863 business purpose loans outstanding -- an average of 53 per institution. These credit unions further estimated that the dollar value of these loans was $362 million -- or $17,362 per loan.

For those credit unions that do not make member business loans, we found that only 103 of the 643 credit unions (16 percent) that provided usable responses to our survey reported having any business purpose loans outstanding. These credit unions estimated that they had a total of 3,031 business purpose loans outstanding as of June 30, 1999 -- or approximately 30 per institution. The respondents estimated that the total dollar value of these loans was roughly $27 million, or $8,850 per loan.

We compared these two sets of survey results -- those from credit unions that also made member business loans and those from credit unions that did not. The results of a statistical test indicate a statistically significant difference in business purpose lending between the group of credit unions that makes member business loans and the group that does not. 39 Credit unions that also make member business loans make more, and larger, business purpose loans than those that do not make member business loans.

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39 We conducted a test of the differences in the means of both total number of business purpose loans and the total dollar value of these same loans based on the survey data. Both tests rejected the null hypothesis of no statistical difference between credit unions with member business loans and those without member business loans.

IV. The Credit Union Membership Access Act and Member Business Lending

The Credit Union Membership Access Act of 1998 imposed aggregate limits on member business lending with some exceptions. Still, we expect the volume of member business lending to continue to grow because of the expanded membership opportunities provided for in the Act.

A. Business Lending Restrictions

The Act limited a credit union's business lending activity to the lesser of either 1.75 times actual net worth or 12.25 percent of total assets (i.e., 1.75 times the minimum net worth requirement for a credit union to be deemed "well capitalized. ") 40 However, there are several exceptions to these limits. A credit union may be exempt from the member business lending limits if the NCUA Board determines either that the credit union was chartered for the purpose of making, or that it has a history of primarily making, such loans. 41 The Act also provides exceptions for credit unions that serve predominately low-income members (i.e., low-income credit unions) and those that are Community Development Financial Institutions (CDFIs). 42

The NCUA issued a final rule in May 1999 instituting these statutory exceptions and outlining the criteria by which they will be granted. 43 Part 723 now offers two different methods for determining whether a credit union has a history of making business loans.44 First, credit unions with member business loans that totaled at least 25 percent of total loans on any Call Report between January 1995 and September 1998 are deemed to have such a history. Second, institutions with member business loans that comprised their largest loan category on any of these same Call Reports are also eligible for the exception.

For credit unions seeking an exception based on the fact that they were "chartered for the purpose of ... primarily making business loans, " the NCUA seeks sufficient documentation. 45 Such evidence may include the original charter, original bylaws, original business plan, original field of membership, board minutes, or loan portfolio. 46

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40 12 U.S.C. § 1757a(a). The Act specifies that a credit union is " well capitalized" if it has a net worth ratio of not less than 7 percent and it meets any applicable risk-based net worth requirement. 12 U.S.C. § 1790d(c)(1)(A).

41 12 U.S.C. § 1757a(b)(1).

42 12 U.S.C. § 1757a(b)(2).

43 64 Fed. Reg. 28,721 (May 27, 1999).

44 12 C.F.R. § 723.17(c).

45 12 U.S.C. § 1757a(b)(1)

46 12 C.F.R. § 723.17(b)

Exceptions for low-income credit unions and those that are certified as CDFIs are covered by separate guidelines. NCUA regulations provide generally that a low-income credit union is one in which the majority of members either:

earn less than 80 percent of the average for all wage earners in the given area;
earn at or below 80 percent of the median household income for the nation; or
are otherwise determined to be low-income members by the NCUA Board. 47

CDFI status, on the other hand, is certified by the Community Development Financial Institutions Fund, a component of the Department of the Treasury. 48

As of year-end 1999, the NCUA had granted 90 exceptions to the aggregate member business lending limits.

B. The Effect of the Credit Union Membership Access Act on Credit Union Member Business Lending

Credit union member business lending steadily increased during the 1990s. Aggregate member business lending went from $2.0 billion as of year-end 1993 to $4.3 billion as of mid-year 2000 – an increase of 115 percent. However, member business lending has remained relatively stable at about one percent of total credit union assets. The number of credit unions with outstanding member business loans went from 1,390 in 1993 to 1,493 in 1999, a 7 percent increase.

Table 9 compares the overall volume and growth of credit union member business lending with bank and thrift commercial lending between 1993 and 1999. Credit unions' $3.9 billion in member business loans as of year-end 1999 is significantly less than banks' $824.7 billion or thrifts' $20.3 billion. While the growth in credit union business lending (97.5 percent) over this period exceeds that of banks (84.2 percent), it falls significantly short of thrifts (240.0 percent).

Table 9: Federally Insured Depository Institution Commercial Loan Growth: 1993-1999

Year	Credit Unions		Banks		Thrifts	
	($ billions)	(% Chg.)	($ billions)	(% Chg.)	($ billions)	(% Chg.)
1993	$2.0	---	$447.8	---	$6.0	---

47 12 C.F.R. § 701.34.

48 12 C.F.R. § 1805, subpart B

1994	$2.9	46.2%	$488.7	9.1%	$5.2	-12.4%
1995	$2.4	-18.9%	$540.4	10.6%	$7.2	37.4%
1996	$2.7	14.0%	$575.8	6.5%	$9.4	30.4%
1997	$2.9	8.2%	$643.2	11.7%	$11.5	22.6%
1998	$3.3	14.4%	$735.7	14.4%	$15.6	35.3%
1999	$3.9	18.0%	$824.7	12.1%	$20.3	30.6%
1993-1999	---	97.5%	---	84.2%	---	240.0%

Source: Sheshunoff Information Services, Inc., BankSearch.
Note: Credit union data is total member business loans. Bank and thrift data is total commercial and industrial lending by domestic bank offices.

Overall, we expect the volume of credit union business lending to continue to increase. Certain provisions in the Credit Union Membership Access Act will tend to aid this growth, while others will serve to hinder it.

We expect that changes to the credit union membership restrictions in the Act will increase member business lending for two reasons. First, by expanding membership opportunities, the Act should serve to increase overall credit union membership and asset growth. Moreover, Call Report data indicate that the credit unions that offer business loans tend to be the larger institutions. 49 Therefore, we expect as credit unions grow, their propensity to make member business loans will increase. Second, more credit unions have adopted community charters in recent years. Community credit unions can accept businesses as members. 50 As a result, we expect to see a greater number of credit unions engaged in member business lending in the future.

On the other hand, the member business lending restrictions contained in the Act, coupled with risk-based net worth requirements issued by the NCUA, should temper this expected growth.

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49 Federally insured credit unions with member business loans averaged $114 million in total assets, while those without such loans averaged $26 million.

50 63 Fed. Reg. 71,998, 72,037 (Dec. 30, 1998) (Chartering Manual).

First, the statutory limit on member business loans to 12.25 percent of assets serves as a binding constraint on long-term growth in this product market. Credit unions that are active business lenders qualify for an exception to this limit. Still, those credit unions are subject to a marginal net worth requirement of 14 percent on member business loans exceeding the statutory limit. 51 This regulation could temper the future growth of member business lending by those credit unions that exceed the 12.25 percent limit.

As for the competitive implications of the Act's membership and business lending provisions, it is reasonable to expect that some of these additional business loans will be new, while others will have been competed away from other depository institutions. Over the next few years, the total effect on other depository institutions should be modest -- especially given credit unions' relatively minor role in serving commercial borrowers. At the same time, there likely will be an increasing incidence of credit unions competing commercial loans away from other depositories in specific local markets. 52

RISKS ASSOCIATED WITH CREDIT UNION MEMBER BUSINESS LENDING

While commercial loans are generally riskier than consumer loans, credit union member business lending tends to be less risky than business lending by banks and thrifts. A simple stress test of the effect of credit union failures precipitated by member business lending on the National Credit Union Share Insurance Fund indicates that the insurance fund would remain solvent if every member business loan defaulted at a loss of 100 percent, assuming no other losses at those credit unions.

A. Commercial Loans are Generally Riskier than Consumer Loans

Banks and thrifts broadly delineate their loan portfolios into consumer and commercial lending. The principal reason for this distinction stems from the personal responsibility for debt repayment assumed with consumer credit. By contrast, when commercial enterprises borrow, firm shareholders generally assume limited liability for the debt.

Consumer lending tends to be less risky than commercial lending for at least three additional reasons:

original amounts on consumer loans are usually smaller than those on commercial loans; consumer loans are often secured by readily marketable collateral such as a house or car; and

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51 65 Fed. Reg. 44,950, 44,968 (July 20, 2000) (to be codified at 12 C.F.R. § 702.106(b)(2)).

52 For example, in 1999, three Wisconsin credit unions formed a for-profit (and taxable) service corporation known as Business Lending Group to offer commercial loans up to $1 million. According to *Credit Union Times*, as of October 2000, Business Lending Group had closed $30 million in loans averaging $400,000 (Elaine Kingoff, *Credit Union Times*, November 29, 2000, p. 1,14).

borrower riskiness is more easily determined through the use of consumer credit reports and credit scoring models.

B. Member Business Loans are Generally Less Risky than Commercial Loans Made by Banks and Thrifts

Credit union member business loans are generally loans to individuals for business purposes. Because an individual (or group of individuals) is personally liable for the debt, member business loans tend to be smaller and less risky than typical business loans made by banks and thrifts. Indeed, credit union member business loans share many characteristics of consumer loans. That is, these loans are generally smaller and fully collateralized, and borrower risk profiles are more easily determined. As a result, the credit risk associated with member business loans may be less than that for most bank and thrift commercial loans.

There are some exceptions to this general rule. First, community credit unions can directly take in businesses as members. (A loan in this case would be made to the business, but would still require a personal guarantee.) Second, loans to non-profit entities do not require personal guarantees. Third, credit card line-of-credit programs offered to businesses are unsecured. Lastly, NCUA Regional Directors have authority to waive security and collateral requirements. Each of these exceptions provides for a possible increase in the credit risk associated with a particular loan.

Table 10 provides information on business loan delinquencies and charge-offs for credit unions, banks, and thrifts. Credit unions define loan delinquency somewhat differently than do banks and thrifts so comparisons of delinquency rates should be interpreted cautiously. 53 Ongoing delinquencies -- for credit unions, loans more than 60 days past due, and for banks and thrifts, loans more than 90 days past due -- are lower for credit unions than for banks and thrifts. Credit unions' mid-year 2000 loan charge-off rate of 0.03 percent was much lower than that for either commercial banks (0.60 percent) or savings institutions (0.58 percent).

Table 10: Business Loan Delinquencies and Charge-Offs as a Percent of Total Business Loans (As of June 30, 2000)

	Recent Delinquencies[4]	Ongoing Delinquencies[5]	Net Charge-offs[6]
All Credit Unions[1]	1.52%	0.32%	0.03%

53 Term of delinquency categories vary between credit unions, on one hand, and banks and thrifts on the other due to differences in reporting. Credit unions report recently delinquent loans as those 60 days or less past due; banks and thrifts report recent delinquencies as 90 days or less past due. Credit unions report ongoing delinquencies as more than 60 days past due whereas banks and thrifts report such delinquencies as more than 90 days past due.

All Commercial Banks[2]	0.85%	1.41%	0.60%
Banks with total assets less than $100 million	1.43%	1.33%	0.36%
Banks with total assets between $100 million and $1 billion	1.25%	1.19%	0.36%
All Savings Institutions[3]	1.42%	1.25%	0.58%
Thrifts with total assets less than $100 million	1.79%	1.94%	0.44%
Thrifts with total assets between $100 million and $1 billion	1.31%	0.90%	0.56%

[1] Credit union business loans are defined as total member business loans.

[2] Commercial bank business loans are defined as total commercial and industrial loans. It also includes "all other loans" for institutions with fewer than $1 billion in total assets.

[3] Savings institutions include both savings associations and savings banks. For savings institutions, business loans are defined as total commercial and industrial loans.

[4] Recent delinquencies are defined as those less than 60 days past due for a credit union loan and less than 90 days past due for bank and thrifts loans.

[5] Ongoing delinquencies are defined as those more than 60 days past due for a credit union loan and more than 90 days past due for bank and thrifts loans.

[6] Charge-offs less recoveries.

Source: Sheshunoff Information Services, Inc., BankSearch and FDIC Quarterly Banking Profile, 2nd Quarter, 2000.

C. Risk to the Share Insurance Fund

In order to assess the current risk exposure of the Share Insurance Fund to member business lending, we ran a series of simple stress tests. Using year-end 1999 Call Report data, we alternately assumed that 25 percent, 50 percent, 75 percent, and 100 percent of credit union member business loans defaulted -- with total loss. To the extent that these losses resulted in credit union failures -- that is, left a credit union with negative net worth -- we then charged

those losses in excess of a credit union's net worth to the Share Insurance Fund. We emphasize that these stress tests are hypothetical and do not represent a judgement that the outcomes are likely. Rather, the tests seek to gauge the Share Insurance Fund's ability to withstand a negative shock to credit unions' member business loan portfolios.

As of December 31, 1999 the Share Insurance Fund reported total equity of $4.2 billion. The Share Insurance Fund's reserve ratio – the ratio of its total reserves to total insured deposits -- was 1.24 percent at that time.

Table 11 presents the results of our four stress scenarios. If every credit union member business loan outstanding as of December 31, 1999, defaulted at a total loss to the credit union, and the credit unions suffered no other losses, the Share Insurance Fund would have remained solvent by $3.1 billion. We conclude that, at this time, member business lending alone does not pose material risk to the Share Insurance Fund.

Table 11: Results of Member Business Lending Stress Tests on the Share Insurance Fund
(As of December 31, 1999)

Percent of Member Business Loans that Completely Fail	Number of Credit Unions Projected to Fail	Loss to the Share Insurance Fund (in million of dollars)	Share Insurance Fund Reserve Ratio After Losses
0%	0	$0	1.24
25%	18	$51	1.22
50%	48	$272	1.16
75%	67	$667	1.04
100%	91	$1,097	0.92

COMPETITION BETWEEN CREDIT UNIONS AND OTHER DEPOSITORY INSTITUTIONS IN BUSINESS LENDING

Congress asked whether credit unions have a competitive advantage in business lending over other depository institutions. While credit unions have certain competitive advantages, such as sponsor subsidies and federal income tax exemption, they also face constraints not faced by other depository institutions. These constraints include limitations on eligibility for member business loans and the restrictions placed on credit unions in making member business loans.

A. Credit Unions Have Certain Competitive Advantages

Relative to banks and thrifts, credit unions have an inherent cost advantage in at least two areas. Specifically, some credit unions are sponsor-subsidized and all of these institutions are exempt from federal income taxation.

First, many occupational and associational credit unions receive sponsor subsidies such as free or reduced-cost operating facilities and equipment. These credit unions may also economize on marketing costs through the simple use of posters and advertisements stuffed in employee paychecks or association newsletters to reach their membership.

Second, credit unions are exempt from federal corporate income taxes. This exemption may allow credit unions to offer more competitive deposit and loan rates, other things being equal. This exemption also aids credit unions in building their net worth, which can only be accomplished through retained earnings.

B. Restrictions on Credit Unions

Credit unions face certain legal restrictions on their business lending that are not applicable to other depository institutions. These limitations are in the form of limitations on the eligibility to receive such loans and on the loans themselves.

First, individuals sharing common bonds of association, occupation, or geographic area define a federal credit union's field of membership. As a result, credit unions may only accept deposits from, and make loans to, eligible members. Such membership limitations are a distinct characteristic of credit unions. However, the Act's allowance for multiple common bond credit unions and the increased popularity of community credit unions make the membership restrictions less binding than in the past.

Second, as described earlier in this report, credit unions face greater constraints in making business loans than do banks and thrifts. For instance, credit union member business lending is generally constrained by the fact that these loans:

can only be made to credit union members;
generally require the personal guarantee of the borrower;
generally require full collateralization; and
are subject to a portfolio limitation of 12.25 percent of total assets.

C. Balancing Advantages and Disadvantages

It is not possible to quantify the value of credit unions' advantages, and the costs of credit unions' added constraints, in making member business loans. Thus, we cannot discern whether or not credit unions have a competitive advantage. It seems reasonable, however, that in some particular situations a credit union may have a competitive advantage, but in other cases not. In any event, credit union membership restrictions and the general requirements for personal guarantees and full collateralization limit the universe of business loans for which credit unions and other depository institutions directly compete.

Two trends point to an increase in credit union member business lending in the future. First, as credit unions continue to increase in size, while decreasing in number, a greater proportion of credit unions will likely pursue this business line. These credit unions will have larger and more diverse memberships and will have the capital and managerial sophistication

necessary to compete vigorously in this market. Second, an increasing movement to community credit unions opens the door to more businesses becoming credit union members and hence eligible for member business loans.

Congress also asked us whether credit unions' competitive advantage – if it exists – could affect the viability and profitability of other insured depository institutions. At this time, member business lending is a relatively small product line for credit unions and credit unions are unlikely to have a systematic competitive advantage relative to other depository institutions in making these loans. Based on these findings, we conclude that today credit unions' member business lending has no material affect on the viability and profitability of other insured depository institutions. Indeed, all types of depository institutions have been very profitable in recent years. As of year-end 1999, credit unions' combined return-on-assets was 0.91 percent compared to 1.24 percent for banks and 0.94 percent for thrifts.

Summary

Treasury prepared this study pursuant to section 203 of the Credit Union Membership Access Act of 1998. The study mandate directed us to investigate six specific issues pertaining to credit union member business lending.

We found that credit unions are generally not active commercial lenders, as member business lending remained at about one percent of total credit union assets during the 1990s. As of June 30, 2000, only 92 of 10,477 credit unions had total member business loans outstanding exceeding their net worth. These credit unions accounted for 46 percent of the unpaid principal balance of member business loans at that time.

We found that most member business loans are for modest amounts. Our survey results showed that three-quarters of member business loans had balances less than $100,000, and that about three-quarters were collateralized by non-agricultural real estate, taxicab medallions, and agricultural-related assets. Service businesses, rental property, and agriculture were the three most frequent types of businesses receiving member business loans, both in terms of the number of loans and the unpaid principal balances.

We found that the NCUA's member business lending regulations should be quite effective at limiting the credit risk associated with these loans. Their specific requirements concerning personal guarantees, portfolio limits, and collateral are much more stringent than those faced by banks and thrifts. Still, we found that the NCUA's enforcement of its member business lending regulations falls short of the requirements set forth by examiner guidance. This was evident in the NCUA's approach to granting waivers from the regulatory limits, our difficulty ascertaining regulatory compliance from examination reports, and the NCUA's follow-up on compliance problems.

We found that member business loans are generally less risky than commercial loans made by banks and thrifts because they generally require the personal guarantee of the borrower and generally must be fully collateralized. Data on member business loan charge-offs for credit

unions, compared to charge-off rates for commercial loans made by banks and thrifts, support this conclusion.

Our survey results suggested that 25.3 percent of member business loans were made to members with household income of less than $30,000. These loans totaled 13.2 percent of the outstanding member business lending balances reported by our survey respondents. The survey results showed that another 20 percent of the loans (with 15 percent of the outstanding loan balances) went to households with incomes reported to be between $30,000 and $50,000. Because of data collection problems described in the report, however, we believe these figures should be interpreted with a great deal of caution.

Credit unions do have advantages over banks and thrifts in making business loans in that some credit unions receive sponsor subsidies, and all are exempt from the federal corporate income tax. However, credit unions do face certain constraints in the form of limitations on membership, and stricter rules governing business lending.

We found that credit union's business lending currently has no effect on the viability and profitability of other insured depository institutions. In certain instances, however, credit unions that are particularly active business lenders may be a source of competition for small banks and thrifts operating in the same geographic areas.

We found that the relaxation of membership restrictions in the Act should serve to further increase member business lending by spurring credit union growth. However, the member business lending limitations in the Act, coupled with risk-based net worth requirements, should temper this growth.

APPENDIX

We conducted two surveys to determine the scope of credit union business lending. The first was a comprehensive survey of all credit unions that reported member business loans on their June 30, 1999 Call Report. In this case, we asked credit unions to complete seven tables of information about their member business loans outstanding. We also asked these credit unions whether they had any business purpose loans outstanding. Both the credit unions that reported making member business loans and a stratified sample of other credit unions were asked about business purpose loans. This appendix presents the survey questions and aggregates the credit unions responses.

All credit unions received the following questions about business purpose loans.

Small Loans for Business Purposes

Under NCUA regulations, loans, lines of credit, and letters of credit are generally classified as member business loans if they are made for commercial, corporate, business, or agricultural purposes. However, loans for these purposes are not counted as "member business loans" if, when added to all other such loans to one borrower, the sum is less than $50,000. These smaller

credits are referred to more broadly as "business purpose" loans and recorded as consumer loans. (An example might be a new vehicle loan to a member that purchases a pickup truck for his/her construction business.)

Does your credit union have any "business purpose" loans outstanding? __ Yes __ No

If so, for loans outstanding as of June 30, 1999 please estimate:

(1) The number of such loans used for business purposes: _____

(2) The aggregate dollar value of these business purpose loans: $_____

Member Business Loans

Did your credit union have any member business loans outstanding as of June 30, 1999?
Yes: ___ No: ___

If so, please check Yes and continue. If not, please check No and return the survey to the Treasury Department.

Note: The following data represent the 68% of credit unions that responded to the survey (1,030 of the 1,516 credit unions that make member business loans). Also, some credit unions were not able to provide data for all tables. Therefore, some tables may reflect data from fewer than the 1,030 respondent credit unions.

Table A-1: Total Dollar Volume of Business Loans (By Collateral Type and Loan Size)

Collateral Type	Loan Size				
	Under $50,000	$50,000 - $100,000	$100,001- $500,000	Over $500,000	Total
Agricultural Real Estate	$26,164,054	$40,213,000	$71,331,085	$1,907,489	$139,615,627
Agricultural Equipment	$50,948,446	$26,438,997	$24,736,864	$0	$102,124,307
Crops and Livestock	$33,046,261	$28,131,185	$30,448,396	$1,032,899	$92,658,741
Non-Agricultural Real Estate	$150,519,347	$282,501,938	$630,987,317	$433,546,385	$1,497,554,987
Non-Agricultural Equipment	$42,178,949	$33,094,328	$41,889,438	$9,596,946	$126,759,661
Accounts Receivable	$2,694,263	$1,124,787	$2,264,947	$0	$6,083,997

Inventory	$2,693,957	$2,285,839	$6,777,091	$762,725	$12,519,612
Taxicab Medallions	$34,915,277	$63,310,263	$503,124,408	$8,185,679	$609,535,627
Other Collateral	$31,714,862	$25,827,662	$24,526,154	$2,245,989	$84,314,667
No Collateral	$9,308,446	$2,768,182	$3,787,327	$0	$15,863,955
Total	$384,183,861	$505,696,181	$1,339,873,027	$457,278,112	$2,687,031,182

Table A-2: Number of Business Loans Outstanding (By Collateral Type and Loan Size)

Collateral Type	Loan Size				
	Under $50,000	$50,000 - $100,000	$100,001- $500,000	Over $500,000	Total
Agricultural Real Estate	998	564	432	12	2,006
Agricultural Equipment	4,142	441	157	0	4,740
Crops and Livestock	2,685	513	273	2	3,473
Non-Agricultural Real Estate	5,241	3,709	3,359	649	12,958
Non-Agricultural Equipment	2,646	546	474	58	3,724
Accounts Receivable	188	23	18	0	229
Inventory	146	51	75	95	367
Taxicab Medallions	1,652	915	2,834	14	5,415
Other Collateral	1,868	508	173	2	2,551
No Collateral	3,110	75	21	0	3,206
Total	22,676	7,345	7,816	832	38,669

The Types and Sizes of Businesses Served

Similar to above, please complete the following two tables relating business type and business sizes. Please classify each loan only once -- choosing the business type that best describes the loan. The information included in these tables should reflect the position of your credit union as of June 30, 1999.

Business types are delineated as:
manufacturing;
taxicabs;
service (other than taxicabs);
agriculture (including fishing);
real estate construction and development (including shopping centers and apa rtment complexes)
rental property (including second homes, vacation property, small office buildings, and small apartment buildings);
religious organizations;
other fraternal organizations; or
other business type.

The size of the businesses (as measured by total assets) are categorized as:
under $100,000;
$100,000-500,000;
$500,001-$1 million; and
over $1 million.

In the first table, present your credit union's total dollar amount of member business loans within the appropriate cell. In the second table, record the number of member business loans within the appropriate cell.
Table A-3: Total Dollar Volume of Business Loans (By Business Type and Size)

Business Type	Business Size (Total Assets)				
	Under $100,000	$100,000 - $500,000	$500,001 - $1 Million	Over $1 Million	Total
Manufacturing	$6,950,659	$8,905,738	$5,176,694	$3,971,027	$25,004,117
Service	$77,549,532	$400,679,408	$318,475,648	$30,627,444	$827,332,031
Agriculture	$141,540,748	$117,934,755	$30,422,080	$14,906,124	$304,803,706
Real Estate Construction and Development	$7,872,364	$42,595,616	$16,210,151	$25,075,992	$91,754,123

Rental Property	$215,298,894	$315,708,080	$107,033,648	$63,135,650	$701,176,273
Religious Organization	$2,666,316	$10,328,274	$12,332,122	$10,762,271	$36,088,983
Other Fraternal Organization	$1,290,581	$2,804,256	$143,776	$337,844	$4,576,457
Other Business Type	$47,392,925	$52,907,311	$19,046,093	$22,853,272	$142,199,601
Total	$500,562,020	$951,863,438	$508,840,210	$171,669,623	$2,132,935,291

Table A-4: Number of Business Loans Outstanding (By Business Type and Size)

Business Type	Business Size (Total Assets)				
	Under $100,000	$100,000 - $500,000	$500,001 - $1 Million	Over $1 Million	Total
Manufacturing	251	82	45	62	440
Service	3,177	4,881	2,011	382	10,451
Agriculture	6,830	2,474	496	184	9,984
Real Estate Construction and Development	156	230	70	93	549
Rental Property	5,149	2,779	497	279	8,704
Religious Organization	70	89	19	320	498
Other Fraternal Organization	31	22	5	1	59
Other Business Type	3,051	727	322	175	4,275
Total	18,715	11,284	3,465	1,496	34,960

Business Loans by Member Household Income

Congress directed the Treasury to determine the extent to which member business lending by insured credit unions helps to meet financial services needs of low- and moderate-income individuals within the field of membership of insured credit unions.

To that end, please report the distribution of your credit union's member business loans according to the borrowing members' income category. The information included in these tables should reflect the position of your credit union as of June 30, 1999.

Table A-5: Total Member Lending (By Member Total Household Income)

Member Household Income	Number of MBLs Outstanding	Total Dollar Amount of MBLs Outstanding
Under $30,000	6,393	$167,742,300
$30,000 - $50,000	5,094	$192,921,579
$50,001 - $100,000	5,959	$335,485,386
$100,001 - $250,000	2,122	$205,830,572
Over $250,000	328	$73,640,279
Borrower is a Business	5,401	$298,890,777
Total	25,297	$1,274,510,893

Business Loan Delinquencies

Please complete the following tables relating total business loan delinquencies and loan size. The information included in these tables should reflect the position of your credit union as of June 30, 1998.

As on the call report, delinquencies are delineated as:
1-less than 2 months;
2-6 months;
6-12 months; and
over 12 months.

Loan sizes are categorized as:
$50,000-100,000;
$100,001-500,000; and
over $500,000.

In the first table, present your credit union's total dollar amount of member business loans within the appropriate cell. In the second table, record the number of member business loans within the appropriate cell.

Table A-6: Total Dollar Volume of Delinquent Business Loans (By Length of Time and Loan Size)

Delinquency Period	Loan Size				
	Under $50,000	$50,000 - $100,000	$100,001 - $500,000	Over $500,000	Total
1 - less than 2 Months	$4,739,161	$4,923,935	$16,520,002	$1,342,556	$27,633,444
2-6 Months	$3,951,261	$3,848,765	$5,234,381	$16,804	$13,169,167
6-12 Months	$1,055,589	$1,550,168	$1,741,407	$1,982,036	$6,640,195
Over 12 Months	$754,065	$1,067,521	$1,430,065	$0	$3,634,515
Total	$10,500,076	$11,390,389	$24,925,855	$3,341,396	$51,077,271

Table A-7: Number of Delinquent Business Loans Outstanding (By Length of Time and Loan Size)

Delinquency Period	Loan Size				
	Under $50,000	$50,000 - $100,000	$100,001 - $500,000	Over $500,000	Total
1-less than 2 Months	279	69	98	16	463
2-6 Months	250	57	27	1	341
6-12 Months	63	11	11	1	96
Over 12 Months	56	14	9	0	88
Total	648	151	145	18	988

Business Loan Participations

Does your credit union have any member business loans outstanding that your credit union originated—a portion of which have been sold or participated with another financial institution?
36 Yes 994 No

If so, please estimate the total unpaid principal balance of the sold or participated portion of these member business loans. $ 228,457,786.38

EXHIBIT C

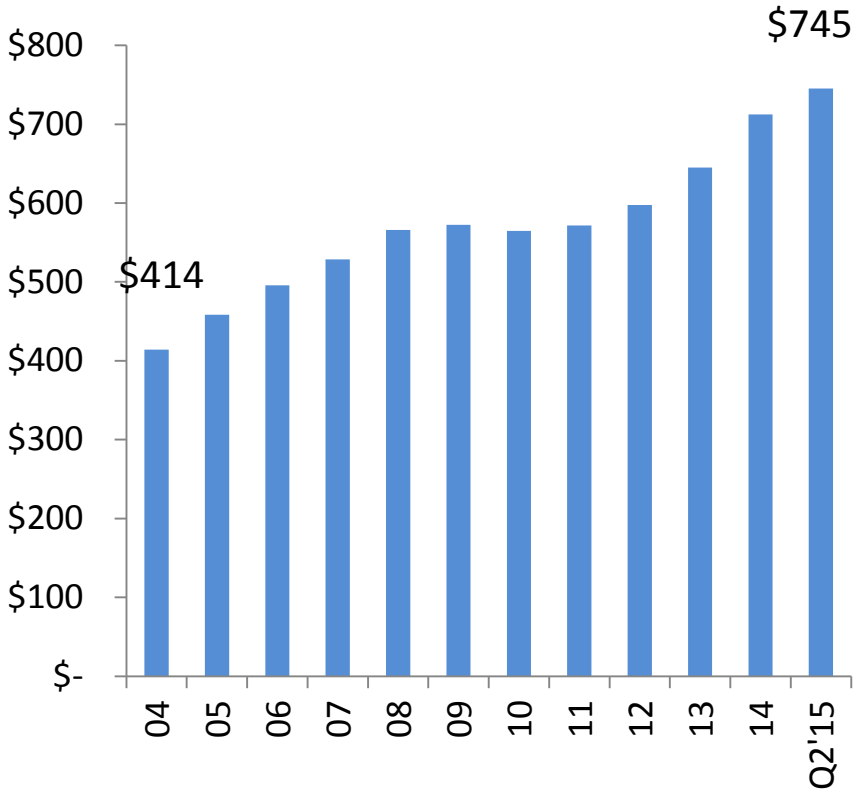
Vincent H. Vieten, MBL PO
Office of Examination and Insurance

MBL

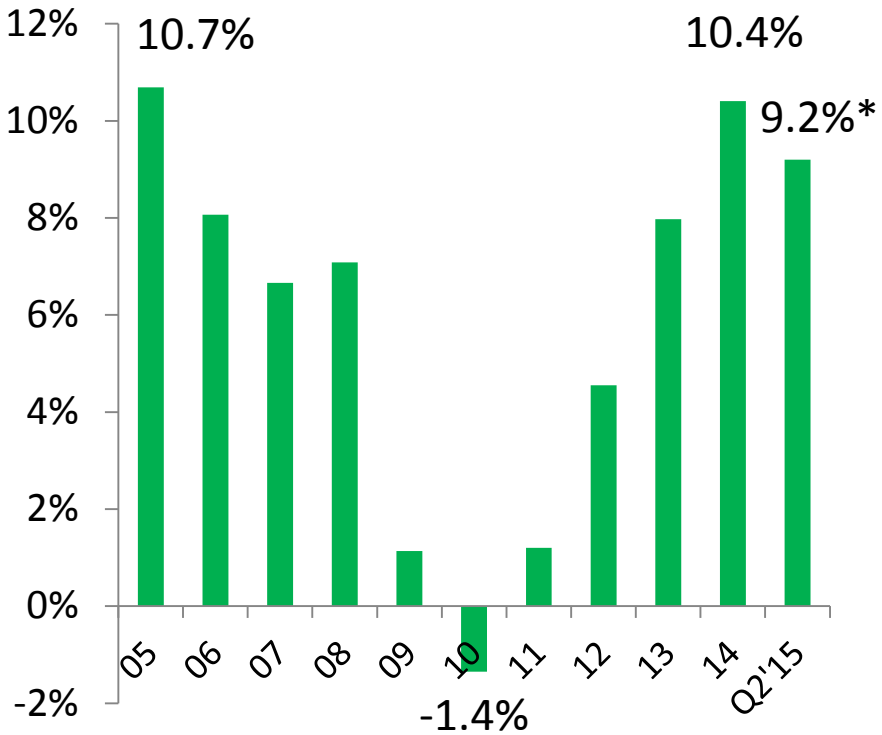
CUNA Lending Council Conference
Fort Lauderdale, FL
November 9, 2015

Credit unions continue to post strong loan growth in first half of 2015

Total Loan Outstandings ($ in billions)

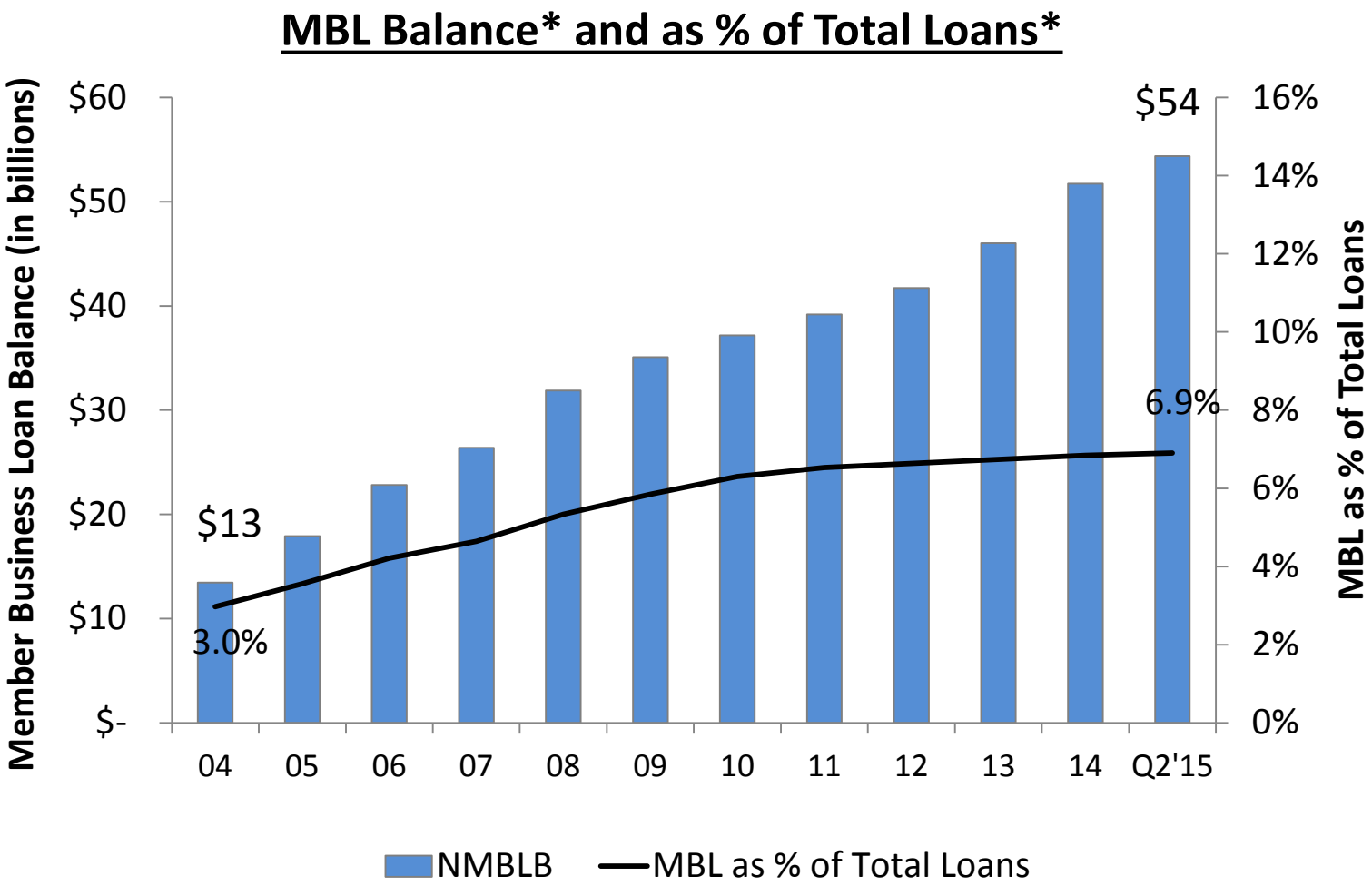


Loan Growth Rate



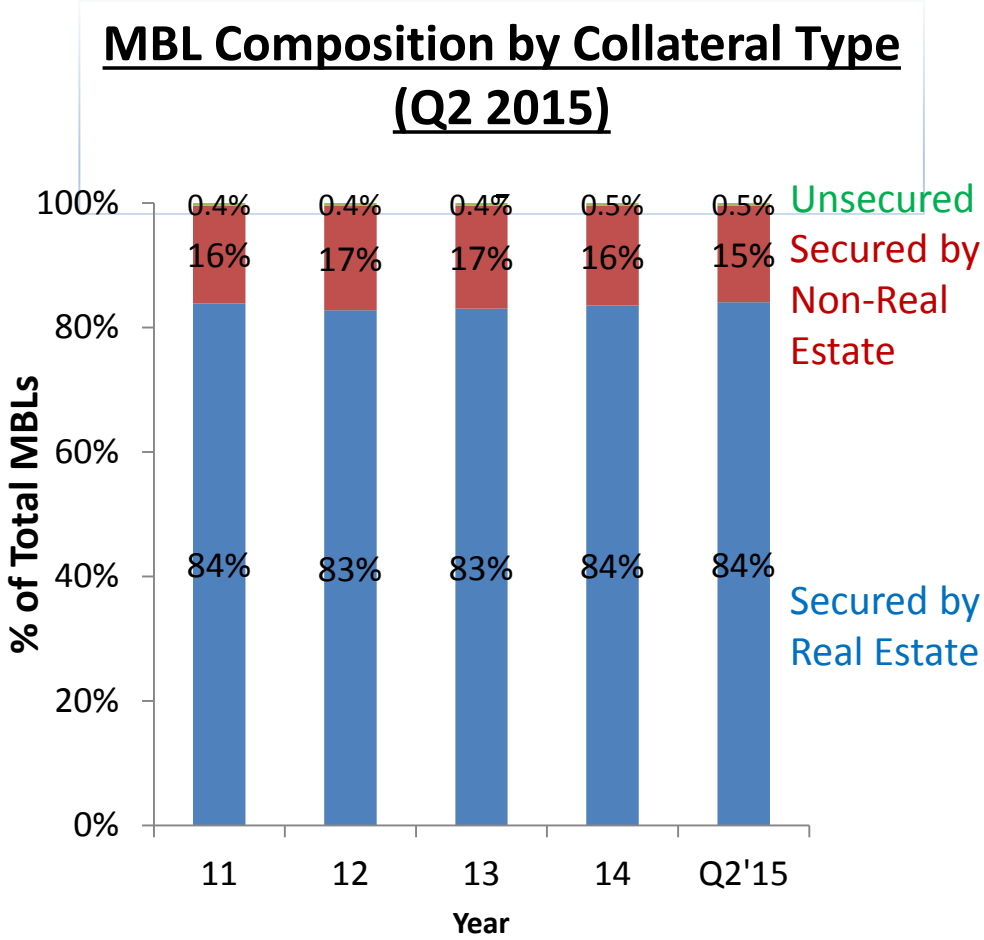
* Annualized growth rate for 2015 Q2

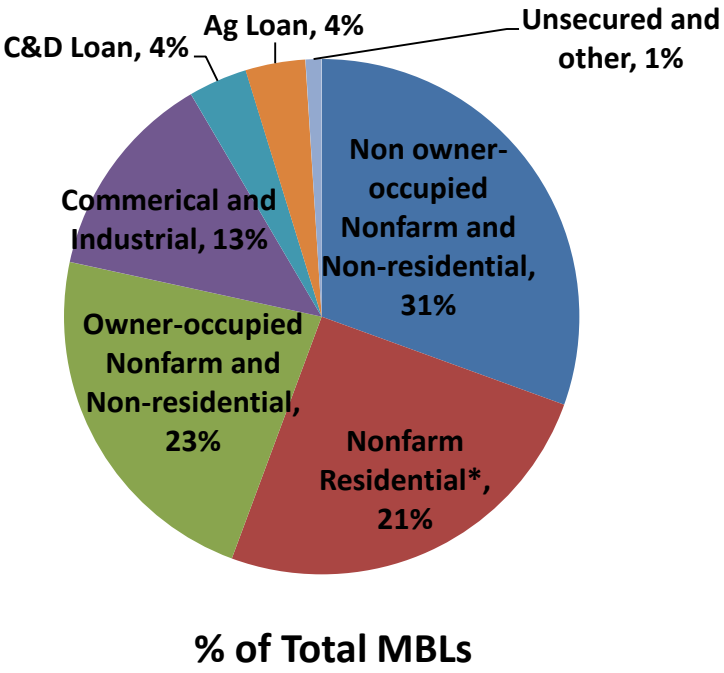
Member business loans have grown significantly over last ten years



- NMBLB, including both member and nonmember business loans. Including unfunded commitments
- MBL as % of total loans are calculated using MBL loan outstandings.

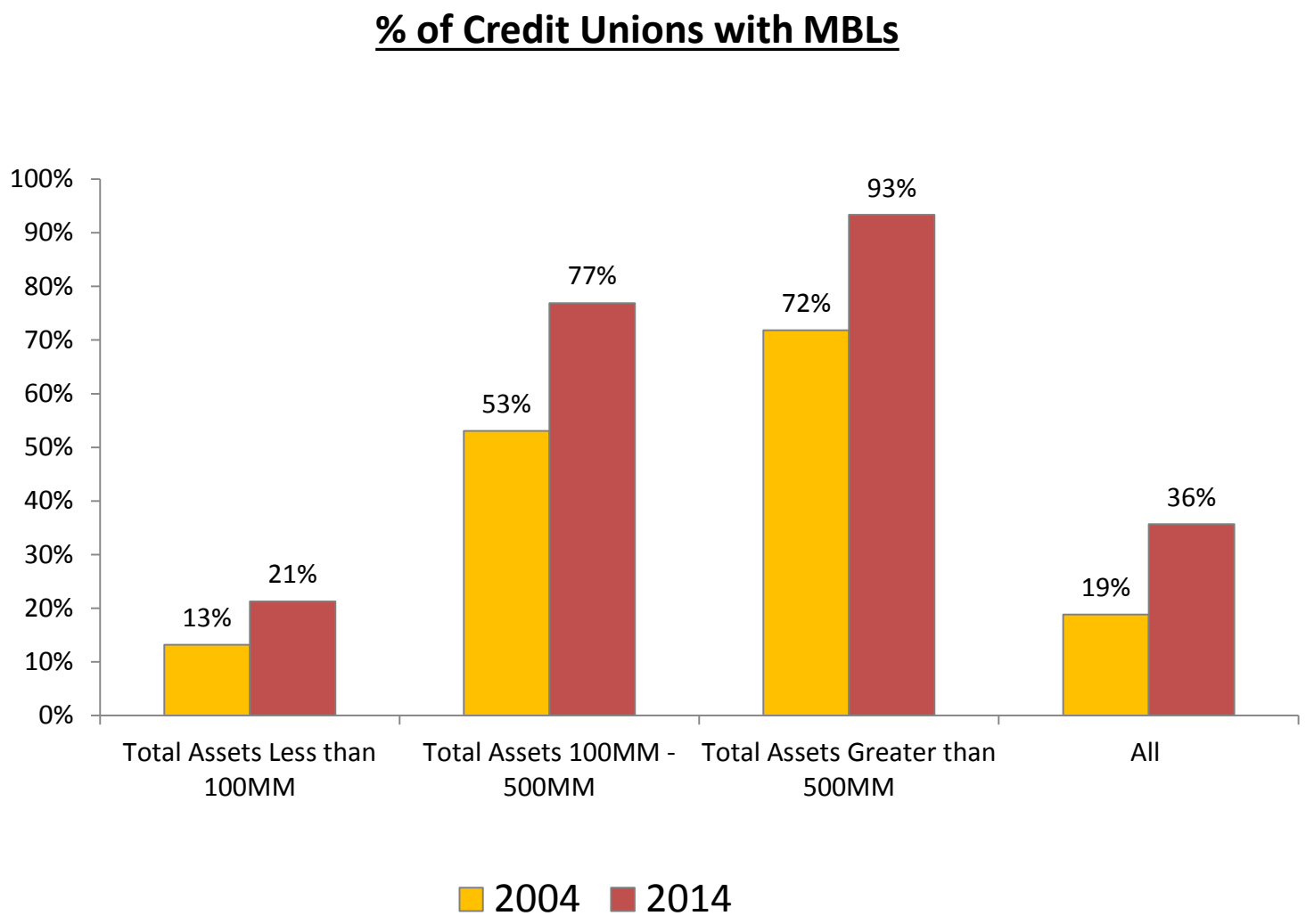
Majority of member business loans are secured by real estate





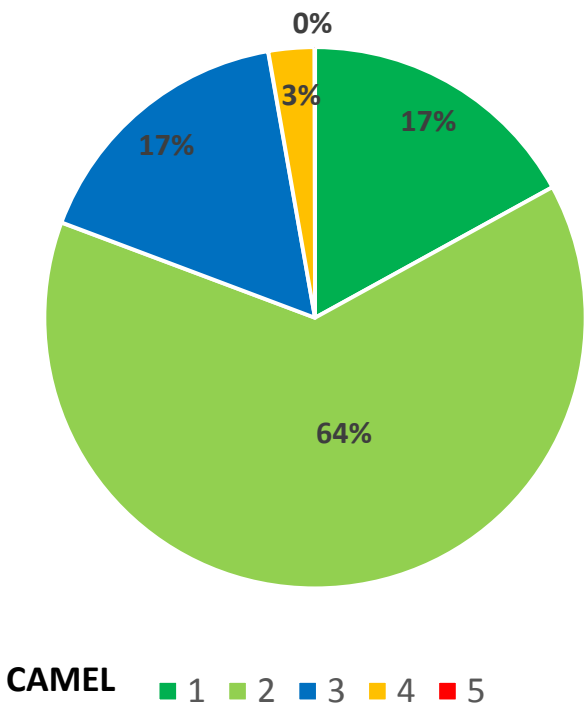
* Nonfarm, residential includes investor 1-4 family residential real estates.

A growing percentage of credit unions have MBLs

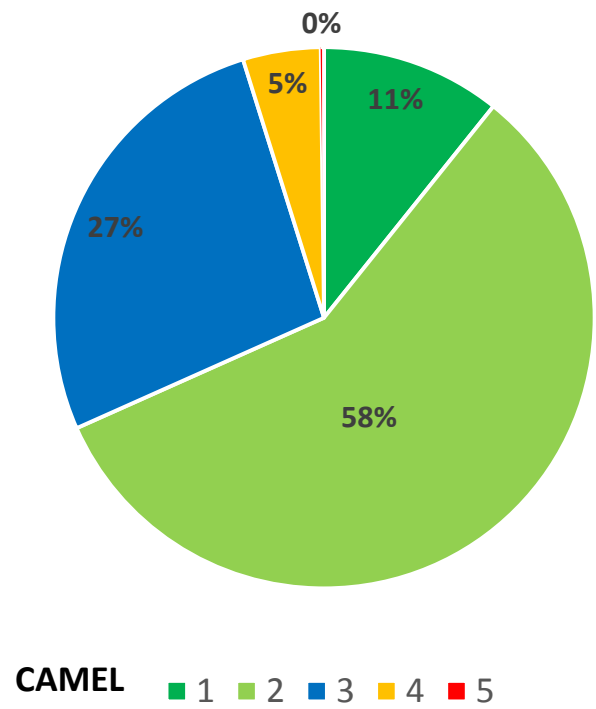


81% of credit unions with MBLs have a CAMEL rating of 1 or 2, compared to 69% for credit unions that do not offer MBLs

CAMEL Distribution for Credit Unions with MBLs (Dec. 2014)



CAMEL Distribution for Credit Unions without MBLs (Dec. 2014)



The role of prudent business lending in credit unions

- CUs are well suited to serve small businesses, a vital and growing segment of their membership
- Improving access to financial services for small businesses helps create jobs
- Properly structured & priced, MBLs can have a positive impact on earnings and net worth
- MBLs can enhance portfolio diversification
- MBLs potentially offset IRR of long-term, fixed-rate residential real estate loans
- The key beneficiary of prudent business lending is the member who will receive financing that meet their needs and within their ability to repay

Comparison of MBLs and Commercial Loans

Type of Loan	MBL	Commercial Loan
Loan fully secured by a 1- to 4- family residential property (borrower's primary residence)	No	No
Member business loan secured by a 1- to 4- family residential property (not the borrower's primary residence)	Yes*	No
Member business loan secured by a vehicle manufactured for household use	Yes*	No
Business loan with aggregate net member business loan balance less than $50,000	No	No

* If the outstanding aggregate loan balance is greater than $50,000.

Comparison of MBLs and Commercial Loans

Type of Loan	MBL	Commercial Loan
Commercial loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions	No	No
Commercial loan in which a federal or state agency (or its political subdivision) fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full	No	Yes*
Non-member commercial loan or non-member participation interest in a commercial loan made by another lender	No	Yes*

* If the outstanding aggregate loan balance is greater than $50,000.

Key Changes and Enhancements

Provision	Current Rule	Proposed Rule
Construction and Development Loans	• 25% equity interest • 15% of net worth	• Removed the limits • Clearly defines collateral valuation method • Requires CUs to value collateral appropriately and ensure risk sharing • Requires CUs to set internal policy limit • Stipulates loan administration requirements

Construction and Development Loans

- **Valuation of the collateral**
  - Lesser of Cost or Market
    - Market to be determined as Prospective Value (USPAP Statement 4)
    - Land contribution lesser of cost or market first 12 months market value after 12 months

- **Costs**
  - All costs necessary to complete the project documented in an approved budget
    - Interest reserve to be calculated based on projected completion/stabilization date (incl. in approved budget)
    - Exclude preferential payments to equity holders, selling cost to be paid from sales

Construction and Development Loans (cont.)

- **Requires approved budget**
- **Requisition process and schedule**
- **Disbursement of funds after an inspection is documented in a written report**
  - The report must state that work is completed along with certification the remaining budget amounts are sufficient to complete the project
- **Certification that there are no intervening liens**

Key Changes and Enhancements (cont.)

Provision	Current Rule	Proposed Rule
LTV	• 80%	• Removed the 80% limit • Requires sufficient collateral commensurate with the level of risk
Personal Guarantee	• Requires personal guarantee	• Removed the explicit requirement • Requires credit unions to determine and document mitigating factors when personal guarantee is not required. • Requires credit unions to set internal policy limits

LTV Requirement

- **Only CU loans and superior lien included in the LTV (All debt and related payments to be considered in ability to repay)**
- **Sufficient to share risk (borrower investment)**
- **LTV should reflect the impact of**
  - Potential obsolesces
  - Marketability
    - Single use
    - Condition
    - Alternatives uses
- **Overall risk of the transaction**
  - Financial trends of the borrower and guarantor
  - Industry
  - Management
  - Guarantor support

Key Changes and Enhancements (cont.)

Provision	Current Rule	Proposed Rule
Experience Requirements	• 2 years of direct experience	• Removed the 2 year requirement • Specifies the types of experience with emphasis on commercial credit risk management
Loan Policy Requirements	• Limited coverage on risk management processes	• Requires underwriting commensurate with size, scope and complexity • **Requires a reliable credit risk rating system** • Stipulates sound risk management processes

Key Changes and Enhancements (cont.)

Provision	Current Rule	Proposed Rule
MBLs to a Single Member	• The greater of $100K or 15% of net worth	• Maintains the 15% limit with added flexibility to go up to 25% if certain conditions are met • Modifies the definition of "associated borrower"
Unsecured MBLs	• Lesser of $100,000 or 2.5% of CU Net Worth to one member (Well Capitalized CUs only) • 10% of CU Net Worth	• Removed the limits • Requires credit unions to set internal policy limits

Key Changes and Enhancements (cont.)

Provision	Current Rule	Proposed Rule
Non-member business loan participations	• Included in the cap unless waiver is granted	• Removed non-member business loans from the calculation against the cap • No longer requires waivers
Board Responsibilities	• Limited coverage (adopt and review policy)	• Clearly articulates that the CU Board is ultimately accountable for the safety and soundness of the commercial lending activities

Key Changes and Enhancements (cont.)

Provision	Current Rule	Proposed Rule
State Rule	• Requires NCUA approval for state rule • 7 states have parallel state rules	• Principles-based rule obviates need for separate state rules • Solicits SSA comments on the three options

MBL Staffing

- **Part 723 requires 2 years direct experience with the type of lending the credit union will be engaging in.**
  - Best experience
    - Financial analysis
    - Managing the relationship
    - Responsible for identifying and managing risk
      - Assign risk grades
      - Maintaining current information.
      - Responsible for the timely recognition of the change in risk
- **Training – Ongoing**
  - Industry sources

Loan Approval Authority

- Loan approval authority should be commensurate with business lending experience
- Complexity, risk and overall impact to the CU should be reflected in the authority
- The authority is limited to the aggregate member relationship
- All approvals and declinations should be reported on a regular basis to senior management and board

Risk Ratings System

- Establish an internal risk monitoring system
- Risk classification from low to high risk
- Rating based on well defined risk grades
- Consistent application of the grades and process
- Risk grades are assigned at the loan inception and periodically reviewed
- Factors to consider are both Qualitative and Quantitative
- Risk rating systems allow for active risk management

Credit Approval Presentation

- Should contain all necessary information for the approving authority to make a fully informed decision
- Should be a standardized format to ensure a consistent, complete and fair evaluation of credit for all borrowers
- Provides the roadmap for consistent creditworthiness assessment
- Should be appropriate for the level of risk and complexity of the transaction

Risk Monitoring

- **Regular site visits**
- **Require regular financial reporting and review.**
- **Use financial covenants when appropriate**
  - Explain to the borrower what is expected.
- ***Test for compliance with the required (mutually agreed) financial performance/covenants***
- **Annual relationship review presented to the appropriate lending authority**
  - Financial, management, market, facilities etc.
- **Establish portfolio concentration limits. (10-CU-03)**

Loan Review

- **Loan review internal or third party.**
  - Best performed shortly before the exam to allow time to address any findings. (assist the examiner in scoping the exam)
- **Outlined in "Attachment 1- Loan Review Systems of Acct. Bull.#06-01 Interagency Guidance for ALLL"**
  - Identify potential weakness in loans
  - Appropriately grade adversely classified loans
  - Identify trends that will affect the portfolio and segments that may be a problem
  - Adherence to policy, Reg's and loan administration
  - Evaluate activities of the lending personnel
  - Provides senior management and board with overall portfolio quality and evaluation of risk practices
  - Assist management with calculating the ALLL

MBL Reg's and Guidance

Rules

- Part 701 Loans to Members
- Part 723 MBLs
- Part 722 Appraisals
- Part 712 CUSOs

Guidance

- 14-CU-06 Taxi Medallion Lending and 15-CU-03 FAQ's Taxi Medallion Lending
- 13-CU-07 Participation Guidance

MBL Reg's and Guidance (cont'd)

- 13-CU-03 Troubled Debt Restructure (TDR).
- 13-CU-02 MBL waivers
- 10-CU-23 Best Practices in RE appraisals
- 10-CU-07 Commercial RE Workouts
- 10-CU-03 Concentration Limits
- 10-CU-03 Risks in Business Lending
- 08-CU-26 Evaluating Participation Programs
- Acct. Bull. # 06-01 Interagency Guidance for ALLL
  - ***Specifically-Attachment 1 Loan Review Systems***

Questions

EXHIBIT D

Supervisory Letter

Evaluating Loan Participation Programs

Loan Participation Programs

Properly managed loan participation programs can be beneficial to both selling and buying credit unions. Loan participations may provide selling credit unions with a mechanism to manage regulatory limits, interest rate, liquidity, credit and geographic concentration risks, as well as an enhanced ability to serve members. Credit unions buying loan participations may benefit from diversifying the balance sheet, using excess liquidity, and increasing revenue.

Loan participation credit and concentration risks are increasing more rapidly than credit unions' overall loan portfolio risk.

- Outstanding loan participations more than doubled between 2003 and 2008.
- Loan participation losses almost doubled in 2008.
- Loan participation delinquencies more than doubled from 2006 to 2008.[1]

Credit unions can control risks by starting small and gaining experience over time, using best practices to measure, monitor, and control loan participation programs. When evaluating loan participation programs, examiners should determine whether credit unions address and document the following concepts in a manner commensurate with asset size, complexity, and risk profile:

- Risk assessment and strategic planning;
- Due diligence; and,
- Risk measurement, monitoring and control.

The same principles that apply to evaluating third party relationships apply to loan participations. A loan participation is a third-party relationship between a seller and a buyer, and as with any third-party relationship, the benefits of loan participations are accompanied by a variety of potential risks. Management should complete a risk assessment and perform due diligence prior to entering the third-party arrangement,

[1] Outstanding loan participations increased 262% between 2003 and 2008, compared to a 149% increase in total loans. Annualized total dollars of loan participations charged off in 2008 were twice 2006 levels, resulting in the charge-off ratio increasing from 0.41% in 2006 to 0.64% in 2008. The charge-off ratio for total loans increased from 0.46% in 2006 to 0.75% in 2008. Loan participation delinquency was 1.10% in 2006 and 2.27% in 2008. Total loan delinquency was 0.68% in 2006 and 1.13% in 2008.

regardless of whether the third party is a credit union, a credit union service organization (CUSO), or another financial institution.

This guidance describes practices examiners will find in a well-run loan participation program involving any type of loans, including automobiles, residential mortgages, and member business loans. Credit unions sometimes engage in loan participations with eligible organizations other than federally-insured credit unions. This Supervisory Letter is relevant to those relationships as well, although other regulatory issues may apply.[2]

Examining Loan Participation Risks

A credit union involved in loan participations is exposed to a full range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation risks. The degree of risk varies depending on whether the credit union is the seller or buyer, the sale is with recourse or non-recourse,[3] the size and complexity of the individual loans, aggregate exposure to net worth, portfolio size including unfunded commitments, the level of experience and expertise on both sides of the transaction, and external economic factors.

When examining a loan participation program, field staff should evaluate management's understanding of risks in the following key areas, and ensure management has addressed the various issues below.

Buying Credit Unions – Risks & Issues

Risk Assessment & Strategic Planning

Prior to starting a loan participation program or entering into a loan participation agreement with a third party, officials must evaluate whether the program is compatible with the board's risk tolerance, loan policies, and overall strategic plan.

Officials can mitigate risk by fully understanding all aspects of the third-party relationship. Examiners will expect officials to provide documentation of an initial risk assessment which, at a minimum, addresses the following issues.

<u>Credit Risk Assessment</u>
Credit risk can vary widely depending on the loan type, size, structure, collateral type, and sources of repayment. When evaluating acceptable credit risk, buying credit unions should consider a broad range of issues including:

- Credit scores;
- Loan-to-value limits;
- Cash flow analysis;
- Concentrations in volatile or unstable markets;
- Concentrations in geographical locations;
- Concentrations in certain types of investment properties;

[2] See Exhibit A, Summary of NCUA Rules Applicable to Loan Participations.
[3] See Examiner's Guide, Chapter 10, Loans, for discussion of "recourse".

- Feasibility of speculative development projects;
- Use of borrower information provided by brokers; and,
- Full analysis of appraisal assumptions and final valuations.

Management must determine in advance the types of loan participations to purchase, based on the depth of staff experience and expertise, and other necessary resources, including management information systems to track changing risks. The buying credit union needs to adopt a policy permitting loan participations, including the specific types of loans to be participated and any deviations from existing underwriting standards.[4] Prudent loan participation policies establish reasonable concentration limits for collateral types, geographical locations, loan participations purchased from one seller, and other key factors.

Loan policies should specify the trade area or market area where loans will be purchased. Management must have the ability to monitor and adjust to changing market conditions on an ongoing basis before deciding to expand the trade area.

Interest Rate Risk Assessment

The interest rate risk for individual loans varies depending on loan type, size, and whether the interest rate is fixed or variable. Interest rate risk increases as the term of the loan extends. Examiners should confirm that a buying credit union has thoroughly evaluated the potential impact of extended maturities on the fair value of their balance sheet.

Competitive and economic conditions may pressure buying credit unions to consider approving reduced rates and terms. A deterioration in a borrower's financial condition may also prompt the consideration of a rate adjustment. These types of adjustments may require the credit union to re-evaluate its asset liability management (ALM) strategies.

Liquidity Risk Assessment

Buying credit unions must have sufficient liquidity available to fulfill obligations in the loan participation agreement, as well as the underlying loan documents. Revolving lines of credit and loans with unfunded commitments (such as construction loans) add to the complexity of monitoring liquidity needs.

Buying credit unions must evaluate the adequacy of:

- Liquidity to meet their own members' future loan demand before purchasing loan participations.
- Management reporting systems to measure and monitor cash flows including disbursements and scheduled payments.
- Funding sources to meet all potential calls to fund loan disbursements.

Transaction Risk Assessment

Buying credit unions must fully understand all aspects of the loan participation arrangement to assess the potential impact on transaction risk. Transaction risk is

[4] Section 701.22(c)(4) requires a selling credit union to use the same underwriting standards for loan participations as used for loans that are not being sold in a participation. Section 701.22(d)(1) permits a buying credit union to participate "only in loans it is empowered to grant, having a participation policy in place which sets forth the loan underwriting standards prior to entering into a participation agreement."

mitigated by a strong internal control culture that results in sound systems, internal controls, audit, and contingency and business recovery plans.

Credit unions must determine how to properly account for and control cash flow streams between themselves and the seller. Management should determine whether bond coverage is adequate for the new products and services.

Compliance Risk Assessment

The buying credit union needs to understand all regulations that apply to loan participations to the same degree as loans originated by the buying credit union, including:

- NCUA regulations applicable to loan participations;[5]
- NCUA regulations governing appraisals;[6]
- Applicable state laws for state-chartered credit unions;
- Bank Secrecy Act;[7] and,
- Consumer protection regulations, such as Truth in Lending, Equal Credit Opportunity Act, and Real Estate Settlement Procedures Act.

A credit union's compliance risk assessment should address the necessary controls to assure conformance with all applicable regulations. This is particularly important if the buyer and seller are subject to different regulations, such as different charter types (federal or state), or loan documents are governed by laws from another state. Loan participation agreements should clearly define which party has the authority and accountability to monitor and enforce compliance. A buyer of loan participations must conform with applicable rules, regulations, and compliance laws.

Strategic Risk Assessment

Officials must determine whether the proposed relationship complements the credit union's overall mission and philosophy. Officials need to document how the relationship will relate to their credit union's strategic plan, considering long-term goals, objectives, and resource allocation requirements.

Reputation Risk Assessment

Buying credit unions must have adequate internal controls, staffing, business recovery plans, and other resources to meet their contractual commitments to the seller in a timely manner. Delays or defaults in fulfilling obligations could jeopardize the ongoing relationship between the seller and loan participants, and expose the credit union to litigation or financial loss.

A seller (credit union, CUSO, or other eligible organization) can create systemic underwriting and loan servicing risk to a large group of credit unions. The length of experience in a lending activity should be an essential component of concentration limits

[5] See Exhibit A, "NCUA Regulations Applicable to Loan Participations".

[6] See Part 722 of NCUA's regulations "Appraisals", and Letters to Credit Unions No. 03-CU-17, "Independent Appraisal and Evaluation Functions for Real Estate-Related Transactions"; No. 05-CU-06, "Frequently Asked Questions on Independent Appraisal and Evaluation Functions"; and No. 05-CU-12, "NCUA and other FFIEC agencies issue Frequently Asked Questions on Residential Tract Development Lending."

[7] See Letters to Credit Unions 08-CU-12, "Suspected Money Laundering in Residential Real Estate Industry Report" and 08-CU-10, "Mortgage Loan Fraud Report."

for buying credit unions. "Caveat emptor" – let the buyer beware – and diversify, is the key to a successful loan participation relationship and program.

Identifying potential risks during the planning and initial risk assessment process increases the opportunity to mitigate losses by determining in advance the necessary controls and reporting systems. Loan participations expose credit unions to all seven risk categories; examiners should evaluate the effectiveness of the credit union's risk assessment relative to each type of risk.

Due Diligence for Loan Participation Programs

Examiners should consider the adequacy of the buying credit union's ongoing due diligence in the areas below, given their risk profile, internal controls, and overall complexity. The credit union's due diligence should be tailored to the complexity of the third-party relationship, and may consist of alternatives to mitigate risk.

Business Model

New business models often emerge due to changes in the regulatory, technological, or economic environments. When evaluating a seller's loan participation program, a buying credit union should be aware of recent or pending changes. Regulatory changes might affect loan underwriting practices if the seller has been approved for loan waivers or meets regulatory flexibility requirements. A buying credit union that does not have the same type of waivers, or does not meet regulatory flexibility requirements, cannot buy loan participations without meeting the same criteria.

Buying credit unions should also consider the following factors:

- The possibility of conflicting interests. A CUSO may use different underwriting standards for loans it sells (rather than retain them in portfolio), in order to maintain volume. Buyers need to ensure the product they are purchasing is within their established risk tolerance thresholds, including adherence to established underwriting standards.
- Financial condition. Based on call reports, Financial Performance Reports (FPRs) or other financial information, the seller must have a demonstrated ability to repurchase the participation if required under the terms of the loan participation agreement.
- The product being sold is time-tested. It is preferable that the seller's loan portfolio has been through several economic cycles. Buyers need to strongly consider the additional risk being taken if the seller is inexperienced in the product and/or the product has not weathered a full economic and interest rate cycle.
- Significant staffing changes. It is important to determine whether the seller has maintained sufficient expertise in all types of loans being underwritten and serviced.
- Trade area. Ensure there is diversification in the trade area, underwriters are knowledgeable of market conditions throughout the trade area, and the servicer has the ability to handle servicing effectively, especially in the case of default.
- Possibility of loss of control. One of the biggest risks faced by buyers of loan participations is the loss of control in monitoring and managing the credit risk.

Buyers need to ensure they have the mechanisms in place to maintain proper oversight over the party servicing loan participations.

Contract Issues and Legal Review

The contract is a critical component of any third-party relationship because, in addition to establishing rights and obligations of the parties, it should clearly address how the relationship operates. Buying credit unions should obtain legal advice regarding the contract[8] to ensure legal and business interests are appropriately protected. Both parties have the right to negotiate terms for mutually beneficial contracts.

The representations and warranties in the participation agreement set out the premises on which the parties contract, and will often have important contractual promises. For example, the selling credit union will often represent that the loan meets all regulatory and legal requirements or the underwriting criteria as agreed in the contract. The buying credit union may warrant that it is authorized to and can legally enter into the agreement. The breach of a warranty or representation may provide the basis for one party's remedy against the other. The participation agreement may provide specific remedies for breach of particular warranties or representations; for example, a selling credit union's re-purchase of a loan interest that fails to meet the warranties the seller has given.

The loan participation agreement should clearly define how risk will be shared among the participants, including whether the transaction qualifies, per FAS 140, for true sale accounting or is a secured borrowing. Risk may be shared equally, pro-rata, or on a senior/subordinated basis where the priority of rights to repayment differs among participants.

The loan participation agreement should also clearly define how and when information will be shared and what actions require the mutual approval of both parties. Specifically, the agreement should address credit documents and information that the seller is required to share with the buying credit union, status reports on payments and interest accrual, exit strategies, procedures for modifying loan terms, standard loan covenants, including limiting borrower's future loans, notification of adverse loan events, collection procedures, turnover in key staff, and other provisions necessary to effectively manage credit risk.

Loan Underwriting

The buying credit union must underwrite the loan to their own standards; they cannot rely on the analysis performed by the seller or the broker. Underwriting should identify all risks that could materially influence a buyer's decision to participate.

Buyers should request the following information for member business loans (MBLs) and/or construction and development loans unless it is described in the seller's loan presentation or supported by loan documentation:

- Cash flow analysis, particularly for businesses and self-employed individuals.
- Many borrowers form a separate limited liability company for each investment property, so loan documents should indentify all responsible parties and

[8] A loan participation agreement is the typical form of contract. When credit unions anticipate multiple loan participation transactions, they may execute a Master Participation Agreement, with each loan participation represented by a separate certificate.

guarantors to the agreement. Underwriting and cash flow analysis should identify all obligations, direct and contingent, of the borrower and all guarantors.

- All associated borrowing relationships should be fully disclosed to meet regulatory requirements for loans to one borrower and to limit concentration risk.
- Verification that all conditions of approval were satisfied before the loan was funded. A take-out commitment for long-term financing is a common repayment source for a construction and development loan. Satisfying all conditions of approval protects enforceability of the take-out commitment.
- Appraisal reviews should evidence that appraisal assumptions were valid and relevant to the collateral property. A seller should inform the appraiser if a lease(s) is not arm's length because leases of owner-occupied properties may not reflect current market conditions.
- Sources of borrower's equity for construction and development loans should be identified. It is possible additional financing will be required if the borrower's balance sheet does not reflect "hard equity" in the form of cash or unencumbered equity in the property, required to be invested by the borrower.
- Progress inspections should be verified. Section 723.3(c) requires on-site progress inspections before release of funds. Sellers should provide participants with copies of the written inspection reports when requesting construction draws.

Sellers sometimes arrange for an outside underwriter for all participants to use. This compromises independence and is prohibited for MBLs.

Examiners should request buying credit unions provide copies of all documentation and information used in the underwriting and analysis of the loan participation. Documentation should include regular management reporting to the board of directors of any exceptions to the buying credit union's policies.

Buying credit unions should consider the risk represented by the total loan commitment. For example, if a credit union buys a $2 million portion of a $25 million loan, their independent analysis needs to be based on the borrower's ability to service the total debt as well as the borrower's other existing and proposed obligations and commitments.

Risk Measurement, Monitoring and Control

The buying credit union must complete a post-closing review of all loan documents to determine that all terms and conditions are in accordance with the original terms presented. If the buying credit union finds that terms changed, it should notify the seller of its findings and the corrective action it desires. Loan participation agreements should include language that requires a seller to buy back loans with missing documents, made outside of policy, or otherwise not in conformance with representations and warranties.

Management must fully understand the terms of the loan participation agreement and underlying loan transaction(s) and be able to explain them to all interested parties, including regulators. Risk assessment, strategic planning, and due diligence assure that officials are fully informed about the program, and provide the opportunity to design and implement procedures and controls to mitigate the risks.

On-going credit administration must include, at a minimum, monitoring member business loans for annual financial statement review. Examiners should analyze documentation of these annual reviews and any changes in risk ratings triggered by results of the reviews.

Independent third-party audits or reviews of a seller's loan participation program can provide buying credit unions with important information regarding sufficiency of underwriting, collateral evaluation, loan documentation, credit risk grading processes, and servicing practices and procedures. The seller should provide the buying credit union with copies of regularly updated audits and the seller's written response to findings and recommendations for corrective action.

Buying credit unions should regularly monitor the liquidity and financial health of the originating credit union. They should also monitor how a CUSO is structured and funded and the financial stability of the CUSO owners.

Selling Credit Unions – Risk & Issues

Risk Assessment & Strategic Planning

The risk assessment, strategic planning, and due diligence issues described above for buying credit unions also apply to selling credit unions. Examiners will review documentation that management addressed these risks in addition to the following risks and issues specific to selling credit unions.

Selling credit unions must fully understand the terms of the loan participation agreement and underlying loan transaction(s) and be able to explain them to all interested parties, including regulators. Risk assessment, strategic planning, and due diligence assure that officials are fully informed about the program and provide the opportunity to design and implement procedures and controls to mitigate the risks.

Selling credit unions must monitor potential liability from maturing balloon extensions or rollovers, particularly with multiple participants on large member business loans. As participants are generally not legally bound to continue to fund the extensions or rollovers, the selling credit union could have significant liquidity, compliance and credit risk in the event the participants decline to renew their involvement.

<u>Credit Union Service Organizations (CUSOs)</u>
Selling credit unions frequently use CUSOs to underwrite, document, and service loans. Some CUSOs locate prospective borrowers through loan brokers then select a credit union to be the seller, based on where the borrower is a member or would qualify for membership.

Selling credit unions should notify buying credit unions if a loan was sourced through a loan broker and the borrower was not an existing member. This puts participants on notice that information about the borrower may not be based on direct knowledge of the seller. In these type transactions, selling credit unions should verify that all third-party

reports, such as appraisals and environmental studies, were obtained in an arm's length, independent transaction, and in full compliance with regulatory guidance.

Regulatory Compliance

Selling loan participations is a common way for credit unions to manage their portfolios within regulatory limits. Part 723 of NCUA's regulations, "Member Business Loans," contains regulatory limits with which participation member business loans must comply: aggregate member business loans, loan-to-value limits, loan-to-one borrower or associated borrowers, construction and development loans, and unsecured loans.

It is not permissible for a credit union to exceed regulatory limits. If a loan would exceed any of the regulatory limits, the originating lender (selling credit union) must make the loan approval conditioned on obtaining firm loan participation agreements from buying credit unions. Also, buying and selling credit unions must fund the full amount of their participation interest in the loan concurrently. Credit unions that are selling participations to stay within a regulatory limit need to distinguish between non-recourse and recourse transactions. Recourse sales (if treated as secured borrowings) count toward regulatory limits.

A selling credit union must request a waiver before exceeding regulatory limits. The Regional Director must approve the waiver application before the loan is funded. Federally-insured state chartered credit unions need to first apply to their state supervisory authority. Regional Director approval is also required.

Full Disclosure

Selling credit unions should fully disclose to potential buyers all available historical information about the borrower, the collateral, and any potential conflicts of interest. Loan participation agreements ordinarily include representations and warranties that the seller will fully disclose all facts pertaining to the transaction and the borrower's creditworthiness at the outset and during the life of the loan. If a buying credit union successfully asserts rights under contract representations and warranties, it could subject the seller to liquidity, interest rate, and reputation risk if forced to take back the loan.

Examples of full disclosure documentation include:

- Stating whether prior loans have been paid as agreed or rewritten, modified, or extended;
- Providing details on the borrower's depository relationships;
- Disclosing policy exceptions and regulatory waivers related to the loan; and
- Potential conflicts of interest.[9]

Credit unions occasionally modify their loan policies in response to changing economic conditions. A selling credit union may determine it is prudent to relax standards when conditions are improving; on the other hand, if economic conditions are worsening, they may decide to sell participations in riskier loans and retain the higher quality credits. In

[9] In particular for MBLs, Section 723.5(b) of NCUA's regulations permits a credit union to use the services of a CUSO even though the CUSO is not independent from the transaction, provided the credit union has a controlling financial interest in the CUSO as determined under Generally Accepted Accounting Principles. Some state supervisory authorities have adopted other MBL Rules & Regulations which may vary in some respects.

ongoing participation relationships, selling credit unions should advise buying credit unions when underwriting standards are modified.

Credit Administration

A borrower's non-compliance with loan agreement covenants represents a technical default which the selling credit union needs to address to assure there is no impairment to the ultimate collectability of the loan. Minimal covenant compliance monitoring includes:

- Notifying the borrower, in writing and on a timely basis, regarding events of technical default.
- Providing buying credit unions with the financial information required by the loan agreement.
- Reporting the results of loan monitoring to buying credit unions.

Failure to fulfill servicing responsibilities could materially increase credit, transaction, and reputation risks for the selling credit union.

Summary

Loan participation programs offer various benefits to credit unions. Credit unions must evaluate and thoroughly understand the potential risks, as well as the benefits, before starting a loan participation program. Management must continue to monitor and control the program and the underlying loans.

Whether selling or buying, credit unions have similar risks in monitoring and managing loan participations. Selling credit unions' risks are centered in regulatory compliance, full disclosure, and credit administration. Buying credit unions' risks are centered in risk assessments, strategic planning, due diligence, contracts and legal review, underwriting credit risk, and internal controls.

Selling and buying credit unions need to control risk with initial risk assessments, strategic planning, and due diligence over loan participation partners, appraisers, auditors, and other third parties. The due diligence process should be well-documented, ongoing, and focus on the other participant's business model, policies and practices, contract issues, and loan administration.

Examiners must evaluate the safety and soundness of a credit union's loan participation program based on the adequacy of documented risk analysis, strategic planning, and due diligence within the framework of the risk-focused examination process.

EXHIBIT A

Summary of NCUA Rules Applicable to Loan Participations

Required and Permissible Loan Participants. Generally, a loan participation is a loan in which one or more "eligible organizations" participate pursuant to a written agreement with the originating lender. 12 C.F.R. §701.22(a)(1). Buying credit unions may only participate in loans in which the original lender remains as a participant. OGC Opinion 07-1035 (October 26, 2007).

A federal credit union (FCU) that is the originating lender must retain at least 10% of each loan in which it sells a participation interest. 12 C.F.R. §701.22(c)(2). An originating lender that is not an FCU must retain a meaningful ownership interest in a loan participation to avoid the appearance that the parties are trying to circumvent the loan participation rule's requirements. *See* OGC Opinion 07-1035 (October 26, 2007). FCUs can only participate in loans they are empowered to grant. 12 C.F.R. §701.22(b).

If a transaction does not meet the requirements of a loan participation under §701.22, refer to the purchase and assumption rule, 12 C.F.R. §741.8.

Interest Rate. Because FCUs can only participate in loans they are empowered to grant, FCUs cannot participate in loans with an interest rate greater than the maximum allowable interest rate, which is currently 18%.

Prepayment Penalties. FCUs cannot impose or collect prepayment penalties. 12 U.S.C. §1757(5)(A)(viii). If a prepayment penalty is included in the loan's terms, an FCU cannot collect its share of the penalty. Additionally, the remaining participants cannot receive a windfall due to an FCU's inability to collect a prepayment penalty, but the FCU's share must be forgiven. OGC Opinion 02-0824 (November 5, 2002).

Interest in a Loan versus Interest in a Pool. The participation agreement must establish that an FCU is buying an interest in a particular loan; FCUs are not authorized under the loan participation rule to purchase a participation certificate as a percentage interest in a pool of loans. 12 C.F.R. §701.22(a)(1) ("*participation loan*" defined as "a loan"). Where a participation agreement involves multiple loans, the documentation, for example, can be as simple as an addendum or schedule for identifying each loan and a participant's interest in that loan.

List of Resources

1. NCUA -regulations, Parts 701, 722, 723, and 741. http://www.ncua.gov/RegulationsOpinionsLaws/rules_and_regs/NCUA%20R%20&%20R%20Book%201%20May%208%202008.pdf

2. NCUA Letter to Credit Unions No. 07-CU-13, December 2007 - *Evaluating Third Party Relationships.*

3. NCUA Letter to Credit Unions No. 08-CU-20, September 2008 - *Risks to Credit Unions.*

4. NCUA Letter to Credit Unions No. 08-CU-10 April 2008 – *Mortgage Loan Fraud Report.*

5. NCUA Letter to Credit Unions No. 08-CU-12 May 2008 – *Suspected Money Laundering in Residential Real Estate Industry Report*

6. NCUA AIRES Questionnaire - Loan Participations. http://www.ncua.gov/CreditUnionResources/aires/aires.html

7. Federal Deposit Insurance Corporation. Risk Management Manual of Examination Policies, Section 3.2 – Loans\Loan Participations. http://www.fdic.gov/regulations/safety/manual/section3-2.html#introduction

8. Office of the Controller of the Currency. OCC's Comptroller's Handbook, Loan Portfolio Management. http://occ.gov/handbook/lpm.pdf

9. Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and servicing of Financial Assets and Extinguishments of Liabilities". . http://fasb.org/pdf/fas140.pdf

EXHIBIT E

CUNA
Credit Union National Association
cuna.org
BILL CHENEY
President & CEO
601 Pennsylvania Ave., NW | South Building, Suite 600 | Washington, DC 20004-2601 | PHONE: 202-508-6745 | FAX: 202-638-3389

October 26, 2011

The Honorable Shelley Moore Capito
Chairman
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives
Washington, DC 20515

Dear Chairman Capito:

On behalf of the Credit Union National Association (CUNA), I wanted to thank you for holding the hearing earlier this month on H.R. 1418, the Small Business Lending Enhancement Act. This legislation is critical job creation legislation which would permit credit unions to lend an additional $13 billion to small businesses in the first year, helping them create over 140,000 new jobs. We appreciated the opportunity to present testimony in support of this legislation and look forward to working with you to move the bill through the legislative process.

At the hearing, several Members, including you, raised questions related to the demand for this legislation. These questions focused both on whether there was enough available small business credit as well as whether there was a need to increase the credit union business lending cap in order to make additional credit available. Some also expressed concern that increasing the member business lending cap would lead to a reduction of bank business lending. I wanted to take the opportunity to address these questions.

Demand for and Availability of Small Business Credit

There is no doubt that there has been a reduction in the demand for business credit as a result of the recession. However, unlike the consumer sector, there is no indication that the small business sector is (or has been) engaged in a process of systemic deleveraging. On the contrary, there is a large body of evidence that confirms a healthy demand for loans as discussed in more detail below.

At the same time, there also is considerable evidence that a significant contraction in the supply of bank business credit has contributed to a reduction in business credit outstanding. Small businesses want credit but far too many cannot obtain the capital they need from the nation's banks. The record is clear: a lack of more robust small business borrowing, business expansion and job growth can be traced in large part to ongoing reductions in lending activity among the nation's commercial banks.

Since mid-2009, no fewer than 25 Congressional hearings have been held to discuss issues related to small business access to credit. Further, credit availability was a major driver behind the enactment of the Small Business Jobs Act of 2010, which

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created the Small Business Lending Fund (SBLF), a $30 billion taxpayer funded incentive to community banks to lend to small businesses.[1]

The importance of access to credit for small businesses was clearly articulated by a witness advocating for the enactment of the SBLF in 2010.

> "The Wall Street meltdown of fall 2008 and the ensuing credit crisis and recession hit small businesses harder than medium and large-size businesses because they have faced greater challenges in obtaining credit. Boosting the flow of credit will help the small business sector to lead the recovery of economic growth and employment… small businesses responded to the recession by laying off more workers than medium and large size businesses. The difference lies in access to credit. Small businesses are more dependent on bank credit than medium and large businesses. Medium and large businesses regained access to credit through the corporate bond market, while small businesses continue to suffer from lack of credit… The greatest potential for job creation is among small business with restored access to credit."[2]

There is considerable evidence suggesting not only that there is unmet demand for small business lending, but also that small businesses that would otherwise be interested in pursuing credit are not doing so because of the perception that credit is difficult to get in this economic environment.

In testimony before the House Small Business Committee earlier this year, the International Franchise Association, whose membership, according to their website, employs 6% of Americans, stated:

> "While we estimate that franchise businesses will be able to access $8.4 billion in lending this year, this analysis also shows that we will face a $2 billion shortfall in available loans. This shortfall will result in the loss of nearly 8,000 franchise unit transactions, both new business development and transfers, and a loss of more than 82,000 jobs and $10.7 billion in annual economic output."[3]

The National Association of the Self-Employed testified before the Senate Small Business Committee in May that, "Access to capital also continues to be a large

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[1] Credit unions did not need and did not seek access to this fund because the chief impediment to credit union small business lending is neither liquidity nor capital. It is the statutory cap on business lending.

[2] Testimony of James D. MacPhee on behalf of the Independent Community Bankers of America before the House Committee on Financial Services Hearing on "Initiatives to Promote Small Business Lending, Jobs and Economic Growth." May 18, 2010. 2.

[3] Testimony of William G. Hall on behalf of the International Franchise Association before the House Committee on Small Business Hearing on "Access to Capital: Can Small Businesses Access the Credit Necessary to Grow and Create Jobs?" June 1, 2011. 4.

problem for the self-employed and microbusinesses, despite efforts by the federal government to spur lending to small businesses."[4]

As noted in our written testimony, the Pepperdine Capital Markets Project conducts on ongoing, twice-yearly survey of U.S. small businesses in conjunction with Dunn and Bradstreet. While the second 2011 full report has not yet been published data collected during the week of August 29, 2011 (from a sample of over 5,500 U.S. small business owners) finds that nearly one-quarter of small businesses sought a bank loan in the preceding 12 month period. Among those that sought bank financing fully 57% indicated that they were not successful in obtaining financing. This is a clear indication that a substantial number of small businesses continue to need more access to capital.[5]

The most-recently published full report from the Pepperdine Project (Survey Report V – Summer 2011) is attached.[6] The Report – summarizes views of 1,221 privately-held businesses that responded to the survey. Among these, 24% had businesses that involved manufacturing and 11% were in the engineering and construction industry. Approximately 59% of respondents have between 11 and 100 employees.

One of the report's key findings was: **"Business owners enthusiastic about growing, but lack resources.** Nearly 95% of privately-held businesses owners report having the enthusiasm to execute growth strategies, yet just 53% report having the necessary financial resources to successfully execute growth strategies."[7]

Given this reported enthusiasm for growing it is not surprising that the report also finds substantial demand for financing on the part of small businesses: Overall, 38% of businesses indicated that they are "currently" seeking financing, with about one-half (48%) of these seeking bank loans.[8] In fact, bankers tell the Pepperdine researchers the same story being told by small business- and one that is disturbingly at odds with what banks been telling policy makers: Overall, 65% of banks responding to the Capital Markets Project Survey tell researchers that they have seen an increase in demand for small business loans compared to six months ago.[9]

On the supply side of the equation, the bank lobby has been telling policymakers that there is an ample supply of business credit. But they provide a starkly contrasting view in the Pepperdine Survey. Indeed the Report states: "Currently, lenders see economic uncertainty (48.6%) and access to capital (25.7%) as the top issues facing privately-held businesses".[10] Yet, despite their public claims to the contrary, bankers reveal to the Pepperdine researchers that they are restricting the supply of credit.

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[4] Testimony of Kristie Arslan on behalf of the National Association for Self-Employed before the Senate Committee on Small Business and Entrepreneurship Hearing on "Small Business Recovery: Progress Report on Small Business Jobs Act of 2010 Implementation." May 19, 2011. 5.
[5] See: http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey. Survey of firms with less than $5 million in annual revenues.
[6] Pepperdine Private Capital Markets Project Survey Report V. Summer 2011.
[7] Ibid. p.8
[8] Ibid. p.19.
[9] Ibid. p. 119.
[10] Ibid. p.111.

Overall, bank survey respondents indicate they are declining 60% of small business loan applications.[11]

Importantly, bank credit restriction in the face of healthy demand has been an ongoing problem. A 2010 Business Week article, *Why Small Business Can't Get Financing*, contains an extensive interview with John Paglia, senior researcher for the Pepperdine Private Capital Markets Survey. In the course of the interview Paglia states: "The No. 1 concern for private companies is access to capital. Nearly 31 percent cited that…" and "The companies also reported, by 71 percent, that if they had additional growth capital they believed they would see an increase in revenue growth." [12]

During the course of the interview, Business Week reporter Karen Klein states "Many bankers say they aren't lending, at least in part, because demand for loans is down. But your survey seems to contradict that assertion." Paglia's response is noteworthy: "Generally speaking, we found more demand for loans among business owners. And among the banks that responded to our survey, 72 percent indicated that the number of loan applications they received had increased during the last six months. So there's demand for capital. Something's not quite sitting right when we hear from the banks that there's no demand." [13]

The National Small Business Association's 2011 Mid-Year Economic Report found that lack of available capital was a concern for 22% of those responding to their survey of small business owners.[14]

According to the National Association of Realtors®, 87% of Realtors® said that lack of financing impacted their clients decisions in 2011; nearly 60% said that they failed to complete a transaction due to financing; and lack of available financing was the most frequent response of Realtors® when asked what were the major obstacles to commercial real estate this year. Sixty-five percent report significantly or somewhat significantly tightening of lending conditions; none reported a significant easement of lending conditions. The Realtors® report further states, "While large corporations do not have difficulties securing capital, small businesses have been struggling to find access to financing."[15]

Some small business owners may have simply given up on the credit market. Multifunding.com, a small business finance consulting organization, conducted a survey of 1200 small businesses in July 2011 and found that 73% of small business owners who say they are in need of a loan have not applied for a loan. Twenty-one

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[11] Ibid. p.118.
[12] Klein, Karen E., "Why Business Can't Get Financing." Business Week. August 31, 2010.
[13] Ibid.
[14] National Small Business Association. "2011 Mid-Year Economic Report". Page 8. August 3, 2011. See: http://nsba.biz/surveys.shtml.)
[15] National Association of Realtors® Research. August 2011. 1.

percent said they were afraid of application rejection; 18% said they were not willing to pay high interest rates.[16]

According to Gallup, 30% of small business owners say it is difficult for them to obtain credit – two to three times more difficult than it was in 2006 and 2007; 21% say credit is easy to get, which is about half the number from 2006 and 2007.[17]

The demand for small business loans is present in the market and the data suggest that banks continue to constrict credit availability while credit unions are expanding their business loan portfolios. Since the beginning of the recession three and a half years ago, total bank business loan portfolios have declined by almost 14%, while credit union business loan portfolios grew at a healthy rate of over 40% – a very stark difference. If indeed the contraction in business credit outstanding was due solely to reduced demand, credit union business lending would have declined as it has at banks. That is obviously not the case.

Why Increasing the Credit Union Member Business Lending Cap Is Necessary

Another question that you and other members of the subcommittee raised at the hearing was whether it is necessary for Congress to permit qualifying credit unions to lend to business owning members in excess of the statutory cap in order for credit unions to continue to meet the business lending needs of their members. We believe that it is.

The recently strong growth of credit union business lending is slowing as an increasing number of credit unions approach the cap, and the support credit unions have provided to America's small businesses cannot continue into the future unless Congress raises the credit union business lending cap.

The bank lobby claims that only a "handful" of credit unions are actually capped, but a total of more than 500 credit unions will be bumping up against the cap in the next three years. Contrary to the bank lobby claims that the credit unions constrained by the cap are a "new breed" of large credit unions, it is worth noting that a credit union seeking to offer business services to its members is not engaging in activity that is "new" to credit unions – credit unions have been offering business services to their members since they were founded in the United States over 100 years ago. In addition, roughly 75% of the over 500 credit unions that are constrained by or at the cap have total assets of $500 million or less, rendering the bank lobby's assertion that these are only large credit unions false.

Most of these credit unions are already looking for ways to moderate their business loan growth.

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[16] Multifunding.com. August 11, 2011. (see: http://www.multifunding.com/uncategorized/multifunding%e2%80%99s-second-quarterly-small-small-businesses-arent-applying-for-loans/ .)

[17] Testimony of Dennis Jacobe before the House Committee on Small Business Hearing on "Access to Capital: Can Small Businesses Access the Credit Necessary to Grow and Create Jobs." June 1, 2011. 3.

- A total of 227 credit unions hold business loans between 5% and 7.5% of assets. These credit unions will be capped within 2.7 years at recent growth rates. They held $6.5 billion in business loans at mid-year 2011 and their business loans grew by $3.9 billion over the preceding three years. Their business lending will have to slow dramatically in the coming few years without an increase in the cap.

- Another 149 credit unions hold business loans between 7.5% and 10% of assets. These credit unions will be capped within 2.5 years at recent growth rates. They held $7.0 billion in business loans at mid-year 2011, and their business loans grew by $2.1 billion over the preceding three years. Their business lending will have to slow dramatically in the coming few years without an increase in the cap.

- 148 credit unions, with $7.1 billion in business loans outstanding, had business loans of more than 10% of assets. These credit unions are essentially capped or will reach the cap in the next twelve months. In the three years ending June 2011, business loans outstanding at these credit unions rose by only $137 million. They will be able to contribute very little to future business loan growth without an increase in the cap.

Taken together these 524 credit unions now account for 75% of all business loans subject to the 12.25% cap. These credit unions have been the major contributors to credit union business loan growth over the past few years – accounting for 83% of total growth in non-grandfathered credit unions.

When the business lending growth in these credit unions is contrasted, the cap limitations are clearly reflected in slower growth rates among credit unions that are closer to the cap. In fact, the aggregate data shows:

- Credit unions with 5% to 7.5% MBL/Asset ratios saw portfolios increase by 36% in the year ending June 2011;
- Credit unions with 7.5% to 10% MBL/Asset ratios experienced an increase of 23%;
- Credit unions with more than 10% MBL/Asset ratios actually saw their loan portfolios decline. These credit unions will be able to contribute very little to future business loan growth without an increase in the cap.

As the economy hopefully recovers over the next few years, the business loan growth of this group of credit unions will disappear without an increase in the cap. In an environment where banks have constricted their lending, the credit constriction resulting from the statutory credit union business lending cap will mean that some members with existing business relationships may find it increasingly difficult to secure business credit from their credit union, and the credit unions which have contributed to business lending growth during the recession will be increasingly unable to serve new member business borrowers. All of this makes it critical that legislation to increase the business lending cap is enacted.

Increased Credit Union Business Lending is Not a Zero Sum Game for Banks

One of the more perplexing arguments made by the bank lobby is that Congress should not increase the cap because there is no excess demand for small business lending but that raising the cap would harm banks by allowing credit unions to take loans from them.

The bank lobby grossly misrepresents the impact of raising the credit union business lending cap on their own lending volumes. Research suggests that additional credit union business lending would not crowd out bank business lending. And certainly, with the banks controlling 95% of the commercial lending market, even a doubling of credit union market share would not significantly alter their dominance of this market.

During the hearing, one of the bank witnesses specifically claimed that that business lending is a "zero-sum game" – which, if true, would mean that every loan originated by a credit union is a loan that is not originated by a bank. This is simply not true.

Economic theory is revealing on the extent to which credit union lending may or may not "crowd out" bank business lending. Raising the credit union business lending cap is equivalent to an increase in the supply of business credit. Unless the demand for business loans were totally price inelastic, that increase in supply would lead to some increase in loans (i.e., the demand curve is not vertical.). Recently, researchers at the Federal Reserve Board estimated a semi-elasticity of demand for unsecured business loans to be -1.4, implying that a 100 basis point reduction in loan rate would be associated with a 1.4% increase in the amount of loans demanded.[18]

This suggests that an increase in credit union lending would not substantially come from reduced bank loans. Using their estimate, and considering that credit unions currently hold on average only about 5% of the small business loans held by depository institutions, and that H.R. 1418 would limit annual business loan growth above the old cap to 30%, if credit unions entered the market lowering interest rates by roughly 100 bp, the vast majority of that new lending could be accomplished without any reduction in bank loans.

In a recently published report for the Small Business Administration, Professor James A.Wilcox also dispels the zero-sum-game myth. While estimates in the Wilcox paper indicate that developments that boost small business loans at credit unions tended to reduce business loans at banks – the effect was very small. The evidence suggests that the offset was about $0.20 per dollar of additional small business loans at credit unions. In other words, a reduction in business loans at banks implies that a $1 increase in the supply of small business loans by credit unions would lead to a net increase in business loans of $0.80.[19] Put simply, on average, 80% of the increase in credit union lending is new capital that would otherwise not be available in the

[18] Basset, William F., Chosak, Mary Beth, Driscoll, John C., and Egon Zakrajsek (All of the Division of Monetary Affairs, Federal Reserve Board.) "Identifying the Macroeconomic Effects of Bank Lending Supply Shocks." December 2010. Page 18. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1758832.

[19] James A. Wilcox. *The Increasing Importance of Credit Unions in Small Business Lending.* SBA Office of Advocacy. Release Date: September 2011.

marketplace. Thus, the vast majority of new credit union lending is not “siphoned” from banks that would otherwise make these loans.

Conclusion

Throughout our history, credit unions have existed to serve the credit needs of their members. From the very first days, this has included the business credit needs of members. During the recession, credit unions remained engaged in member service, and increased lending to small businesses when other lenders fled the market. The credit unions that contributed the most to this growth are or soon will be approaching the cap. In order for these credit unions to continue to serve their small business owning members, Congress must raise the statutory cap. Representatives Royce and McCarthy have put forward a thoughtful bill to achieve this that includes provisions designed to enhance safety and soundness. We urge you to strongly support this legislation, which would allow credit unions to lend an additional $13 billion in the first year, helping small businesses create 140,000 new jobs.

Again, we appreciate your holding the hearing on H.R. 1418, the Small Business Lending Enhancement Act. We look forward to working with you and your staff as this legislation moves forward.

Best regards,

Bill Cheney
President & CEO

Attachment

EXHIBIT F

CUNA
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MBL
Lenders Roundtable Discussion
2015

Bob Stowell
Senior Vice-President/
Chief Strategy Officer
US Federal Credit Union
bob.stowell@usfed.org

CUNA
LENDING COUNCIL

Bob Stowell

Senior Vice-President, Chief Strategy Officer
US Federal Credit Union
$1 Billion + assets 70,000+ members
33+ years experience, 9+ at USFCU

MBL, Operations, Training, Investments, Credit/Debit Card

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Learning Objective:

"A three-hour tour" – This session is for experienced MBL lenders to explore their most critical issues.

0915 – 1030 I will lead a general discussion on MBL topics
1030 – 1100 Break
1100 – 1130 Table Topic Session one
1130 – 1200 Table Topic Session two
1200 – 1230 Complete general discussion and wrap-up by Bob Stowell

Table Leaders and their Table Topics: Each of these will repeat.

- Analysis Software – John Pruitt
- Portfolio Management – Andy Weingartner, Rob Farrington and Gary Sneed
- Participations sold and purchased – Jeff Barnes and Larry Jones
- Starting an MBL Department – Ethan Morris, Chuck Anderson
- Commercial construction loans – Tom Ries and Dale Frankhouse
- Operating LOC's, BBC's and other – Mike Poirier and Gwen Wong

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Member Experience

- Business members, like your other members, want a memorable experience and great products and services.
- We have lots of competition in the marketplace and I will discuss this later.
- We are a great alternative to banks and other disruptors.
- How are you doing in offering Mobile solutions and on-line solutions along with great products and services.. Think differentiator.
  - Remote check deposit
  - Financial planning
  - Merchant Services
  - Mobile and on-line solutions-
    - card payments, check deposit, cash management, mobile banking, etc.

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Credit Unions versus Banks

- 1.1T vs 15.6T
- The 4 largest banks have more assets than the entire credit union movement.
- It took 106 years for CU's to grow to 1.1T, the banks grew that much in just the last two years.
- Banks control about 94% of the assets and credit unions about 6.5%. It was 5.6% in 1992. OPPORTUNITY!!!

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MBL Stats (as of 12/31/14)

- Number of U.S. Credit Unions: 6,398 and decreasing about one per day!!
- Assets: $1,136T and growing!!
- Number of CU's offering MBL's: 2,288 and increasing!!
- CU MBL outstanding: $53,313,281,593 and increasing!!
- Average loan size: $215,394
- MBL's as a % of assets at offering CU's: 5%
- 12 month loan growth: 12%
- As it stands now, almost 500 credit unions are or will be bumping up against the cap soon. (Without a change, options are to: moderate growth or participate out loans)

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MBL Update and Issues (1)

- Competition—It is not just banks. There are other disrupters….
  - Community Development Financial Institutions (CDFI's)
  - On-Line alternative lenders
    - OnDeck Capital
    - Kabbage
    - Lending Club
    - Prosper
    - Fundation
    - Funding Circle
    - Lender-agnostic marketplaces (they create their own marketplace)
      - Biz2Credit, Lendio and Fundera

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MBL Update and Issues(2)

- Conversions: Fed to State and vice-versa.
- Taxi-Medallion/Uber—Disrupter—CU impact.
- CUNA System Structure and Governance Task Force Report.
- MBL Cap limits—with growing balances, more pressure for CU's to either moderate or be in the participation arena. Raising the cap limit benefits credit unions currently offering MBL services and those CU's considering offering MBL services. (***Meaning the cap is a barrier to entry into offering MBL services.)***
- Proposed NCUA MBL Rule change.

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NCUA Proposed Rule 723

Synopsis: the proposed rule provides the following: Principle vs. prescriptive based

- 1. Revises MBL limit to 1.75 times the applicable net worth requirement for a credit union to be categorized as well-capitalized (Interpret this to mean)—see a. through d below:
  - a. Example – A CU has $3 billion assets
  - b. Well capitalized defined by NCUA as 7% capital
  - c. $3 billion x 7% = $210 million
  - d. $210 million x 1.75 = $367.5 million MBL limit
- 2. Allows CU to make decision to waive a member from a personal guarantee
- 3. Remove LTV limits and the waiver process completely
- 4. Lift limits on C&D loans
- 5. Clarify that participation in loans to non-members do not count against the statutory member business lending cap
- Costs to train examiners (approx 1.9m), supervisory guidance when review policies, and more interesting conversations with CU's and examiners (think difference of opinion)
- New or updated policies will be needed by credit unions and will get close scrutiny by the NCUA at exam time.

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Portfolio Management

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Portfolio Management

- **Monitoring and Reporting**
- **Risk Rating Matrix**
- **Concentrations in the Credit Portfolio**
  - Location, Industry, Loan Type
- **Host system capability issues**
- **Software for analysis and tracking**
  - Bukers, FICS, BrokerPro, BakerHill, Integra, Sageworks, Moodys, Fiscal, Web Equity
- **Integration of MBL program into the ALM program and enterprise-wide risk considerations**
- **Pricing strategies and term**
  - Consideration for overall interest rate risk and liquidity management
- **On every loan, consider…**
  - What could possibly go wrong?
  - Can you mitigate it?
- **Spend more time in the loan write up detailing risks and mitigations.**

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Loan Loss Reserve Methodology

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Loan Loss Reserve Methodology

- **Historical**
- **Historical plus industry standards or General Valuation Allowances**
- **Impairment analysis**
- **Codification**(ASC-Accounting Standards Codification)
  - **Codification FASB ASC 450 (formerly FAS 5)**
  - **Codification FASB ASC 301-10 (Impaired loans, TDR's)**
  - **Codification FASB ASC 310-10 (formerly FAS 114)**
- **Regulator/Examiner perspective**
- **Independent Accountant perspective**
- **Policy on TDR**
- **OREO Portfolio Accounting Procedures**
- **OREO Portfolio Management Procedures**
- **Environmental Factors**
  - Economic
  - Underwriting changes
  - Collection practices
  - Local or national situations (such as housing or commercial valuations)

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Examinations

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Examinations

- **NCUA hot buttons for MBL**
  - Key credit union operational issues
    - Concentration risk
    - Interest rate risk
    - Use of CUSO's
    - Loan Participations—more important as CU's getting closer to Caps.
      - Sold
      - Purchased
- **Internal exams**
- **External exams** (NCUA and Third Party)
  - Frequency
  - Documentation and credit quality
  - How does this change with the proposed NCUA rules?
- **Portfolio Analysis**

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Workouts (Makeovers)

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Workouts

Collection strategies / philosophy
Forms of modification
Restructuring
Forbearances
Troubled Debt Restructuring (TDR) requirements
What is your experience with TDR's? How did you handle items such as:

- Defining a TDR (Troubled Debt Restructuring)
- Items that can benefit TDR's e.g.:
  - Increases the likelihood of repayment on loans to members having financial difficulty
  - It lessens the likelihood of repossession or foreclosure losses

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Workouts (continued)

Define the accounting considerations

- Held for Use
- Held for sale

Your Valuation Process

Reporting and Tracking

Loan Loss provisions

Foreclosures

OREO (Use of Appraisals, current comps, or other valuation methods)

OREO assets: (Held for sale versus Held for use)

- Capital Improvements
- Accounting
- Interim Market value fluctuations
- Time frame
- Depreciation
- Environmental Factors

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Political Issues

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Political Issues

- **NEEDED: Cap Limits legislation: 12.25% to 27.5% or the current translation based on the NCUA proposed rule**
  - **Raising the Cap benefits both those credit unions currently providing MBL services and <u>those thinking about offering MBL services.</u> H.R. 1188 and S.F. 2028.**
- **H.R. 1133 exempt loans to veterans**
- **NCUA Proposed MBL Rule 723 revamp**
- **Other**

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Follow up Questions?

Thank you for your participation and support of the MBL Roundtable

Thanks so much to all our Table Leaders…

Please make sure we have your email address!!!

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MBL
Experienced Lenders' Roundtable Discussion

Bob Stowell
Senior Vice-President/
Chief Strategy Officer
US Federal Credit Union
bob.stowell@usfed.org

EXHIBIT G

ICBA
INDEPENDENT COMMUNITY
BANKERS of AMERICA

Testimony of

Noah Wilcox

President and CEO of Grand Rapids State Bank

Grand Rapids, MN

On behalf of the

Independent Community Bankers of America

Before the

United States Senate

Committee on Banking, Housing, and Urban Affairs

Hearing on

"Credit Unions: Member Business Lending"

June 16, 2011

Washington, D.C.

Opening

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I am Noah Wilcox, fourth generation President and CEO of Grand Rapids State Bank and a member of the Executive Committee of the Independent Community Bankers of America. Grand Rapids State Bank is a state chartered community bank with $236 million in assets located in Grand Rapids, Minnesota. I am pleased to represent community bankers and ICBA's nearly 5,000 members at this important hearing on credit union member business lending.

ICBA appreciates this opportunity to testify on legislation (S. 509) that would expand credit union powers by raising the cap on member business loans as a percentage of assets. We strongly oppose the Small Business Lending Enhancement Act. Congress should not expand credit union business lending powers unless it is also prepared to tax credit unions and require them to comply with the Community Reinvestment Act. The credit union tax exemption is directly linked to and can only be justified by their original mission of serving individuals of modest means. Any expansion of their powers beyond the original mission should result in the loss of their tax exemption.

I want to make clear that community bankers strongly support locally-based non-profit organizations. I have served on a number of non-profit boards, including the Grand Rapids Area Community Foundation and the Itasca County Family YMCA. Many of my community bank colleagues perform similar service. These non-profits justify their tax exemption by serving a public mission. Our concern is that credit unions, having strayed far from their statutory mission, are abusing their tax exempt status and are seeking to go even farther.

This topic is not in the least abstract for me. For my bank, credit union business lending represents an immediate threat. I'm happy to compete with other tax-paying lenders, even large banks, but the credit union tax exemption creates an unfair advantage and distorts the market. I have very aggressive credit unions in my market. On countless occasions, I've lost business lending opportunities with established customers to credit unions who underpriced my competitive rates. Just last Friday, as I was preparing for this hearing, a longtime customer, with both personal and commercial lending relationships, told me they were taking three loans to two different credit unions. One of the loans was a loan on real estate for development that the credit union priced about 400 basis points less than our rate, which is competitive. This rate is even lower than can be accounted for by the tax advantage, suggesting that the credit union, inexperienced in business lending, did not appropriately price the risk. The second loan is a small commercial loan. And the third loan is a mortgage on the borrower's residence, on which, though it does not qualify for the secondary market, the credit union, has offered a rate in the mid-3 percent range.

S. 509 would allow the NCUA to approve member business loans that raise a credit union's total amount of outstanding loans to 27.5 percent of assets – more than double the current cap of

12.25 percent. The current cap was established in 1998 as part of the Credit Union Membership Access Act, which completely undermined the original "common bond" requirement for credit union customers. The 1998 law reversed a recent Supreme Court decision and allowed credit unions to serve a customer base with multiple common bonds. Because the law made the common bond requirement nearly meaningless, the member business lending cap was deemed especially important to maintain a distinction between credit unions and banks. The 12.25 percent cap was not chosen arbitrarily but was intended to ensure that commercial lending would comprise no more than a marginal part of a credit union's lending.

The credit unions have portrayed S. 509 as an effort to make more credit available for small businesses. The truth is that only a small number of credit unions are at or near the current member business lending cap – we estimate this number to be about 0.5 percent of the approximately 7,400 credit unions. Over 70 percent of credit unions report no member business loans at all. Those credit unions that are at or near the cap are the largest and most complex credit unions, and the business loans they make are often multi-million dollar, speculative, commercial loans – not small business loans. There is ample capacity for the remaining 99.5 percent of credit unions to expand their member business lending. The fact that only 4.5 percent of credit union assets are invested in commercial loans – a figure cited by advocates of S. 509 – does not suggest that the current cap of 12.25 percent is too low. What's more, there are numerous exceptions to the member business lending cap, including:

- Any loan of less than $50,000;
- Small Business Administration loans, including 7(a) and 504 SBA loans of up to $5 million;
- Non-member loans and loan participations purchased from other credit unions;
- Loans made by any credit union grandfathered by the 1998 law because they had a history of making business loans or were chartered for the purpose of making business loans;
- Loans made by low income or community development financial institutions; and
- Loans secured by the borrower's primary residence.

With regard to this last exception, I note that some of the examples of supposed commercial credit union loans cited by advocates of S. 509 are actually loans secured by the borrower's residential mortgage, which are not subject to the cap. These loans are not small business loans based on the lender's understanding of the business's cash flow, debt coverage, and other factors that go into commercial credit underwriting. Rather, they are second mortgages based on the home's value as collateral should the business fail -- a type of lending that is irresponsible at best.

S. 509 is not driven by the need to bring credit to small businesses. It is driven by a small number of credit unions who want to increase their assets and their revenues while still enjoying their tax-exempt status.

Credit Unions Lack Expertise in Commercial Lending

What's more, commercial lending is not for novices. It takes many years of experience and a firm grasp of the commercial environment to properly evaluate a business loan application, to value the collateral, and to understand the risk and price accordingly. Credit unions lack the experience and the expertise to safely conduct commercial lending, and their regulator, the NCUA, lacks experience in supervising commercial lending. I recognize that S. 509 includes provisions that are intended to ensure that credit unions have a track record – however limited – in commercial lending. These provisions are inadequate and leave too much discretion to the NCUA. As we emerge from the financial crisis and economic recession, this is the wrong time to jeopardize the safety and soundness of our financial system.

Credit Unions Not Fulfilling Their Tax-Exempt Mission

The purpose of the cap on member business loans established by the 1998 law was to ensure credit unions would focus on serving members of modest means, not commercial lending. Numerous independent studies have concluded that credit unions are not fulfilling their core mission.

A 2005 study by the National Community Reinvestment Coalition determined that banks do a better job of fulfilling the credit unions' mission than the credit unions. The study highlighted how banks "consistently exceed credit unions' performance in lending to women, minorities, and low and moderate-income borrowers and communities." A 2003 Government Accountability Office study found that credit unions serve a more affluent clientele than banks. This GAO study concluded that "credit unions overall served a lower percentage of households of modest means than banks."

Another study by the Woodstock Institute concluded that credit unions serve a higher percentage of middle and upper-income customers than lower-income households. Similarly, a study by the Virginia Commonwealth University concluded that credit unions tend to serve a higher proportion of wealthier households in their customer base.

The recent push by many credit unions into payday lending makes a travesty of their original tax-exempt mission. A recent investigation conducted by *The Washington Post* documents credit union payday lending abuses. While many credit unions offer short term, small dollar loans under reasonable terms, some credit union products are nearly as predatory as those offered by a store front check casher. The *Post* identified at least 15 credit unions that offer high cost loans closely resembling payday loans. In particular, some credit unions earn commissions by acting as fronts for third party lenders with names such as "QuickCash" and "CU on Payday."

Credit unions' involvement in a Florida real estate investment scheme, dubbed "Millionaire University," illustrates just how far credit unions have strayed from their original tax-exempt mandate to serve low and moderate income families and into risky business loans. In this scheme a number of credit unions granted speculative out-of-market land development loans to residents from far away states. Borrowers became credit union 'members" by paying a $5 dollar membership fee. Three of those credit unions failed. What original members were served in their home states of Colorado and Michigan when these credit unions made risky loans on Florida real estate? Congress cannot allow tax-exempt credit unions so stray even further into such risky business lending endeavors by increasing the business lending cap while remaining subsidized by taxpayers.

Congress explicitly placed limits on the types of lending tax-exempt credit unions can do for a good reason – so credit unions can focus their efforts on serving people of modest means that share a common bond. This is not only better for local communities; it is also a much safer form of lending.

Credit Union Lending Comes at a Significant Cost to Taxpayers

The neglect of credit unions' original mission is unfair to the people credit unions were intended to serve; it's unfair to taxpaying community banks, but it's also unfair to all taxpayers. Some advocates of S. 509 claim that expanded credit union commercial lending would come at "no cost to taxpayers." This is patently false. Lending by tax-exempt credit unions displaces lending by taxpaying banks, and thereby reduces tax revenue to the government. In light of the urgent need to reduce the federal budget deficit, we must consider the cost-benefit analysis of the credit union tax exemption.

The most comprehensive analysis of the credit union's federal tax exemption was undertaken by the non-partisan Tax Foundation in 2005. This analysis considered not only the cost of the tax subsidy, but what happens to the tax subsidy – i.e., whether and to what extent it is passed on to customers – and the effect of the subsidy on the marketplace for financial services. The Tax Foundation found that:

- The value of the tax subsidy was $2 billion in 2003 – and growing to over $3 billion annually today. This included not only the direct tax expenditure that resulted from not taxing the net revenue of credit unions, but the indirect effect on tax revenues of a less competitive marketplace for financial services. This is a more comprehensive analysis of the tax subsidy than is provided by the Joint Committee on Taxation and the Office of Management and Budget, which consider only the static tax expenditure and exclude behavioral changes in the marketplace. Still, JCT and OMB also confirm the dramatic growth of the tax expenditure in recent years.
- The subsidy would cost the taxpayer over $32 billion over a ten-year budget window.
- The subsidy boosted the return on assets, for the average credit union, by 50 basis points.

- Of those 50 basis points, only a meager 6 basis points are passed onto customers in the form of lower interest rates on loans. There is little to no effect on deposit rates. 11 basis points are absorbed by higher labor costs at a credit union than at a comparable bank (due to inefficiencies).
- The remaining 33 to 44 basis points of subsidy accrue to the credit union owners in the form of higher equity and larger assets they use to expand rapidly.

In summary, the Tax Foundation study shows that credit unions generally do not pass on their subsidy to customers. However, the competitive threat to community banks comes from the fact that credit unions have the *option* to use the subsidy to secure business they want. This is what I see repeatedly in my business. The credit union loan that I mentioned earlier, that was underpriced by 400 basis points, was surely made possible by the tax subsidy, and perhaps a failure to adequately evaluate the risk. Given the projected growth in the federal budget deficit in the coming years and the threat it poses to our national prosperity, we can no longer afford a tax subsidy divorced from its original purpose that generates no public benefit and poses a threat to tax-paying community banks. This view is also shared by the Debt Reduction Task Force of the Bipartisan Policy Center, Chaired by former Senator Pete Domenici and former OMB Director Alice Rivlin, whose recent report recommends eliminating the tax exemption for credit unions. In addition, the Congressional Budget Office, in its annual "Budget Options" report, noted the option of taxing large credit unions. Any serious effort to reduce the deficit must consider the merits of repealing the credit union tax exemption. While I have focused my comments on the federal budget, the credit union tax exemption also deprives state and local governments, many of which are facing cuts to essential public services to remain solvent, of desperately needed revenue.

The recent bailout of corporate credit unions further demonstrates the fundamental unfairness of the tax exemption. On September 24, 2010 three corporate credit unions were taken into conservatorship by the NCUA, bringing the total to five over a period of 18 months. Seventy percent of corporate credit unions assets were held under conservatorship. The corporate credit unions had invested in $50 billion of subprime, private label, mortgage-backed securities, a failure of prudent lending illustrating that their judgment seems to have been no better than that of the Wall Street banks that also had to be bailed out. Had NCUA not intervened with the provision of a taxpayer-funded backstop, consumer credit unions would have suffered system-wide losses of an estimated $40 billion and as many as 30 percent of federal credit unions would have failed, according to NCUA estimates. Credit unions benefit from taxpayer resources when times are rough, but they do not contribute when they are profitable. This is an affront to taxpayers and to the community banks that sustain their communities and the nation with hard-earned tax dollars. Community banks pay their fair share; credit unions should be held to the same standard.

The case for repealing the exemption stands on its own merits as a deficit reduction measure. When considered in the context of the current effort by credit unions to expand their business lending powers and become the equivalent of banks, linking expanded lending powers to repeal of the tax exemption is a matter of fairness and free market principle. If credit unions seek to have no distinct business model verses commercial banks than Congress must tax them under any equitable tax system.

Credit Unions Could Convert to Mutual Thrifts

The implicit reason for expansion of member business lending proposed in S. 509 appears to be that the current credit union charter is inadequate for the needs of some credit unions and their customers. However, ICBA believes that there is a far more appropriate alternative for them. If they need bank powers to better serve their customers, they should be encouraged to convert to a Federal savings association charter. Over 30 credit unions have taken advantage of this option, despite the substantial roadblocks that the National Credit Union Administration has put in the way of credit union-to-thrift conversions.

Conclusion

Thank you again for convening this important hearing. As a community banker, I feel the direct impact of credit union commercial lending, so I'm grateful for the opportunity to provide my perspective.

ICBA strongly urges this committee to reject calls for new powers for the tax-subsidized credit union industry that will not, despite assertions to the contrary, expand small business credit or create jobs. ICBA adamantly opposes S. 509 as an unjustified and unfair credit union power-grab at the expense of taxpaying community banks and individuals. Credit unions should be granted no new powers as long as they remain tax exempt and are not even meeting their statutory mission to serve individuals of modest means.

Thank you for this opportunity to testify and express the views of the community banking sector.

EXHIBIT H

CUNA
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August 5, 2013

Mr. Michael J. McKenna
General Counsel
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

RE: Regulatory Review for 2013

Dear Mr. McKenna:

This letter responds to the request for comments regarding the National Credit Union Administration's (NCUA) Regulatory Review for 2013, under voluntary compliance with Executive Order 12866. CUNA is the nation's largest advocacy organization for our nation's state and federal credit unions, which serve more than 96 million members. Many of these comments draw on current concerns and issues as well as issues we have raised in the past but that remain unresolved.

Executive Summary

Compliance costs resulting from regulatory burdens continue to be a major concern for credit unions. NCUA's annual review of its regulations is an opportunity for the agency to consider and enact meaningful changes to its rules that could decrease the regulatory load under which credit unions operate and the compliance costs they incur. The list below summarizes the key points and recommendations CUNA has addressed in our comment letter.

National Credit Union Share Insurance Fund – Part 745

- NCUA should eliminate Temporary Corporate Credit Union Stabilization Fund Assessments.
- NCUA should stop applying federal rules to state credit unions as part of NCUSIF coverage.
- NCUA should offer insurance to IOLTA accounts on the same basis as the FDIC.
- NCUA should allow insurance on prepaid debit cards when the person giving the card is a member.

Member Business Loans – Part 723

- NCUA should eliminate all requirements that are not specifically stated in the FCU Act, such as construction and development loan limits; the requirement for the personal guarantee of the borrower(s); loan-to-value ratios; appraisal requirements, and others.
- NCUA should continue to champion legislation increasing the cap.
- NCUA should revisit exemptions under "history of primarily making" language in the FCU Act.

Credit Union Service Organizations – Part 712

- NCUA should not advance its proposed CUSO regulation.
- NCUA should minimize CUSO regulatory requirements.
- NCUA should revamp CUSO requirements in the proposed derivatives rule.

Appraisals – Part 722

- NCUA's requirements should not be more stringent than those of bank regulators.
- NCUA should modify appraisal requirements to align with the guidance provided by the December 2010 Interagency Appraisal and Evaluation Guidelines.

Fidelity Bond and Insurance Coverage – Part 713

- CUNA supports a waiver process under which credit unions that no longer qualify for the higher deductible could have more than the 30 days to obtain the required coverage.

Privacy – Part 716

- NCUA should support efforts to eliminate annual privacy notice requirements.

Fair Credit Reporting – Part 717

- NCUA should revise this regulation to reflect that the CFPB now has significant responsibility for this law.
- NCUA should also work with the CFPB to reduce FACT Act burdens.

Incidental Powers – Part 721

- NCUA should allow FCUs to engage in incidental activities authorized for state credit unions in the state or states in which they operate, to the extent such powers are not inconsistent with the FCU Act.
- NCUA should supplement its three-part test for determining an incidental power with the approach used by the Comptroller of the Currency in recent opinion letters, which broadens the test and renders it more flexible.
- NCUA should approve the following:
  - Pre-paid funeral home accounts under the Trustee or Custodial Services category;
  - Management of repossessed residential properties for other credit unions; and
  - A foreign currency investment pilot program.

Central Liquidity Facility – Part 725

- The CLF should be updated.

Accuracy of Advertising and Notice of Insured Status – Part 740

- NCUA should simplify its rules along the lines line of the FDIC requirements.

Administrative – Part 747

- NCUA should vastly improve the examination appeals process to ensure fairness.
- NCUA should improve its appeals process for other administrative issues.

Credit Unions' Regulatory Burdens Must Be Considered Before Any New Rules Are Imposed

The NCUA Board Chairman has made efforts to help mitigate the impact of some needlessly onerous rules. Yet, the capacity for many credit unions to absorb, implement and monitor compliance under additional new rules is nearing its limit and regulatory burdens will endanger the future viability of credit unions if the current pace of rules continues unabated.

In light of that, we urge NCUA to take into full consideration the scope and magnitude of the regulatory requirements from a variety of regulators that credit unions must already meet in all areas of their operations before imposing new requirements. Moreover, we urge NCUA to eliminate rules that are unnecessary, several of which are highlighted in this letter.

National Credit Union Share Insurance Fund – Part 745

CUNA remains concerned regarding assessments from the Temporary Corporate Credit Union Stabilization Fund (TCCUSF). These assessments have been a major cost burden to credit unions. Based on CUNA's analysis, this year's assessment could cover the remaining losses regarding the legacy assets and with the continued improvement in the performance of legacy assets, future assessments are not necessary. For these reasons, we urge NCUA to eliminate further TCCUSF assessments.

In addition, share insurance costs remain a great concern for federally insured credit unions, and CUNA supports the NCUA Board's efforts to minimize those costs. CUNA also strongly urges NCUA to consider lowering the normal operating level of the NCUSIF from 1.3% to 1.2%, as is permissible under the FCU Act, which would help to contain insurance costs while providing sufficient funding for the NCUSIF.

Also regarding share insurance issues, CUNA continues to request that NCUA revisit its stance on insuring Interest on Lawyers Trust Accounts (IOLTAs). These accounts are established by an attorney or a law firm and are comprised of funds that are owned by specific clients of the attorney or firm. The FDIC has held that these accounts are "fiduciary" accounts that are insured based on the client's interest in the account (FDIC Advisory Opinions 92-30 (May 12, 1992) and 98-2 (June 16, 1998).

Currently, NCUA treats IOLTAs as agent accounts, tying insurance coverage to the membership status of the client, rather than the attorney. "…Client funds in an IOLTA account are insured by the NCUSIF only for those clients who are members of the credit union." (NCUA OGC opinion 08-0840, October 8, 2008).

However, if NCUA were to consider IOLTAs as fiduciary accounts as the FDIC does, rather than agency accounts, it could afford insurance coverage for the funds of all the clients, up to the insurance limits, regardless of their membership status, as long as the attorney is a member of the credit union. NCUA treats guardianship, custodian, and conservator accounts as fiduciary accounts and has determined that for these accounts "either the party establishing the account…or the beneficiary" may obtain insurance coverage. NCUA's current interpretation of the FCU Act as it relates to these accounts puts credit unions at a disadvantage because banks can offer more favorable insurance coverage for the clients' funds.

Another issue regarding insurance coverage has surfaced in the context of pooled accounts under an interim final rule issued January 2011 by the Financial Management Services concerning Federal Government Participation in the Automated Clearing House. Under the interim final rule, a credit union may only offer a prepaid debit card to a member for receipt of the member's federal benefit payments if the card meets several conditions, including meeting the requirement

for pass-through Share Insurance by the NCUSIF. The FDIC has already determined that such pooled accounts will receive the same insurance coverage as other deposit accounts. (FDIC GCO No. 8, November 13, 2008). We urge NCUA to act consistently with the FDIC regarding insurance coverage for these accounts.

Member Business Loans – Part 723

Credit unions are an important source of funding for small businesses in their fields of membership. Such activity benefits not only the individual businesses but also the communities in which the businesses are located. Further, credit union business lending helps to strengthen our economy. Contrary to the portrayal of member business lending in comment letters from banking trade associations, credit union member business lending is a safe and prudent endeavor, as 5300 Call Report data indicates.

CUNA strongly supports (H.R. 688) and Senate (S. 968) MBL legislation that would lift the current cap on MBLs to 27.5% of total assets, up from the current 12.25% ceiling. CUNA also supports Representative Pete King's (D-NY) Capital Access for Small Businesses and Jobs Act (H.R. 719). The act would allow well-capitalized credit unions to match a growing deposit base from a growing membership with capital from sources other than retained earnings, which currently is the only type of capital that counts toward the capital ratio.

We also appreciate NCUA's efforts to support increased MBL authority, including repeated statements from the Chairman to encourage greater leeway for credit unions to make more business loans.

On the regulatory side, we think there is also more that can be done to streamline small business lending for credit unions. All of the regulatory requirements for MBLs that are not specifically required by the Federal Credit union Act should be eliminated. These include: the requirement for the personal guarantee of the borrower(s), loan-to-value ratios, construction and development loan limits, appraisal requirements, and other regulatory restrictions.

While these requirements may be waived upon application by the credit union to NCUA, the waiver process has been strongly criticized by a number of credit unions. Rather than subject credit unions to a cumbersome waiver process, we think the agency should eliminate these requirements. At the very least, we urge the agency to develop and implement in all regions a waiver process that will be timely and allow credit unions to obtain much needed flexibility in operating their member business loan programs.

We also strongly urge the agency to revisit exemptions for federal credit unions under the "history of primarily making" language in the FCU Act. (PL 105-219, 1998, HR 1151, Credit Union Membership Access Act.) We brought this issue to the attention of agency staff in previous years. As you know, the FCU Act provides

exceptions from the cap on MBLs of the lesser of 1.75 times the minimum net worth of a well-capitalized credit union or 1.75 times the credit union's actual net worth. One of the exceptions is for credit unions that have a "history of primarily making member business loans" to their members, and Congress delegated to NCUA the authority to define "history of primarily making" MBLs.

In implementing PL 105-219, NCUA defined "history of primarily making" to focus on those credit unions that had MBLs comprising at least 25% of their outstanding loans or MBLs comprised the largest portion of the credit union's loan portfolio. Under NCUA's rule, credit unions could show evidence of a history of primarily making MBLs with call report data from January 1995 to September 1998. The agency has not reviewed the definition of "history of primarily making" since that time.

The FCU Act does not require NCUA to measure a credit union's history of primarily making MBLs from the passage of the Act and would allow the agency to set a reasonable, contemporaneous time period for a credit union to establish a "history" of making MBLs.

This action is supported by the Legislative History to HR 1151. It provides that Congress intended for the NCUA to "interpret the exceptions … [to the cap], to permit worthy projects access to affordable credit union financing." Thus, NCUA is free to reset the definition using a current timeframe that reflects the current lending practices of credit unions.

NCUA's waiver process, personal guarantee, and other requirements remain impediments for credit unions making MBLs. The recently issued Supervisory Letter 13-CU-02 addresses waiver criteria but does not indicate that credit unions should have the flexibility to make MBLs to members without a personal guarantee or should be granted a blanket waiver from the personal guarantee requirement. Credit unions with well-run MBL programs should be given latitude to run their programs without undue constraints from the NCUA.

Credit Union Services Organizations (CUSOs) – Part 712

Because the financial marketplace continues to evolve, CUNA supports authority for credit unions to invest in or lend to CUSOs that may engage in a broad range of activities that will help support the diverse needs of credit unions and their members. Many credit unions rely on CUSOs and these organizations must have flexibility to provide services that will help ensure credit unions are responsive to the needs of their members yet consistent with the Federal Credit Union Act.

As we stated in our comment letter dated September 13, 2011 on NCUA's proposal regarding CUSOs, we believe the proposal was too harsh, and we continue to question the agency's authority to regulate CUSOs directly as the proposal called for. We appreciate that NCUA has delayed further consideration of the proposal,

and we urge NCUA to drop it altogether. The agency already has sufficient authority to address credit union safety and soundness concerns that involve CUSOs. A new broad rule regarding CUSOs should not be driven by problems a few credit unions have encountered with their CUSOs, particularly when the vast majority of CUSOs are operated in a safe and sound manner, providing much needed services to credit unions and their members.

One aspect of NCUA's requirements regarding CUSOs should be reconsidered. That is, the requirement involving financial statement audits. As NCUA has indicated, generally accepted accounting principles (GAAP), specifically Accounting Research Bulletin 51, Consolidated Financial Statements, allow a credit union that is the majority owner of a CUSO to utilize a consolidated audit.

However, NCUA has limited this ability to use a consolidated audit to wholly-owned CUSOs. Under GAAP, subsidiaries generally are fully consolidated if the parent institution holds more than 50% of the subsidiary. This standard is the proper one to apply in the context of these rules and, therefore, we strongly encourage NCUA to permit a consolidated audit for a majority-owned CUSO as defined under GAAP.

Although not specifically part of the CUSO regulation, we urge NCUA to revisit the limitation on the use of CUSOs in the agency's proposed derivatives rule. The proposal differentiates the services offered by wholly-owned CUSOs and CUSOs with shared ownership. This represents a change in the regulation of credit unions involved with CUSOs, and one that is not for the better. We do not think this approach is appropriate and we urge NCUA not to adopt it as part of the derivatives rule.

Appraisals – Part 722

CUNA believes that current NCUA regulations pertaining to appraisal requirements for loan modifications, renewals, and refinancing put credit unions' members at a significant disadvantage, especially when compared to bank customers. Since Title XI of the Financial Institution Reform, Recovery and Enforcement Act (FIRREA) was adopted in 1989, new appraisals for extensions of existing credit have not been required when there are no new monies advanced beyond closing costs or when there have been no obvious and material changes in market conditions. FIRREA allows an evaluation to be used in lieu of an appraisal when only one of these conditions is present. The Interagency Appraisal and Evaluation Guidelines published on December 2, 2010 reaffirmed this.

However, current NCUA regulations require that credit unions meet a stricter standard, thus disadvantaging credit union members. For credit unions, a new appraisal is required in instances where both: 1) no new funds are advanced beyond closing costs, and 2) and there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy

of the credit union's collateral protection. As a result, credit union members are subjected to added costs and increased processing time.

NCUA also requires credit unions to apply for individual waivers when the LTV is over 80% (115% if a blanket waiver has been issued). Other regulators do not place this burden on their institutions. Instead they only require tracking and reporting of LTV exceptions to the financial institution's Board of Directors, with some limitations on the amount of exceptions as a percentage of Tier 1 capital (Appendix A to Part 365 – Interagency Guidelines for Real Estate Lending Policies). Again credit unions and their members are comparatively disadvantaged.

When the transaction is deemed to be a Troubled Debt Restructuring (TDR), NCUA does allow credit unions to forego NCUA approval for LTV waivers (Supervisory Letter No 13-01 (Evaluating Credit Union Requests for Waivers of Provisions in NCUA Rules and Regulations Part 723, Member Business Loans)). This is positive and improves credit unions' ability to accommodate well-structured modifications. However, NCUA still requires new appraisals for both residential and MBL loans in these cases. Such appraisals are not required for other financial institutions under the same conditions.

CUNA believes that there are some cases in which a new appraisal is necessary. However, the decision about whether a new appraisal should be ordered should be left to the credit union's judgment, as is the case of other financial institutions. The information that updated valuations provide may be valuable, but can usually be adequately addressed through alternative valuation approaches.

NCUA appraisal requirements should align with the guidance provided under the December 2010 *Interagency Appraisal and Evaluation Guidelines*. This change would enable credit unions to provide better service to their members. The ability to address appropriate modifications on a timelier basis will also help prevent potential losses without increasing risks to the credit union or the National Credit Union Share Insurance Fund.

Fidelity Bond and Insurance Coverage – Part 713

Although CUNA did not support the elimination of the Regulatory Flexibility (RegFlex) Program, CUNA generally supported the agency's updates to this part in December 2012 to provide the maximum deductible of up to $1 million for credit unions that are qualified under the new standards. To further improve this rule, CUNA urges NCUA to add a waiver process under which credit unions that no longer qualify for the higher deductible could have more than the 30 days to obtain the required coverage.

Leasing – Part 714

We believe that credit unions should determine for themselves whether obtaining a full assignment is necessary to protect their interests. The Office of the Comptroller of Currency's (OCC) leasing rules do not require full assignment. The OCC rules require a perfected lien and treat the end user lessee as the obligor.

The decision to obtain a full assignment should be based on the credit union's business practices and not on regulatory requirements. Some credit unions may very well decide that a full assignment is the best method to maintain full control of any situation that may arise, especially in the case of default and vehicle disposition, but some credit unions may be justified in deciding this step is unnecessary.

We believe that NCUA should add more flexibility regarding the residual value limits. Leasing transactions differ based on such factors as the length of the lease term and the property involved. The length of the term and the varying rates at which different vehicles depreciate may both affect the decision regarding the appropriate residual value. Credit unions should have discretion to review these factors to make their own determinations, with the assistance of accepted residual leasing guides. Moreover, NCUA should clarify the types of leasing relationships covered by this regulation.

Privacy – Part 716

CUNA continues to believe that the current requirement to deliver privacy notices on an annual basis is unnecessary, especially for credit unions that are not required to provide their members with the right to opt-out of certain information-sharing. Privacy notices should only be required when a member relationship is established and when changes are made to a privacy policy. Eliminating the annual privacy notice requirement, except in the event any changes have been made to the institution's privacy policy, will help to relieve the regulatory burden on financial institutions. This is particularly true for small institutions for which mailing an annual privacy notice is often costly, posing a significant regulatory burden.

Therefore, CUNA supports the Eliminate Privacy Notice Confusion Act (H.R. 749) that Representatives Blaine Luetkemeyer (R-MO) and Brad Sherman (D-CA) have introduced. Eliminating these superfluous annual privacy notices would make the needed privacy notifications more meaningful for consumers while simultaneously reducing the regulatory burden on credit unions. Such relief would afford credit unions added time and resources to spend providing more important financial services to their members. CUNA strongly urges NCUA to advocate for this common sense regulatory relief measure.

Fair Credit Reporting – Part 717

The Dodd-Frank Act transferred FACT Act authority to the CFPB. The CFPB issued Regulation V, which substantially duplicates most of the requirements found in part 717. The Dodd-Frank Act, however, did not transfer all rulemaking authority under the Fair Credit Reporting Act. NCUA retains the authority to promulgate rules on: the disposal of consumer information, ID theft red flags, and rules on the duties of card issuers regarding changes of address. NCUA needs to amend part 717 so it properly reflects the NCUA's current regulatory authority and not pre Dodd-Frank Act regulatory authority.

The FACT Act is particularly burdensome and most credit unions are not in a position to readily absorb the costs of additional FACT Act rules, such as training or software. We believe additional emphasis must be placed on reducing the cumulative burdens associated with the FACT Act rules. NCUA and the other federal financial institution regulators, under the auspices of the CFPB, should conduct a specific review of the FACT Act rules as soon as possible.

Incidental Powers – Part 721

As we have in the past, CUNA urges NCUA to take steps to expand FCUs' authority to engage in incidental powers. Such steps should include:

- Supplementing NCUA's three-part test for determining an incidental power with the approach used by the OCC in their opinion letters, which broadens the test and renders it more flexible; and
- Allowing FCUs to engage in incidental activities authorized for state credit unions in the state or states in which they operate, to the extent such powers are not inconsistent with the FCU Act.

CUNA also recommends that NCUA approve the following additional incidental activities, which are:

- Allowing FCUs to accept pre-paid funeral home accounts under the Trustee or Custodial Services category;
- Permitting FCUs to manage repossessed residential properties for other credit unions; and
- Authorizing a foreign currency investment pilot program.

National Credit Union Central Liquidity Facility (CLF) – Part 725

The financial crisis has shown that the CLF played an essential role in facilitating the ability of the NCUSIF to borrow from the federal government during times of economic stress. As such, CUNA is looking at ways the CLF could be modernized to meet potential future system liquidity needs and will be sharing that review with NCUA.

CUNA also firmly backs Representative Gary Miller's (R-CA) "Regulatory Relief for Credit Unions Act" (H.R. 2572). The bill would, among other things, direct the Government Accountability Office to study the need for improvements and modernizations to the CLF. It would also require that the NCUA study the CLF and make legislative recommendations for its modernization. CUNA believes that with modernization, the CLF can play a very important role by meeting the potential future system liquidity needs of the industry.

Accuracy of Advertising and Notice of Insured Status – Part 740

A number of credit unions are advertising via mobile banking/text messaging and have expressed to us concerns with the requirement under section 740.5 that all advertisements include NCUA's official statement, "This credit union is federally insured by the National Credit Union Administration," or the abbreviated statement, "Federally insured by NCUA."

Financial institutions insured by the FDIC may comply with the FDIC's advertising statement requirement by simply displaying "Member FDIC." In an era of communication via condensed messaging (e.g., Twitter), each character in a text message or on a mobile website must be chosen very carefully. In that connection, we ask NCUA to consider revising Part 740 to permit credit unions to use a further abbreviated advertising statement as an option for complying with the agency's Accuracy of Advertising and Notice of Insured Status rule.

Administrative Actions – Part 747

CUNA continues to encourage strong safety and soundness regulation, which is essential to protect credit union members and to minimize NCUSIF costs for all credit unions.

Additionally, we urge the Office of General Counsel to work closely with your field and examination staff to ensure all administrative actions are handled appropriately, fully reflecting safety and soundness concerns as well as the rights of credit union officials. CUNA remains concerned with the appeals process for exam findings and other actions, including appealing waiver decisions.

The appeals process is at best inconsistent and sometimes seemingly non-existent. CUNA wants to work with NCUA to ensure that a robust appeals process is put in place so that credit unions are assured that they have an avenue to seek relief when they believe the agency has rendered an unjust decision that negatively impacts their credit union.

Process for Identifying Rules for Review and Soliciting Comments

We continue to believe the process for seeking comments on regulations that are included in the agency's Regulatory Review could be improved. For example, some of the rules included may already be the subject of proposed changes or recent modifications. It is confusing for those rules to be included on the regulatory review list.

Thank you for the opportunity to respond to NCUA's review. If you have any questions about our letter, please do not hesitate to give me a call at (202) 508-6736.

Sincerely,

Mary Mitchell Dunn

Mary Mitchell Dunn
CUNA Deputy General Counsel and Senior Vice President

Cc: NCUA Board Chairman Debbie Matz
NCUA Board Member Mike Fryzel
Incoming NCUA Board Member Rick Metsger

EXHIBIT I

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

DECLARATION

In accordance with 28 U.S.C. § 1746, [redacted], offers the following declaration:

1. My name is [redacted]. I am employed by [redacted] (the "Bank") as its President and Chief Executive Officer ("CEO"). As part of my job duties, I regularly monitor lending activity, maintain relationships with customers, and monitor competition from other financial institutions. My testimony herein is based upon my personal knowledge and a review of records kept in the ordinary course of business by the Bank.

2. The Bank is a locally owned and operated community bank headquartered in [redacted], Michigan. The Bank operates seven full-service banking offices and regularly makes commercial loans. We have many commercial financing relationships with small retail businesses, which are run as "mom and pop" shops.

3. In our commercial lending business, we compete directly with a number of credit unions. At least one of the Bank's credit union competitors belongs to a credit union service

organization ("CUSO"). This CUSO represents an established syndicate of 29 credit area unions that work together to offer commercial loans. The CUSO advertises that, last year, it booked over $150 million in new loans. When a CUSO generates commercial loans, it participates loan interests around to various credit unions.

4. Based on information we have obtained from our customers or potential customers, the Bank has recently lost around $4 million in various types of commercial loans to credit unions. The borrowers on these loans were seeking the type of commercial financing regularly offered by the Bank (*e.g.*, construction loans and industrial loans). However, the competing credit unions were able to offer more favorable rates and terms than would be feasible for a Bank (*e.g.*, abnormally long fixed rates and abnormally low interest rates given the borrower's risk profile). In at least one case, we learned that the commercial loan closed without requiring any prior due diligence.

5. Credit unions that compete with the Bank for commercial loans have a long track record of offering commercial loan interest rates and other terms that generally are only available for consumer or mortgage loans.

6. Since 2003, the Bank has experienced a steady increase in competition from credit unions and CUSOs for commercial loans.

7. Based on my view of the current market for commercial financing and the restrictions under which credit unions and CUSOs currently operate, NCUA's 2016 member business loan ("MBL") rule will make the current situation significantly worse because credit union syndicates will have to count almost none of their commercial loans towards the MBL cap under the Federal Credit Union Act. This is a significant threat to the Bank's business because,

from a cost and a risk perspective, the Bank cannot compete with the commercial lending terms offered by our credit unions and CUSO competitors.

8. The March 2016 announcement of the National Credit Union Administration's final member business loan rule has already impacted the Bank. Like other businesses, the Bank's present value and cost of capital are determined based on the Bank's prospects for future earnings and growth. When the Bank loses a commercial loan, it loses a profitable income stream. The 2016 MBL Rule has impaired the Bank's present value, and made it incrementally more difficult to attract capital, because the Bank is less likely to be able to successfully make and retain profitable commercial financing relationships in the face of aggressive credit union competition that is unlimited in its ability to participate in the commercial lending market.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on November 15, 2016.

[redacted]

EXHIBIT J

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

DECLARATION

In accordance with 28 U.S.C. § 1746, [redacted] offers the following declaration:

1. My name is [redacted] I am employed by [redacted] (the "Bank") as its President. As part of my job duties, I regularly monitor lending activity, maintain relationships with customers, and monitor competition from other financial institutions. My testimony herein is based upon my personal knowledge and a review of records kept in the ordinary course of business by the Bank.

2. The Bank is a locally owned and operated community bank headquartered in [redacted] Montana. We offer an array of financial services, but focus heavily on making commercial loans as part of our growth strategy.

3. The Bank competes directly with multiple credit unions in our market for commercial loan opportunities. We often lose commercial loans to credit union competitors who use their tax-exempt status to undercut what the Bank is able to offer borrowers on loan terms,

fees, and interest rates. The Bank cannot profitably offer the same terms as the competing credit unions.

4. For example, one of our clients in the commercial real estate business has secured financing on four of its commercial real estate projects through a large credit union in Montana. These are the types of commercial loans offered by the Bank, and based on our relationship with the customer, I expect that the Bank would have provided these loans to the customer but for the competition from the credit union. The Bank was not able to match the loan terms offered by the credit union, which has a lower cost structure as a result of its tax exemptions.

5. In addition, another well-established customer of the Bank in the construction business recently used the same credit union to refinance a series of commercial loans previously provided by our Bank on non-owner-occupied residential rentals. Again, the customer shifted this commercial loan business from the Bank to the credit union because the credit union offered the customer terms that the Bank could not match.

6. For years now, the bank has been losing valuable commercial lending relationships, such as these, to credit union competitors. Indeed, since 2003, the Bank has been experiencing an increase in the competition from credit unions for commercial loans. I estimate that the Bank has lost around $30 million in loans to credit union since that time.

7. NCUA's 2016 member business loan ("MBL") rule will make the situation significantly worse. Credit unions often pool their resources to finance loans as syndicates. Under the 2016 MBL rule, only the credit union to which the borrower belongs will have to count the commercial loan amount toward its MBL cap. This will create a significant amount of new commercial lending capacity in the credit union system. Given our inability to compete

with credit unions on equal footing, I expect that our commercial lending business will begin to suffer immediately when the rule goes into effect in January 2017.

8. The announcement of the National Credit Union Administration's finalization of the 2016 MBL rule has already has had a negative economic impact on the Bank. Given the Bank's history of losing commercial loans to the aggressive credit union competition in our market, and new lending capacity that the 2016 MBL rule will generate when it goes into effect in January 2017, the Bank's outlook for its ability to grow its commercial lending business in the future has been impaired. When the Bank loses a commercial loan, it loses a profitable income stream. The Bank's present value is based on its prospects for future earnings and growth. The negative outlook for future growth of the Bank's profitable commercial loan business harms our value, and to some extent our ability to raise capital, today.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on November 15, 2016.

[redacted]

[redacted] President

[redacted]

EXHIBIT K

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

DECLARATION

In accordance with 28 U.S.C. § 1746, [redacted] offers the following declaration:

1. My name is [redacted]. I am employed by [redacted] (the "Bank") as its President and Chief Executive Officer ("CEO"). As part of my job duties, I regularly monitor lending activity, maintain relationships with customers, and monitor competition from other financial institutions. My testimony herein is based upon my personal knowledge and a review of records kept in the ordinary course of business by the Bank.

2. The Bank is a small community bank headquartered in [redacted], West Virginia. We operate nine branches in northwest West Virginia and southeast Ohio. The Bank regularly makes commercial loans. Our typical commercial loans include residential rentals, motels, construction loans, and industrial loans (*e.g.*, heavy equipment).

3. The Bank competes directly with multiple credit unions in our markets for these same commercial loan opportunities. In fact, we regularly compete with and lose commercial loans to credit unions that are able to undercut our rates and terms because of their tax advantage.

4. For many of these commercial loans, the borrowers or the guarantors are substantial businesses or wealthy investors who are attracted to the lower interest rates and other terms that credit unions are able to offer by virtue of their tax-exempt status as credit unions. Thus, in many cases, the credit unions that are extending these commercial loans are using their tax-advantaged status to benefit high net worth individuals and large business interests, not small mom-and-pop businesses or individuals of modest means who would not otherwise not be able to obtain commercial credit on reasonable terms.

5. For example, the Bank recently lost out on a loan of over $6 million to finance the construction and operation of a local motel. We learned that the project was ultimately financed by a consortium of credit unions operating through a credit union service organization ("CUSO").

6. It would not be feasible for the Bank to offer the same terms as the competing credit unions.

7. For years, the Bank has been losing valuable commercial loans to this syndicate of credit unions. This has been a growing problem since 2003.

8. NCUA's 2016 member business loan ("MBL") rule will make the situation worse. Similar to the situation described above, credit unions that we compete against often pool their resources to finance loans as syndicates. A regional CUSO facilitates these loans. Under the 2016 MBL rule, only the credit union to which the borrower belongs will have to count the commercial loan amount toward its MBL cap. The new rule will open the gates to new credit union commercial financing that would have been sidelined after reaching the MBL cap under the previous rule. Since credit unions have an operating cost advantage due to their tax

exemptions, our commercial lending business will definitely suffer when credit unions can make even more commercial loans in January 2017.

9. The announcement of the National Credit Union Administration's final MBL rule has already has had a negative economic impact on the Bank. Indeed, since NCUA's finalization of the rule, we have had to renegotiate previously established commercial loan rates with some of our borrowers in an attempt to stop those borrowers from taking the loans to credit union competitors. These competing credit unions have recently been very active in attempting to lure away our commercial borrowers. As a result of renegotiating interest rates on these commercial loans, our revenue has declined.

I declare under penalty of perjury that the foregoing is true and correct.

Executed on November 15, 2016.

[redacted]

[redacted], President & CEO

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

MOTION TO FILE DOCUMENTS UNDER SEAL AND FOR A PROTECTIVE ORDER

Pursuant to Rule 5 of the Local Civil Rules of this Court and Fed. R. Civ. P. 5.2(e), plaintiff Independent Community Bankers of America ("ICBA") respectfully moves this Court for an order allowing ICBA to file three unredacted declarations under seal and protecting from disclosure to nonparties the unredacted declarations and the individual identifying information, as described in the accompanying memorandum. Plaintiff ICBA asks that the Court direct the Clerk to accept the following documents for filing under seal:

1. Unredacted Exhibit I to the Declaration of Christopher Cole in Support of Plaintiff ICBA's Response in Opposition to the Motion to Dismiss.

2. Unredacted Exhibit J to the Declaration of Christopher Cole in Support of Plaintiff ICBA's Response in Opposition to the Motion to Dismiss.

3. Unredacted Exhibit K to the Declaration of Christopher Cole in Support of Plaintiff ICBA's Response in Opposition to the Motion to Dismiss.

The facts and law supporting the granting of this Motion to File Documents Under Seal and for a Protective Order are contained in the accompanying memorandum. A proposed order granting this Motion is attached.

November 16, 2016

Respectfully submitted,

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Attorneys for Plaintiff

* *Pro hac vice*

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on November 16, 2016, I will electronically file the foregoing with the Clerk of Court using the CM/ECF system, which will send the notification of electronic filing to the following:

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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

MEMORANDUM IN SUPPORT OF PLAINTIFF'S MOTION TO FILE DOCUMENTS UNDER SEAL AND FOR A PROTECTIVE ORDER

Plaintiff Independent Community Bankers of America ("ICBA"), by its undersigned counsel and pursuant to Local Civil Rule 5 and Fed. R. Civ. P. 5.2(e), respectfully submits this memorandum in support of its Motion to File Documents Under Seal and for a Protective Order (the "Motion"). Counsel for NCUA has been consulted and takes no position on the motion at this time.

BACKGROUND

On September 7, 2016, ICBA brought this action under the Administrative Procedure Act, 5 U.S.C. §§ 701-706, to challenge a final agency rule (the "2016 MBL Rule") promulgated by defendant National Credit Union Administration ("NCUA"), the federal agency responsible for supervising federally insured credit unions. (Dkt. No. 1.) On November 2, 2016, NCUA moved to dismiss this action for lack of subject-matter jurisdiction pursuant to Fed. R. Civ. P. 12(b)(1) and for failure to state a claim under Fed. R. Civ. P. 12(b)(6). (Dkt. Nos. 18-19.) Among other things, NCUA asserts that ICBA lacks standing to pursue this action.

On November 16, 2016, contemporaneous with this Motion, ICBA timely filed its Response in Opposition to the Motion to Dismiss (the "Opposition"). In support of its claim of associational standing to pursue this action on behalf of its member community banks and to provide examples of how its members are harmed in their own right by the 2016 MBL Rule, ICBA has attached to its Opposition a declaration from a senior ICBA officer (the "Cole Declaration"). The Cole Declaration describes, among other things, the harms that ICBA's members either are experiencing or will imminently experience as a result of NCUA's adoption of the rule. ICBA has attached a number of exhibits to the Cole Declaration, including declarations from officers of three of ICBA's member banks (the "Member Declarations"). (Cole Decl. Exs. I, J, & K.) The three Member Declarations describe specific examples of harm suffered by particular ICBA members from NCUA's action permitting increased commercial lending by credit unions in competition with community banks, and the Member Declarations also explain the competitive disadvantages community banks face relative to credit unions.

ICBA has filed redacted versions of the three Member Declarations in the public record in this case. Specifically, ICBA has redacted from the public versions of each of the Member Declarations only the following individual identifying information: (i) the declarant's name; (ii) the name of the declarant's particular ICBA member community bank; and (iii) the specific city in which the member community bank is headquartered (the "Individual Identifying Information"). In the accompanying Motion, ICBA now seeks to file the unredacted Member Declarations under seal in accordance with Local Civil Rule 5 and respectfully asks this Court for an order permitting redaction of the Individual Identifying Information from the public record in this case and protecting the unredacted Member Declarations and the Individual Identifying Information from disclosure to nonparties pursuant to Fed. R. Civ. P. 5.2(e).

MATERIALS FILED UNDER SEAL

The materials that ICBA requests be filed under seal are the three unredacted Member Declarations submitted as Exhibits I, J, and K to the Cole Declaration filed in support of ICBA's Opposition. ICBA respectfully requests an order from this Court permitting the redaction of the Individual Identifying Information, as described above, from the versions of the Member Declarations filed in the public record of this case and protecting the unredacted Member Declarations and Individual Identifying Information from disclosure to nonparties.[1]

JUSTIFICATION FOR REQUESTED RELIEF

The law recognizes an exception to the general rule favoring public access to the records of judicial proceedings where such access "could provide a source[] of business information that might harm a litigant's competitive standing." *Nixon v. Warner Communs., Inc.*, 435 U.S. 589, 598 (1978); *see also Kettler Int'l, Inc. v. Starbucks Corp.*, 2015 U.S. Dist. LEXIS 1486, at *4 (E.D. Va. Jan. 5, 2015) (granting motion to seal confidential business information and noting that "this type of information is typically sealed by this Court"); *East West, LLC v. Rahman*, No. 1:11-cv-1380 (JCC/TCB), 2012 WL 3841401, at *3 (E.D. Va. Sept. 4, 2012) (granting motion to seal where disclosure of exhibits would likely harm competitive positions).

ICBA seeks to preserve under permanent seal and to protect from disclosure to nonparties the Individual Identifying Information in the three Member Declarations. In support of ICBA's claim of associational standing in this action, the Member Declarations describe the specific competitive disadvantages faced by the particular member community banks represented by the

[1] As required by Local Civil Rule 5(A) and (C) and contemporaneous with these filings, ICBA is filing a motion to file documents under seal and for a protective order, requesting the permanent sealing of the unredacted versions of the Member Declarations; a proposed order; and a notice of filing under seal. Unredacted paper copies of each of the documents sought to be preserved have been delivered to the Court and provided to defendant's counsel.

declarants and particular instances of commercial lending business that these banks have lost to competing credit unions in their local markets. The disclosure to nonparties of the identities of the particular community banks described in the Member Declarations, together with the specific information described in the Member Declarations, could enable competitors of these banks to gain competitive advantages to the further detriment of these banks. For example, competitors could use the information contained in the Member Declarations against these community banks in soliciting commercial lending business in the local markets where the banks operate. Such competitive harm would further exacerbate the harms that ICBA's member banks are already experiencing when they compete for commercial loans with tax-advantaged credit unions under the regulatory policy of NCUA that ICBA is challenging in this action.[2] The information described in the Member Declarations is not publicly available in combination with the Individual Identifying Information that ICBA seeks to redact from the public record.

Only the Individual Identifying Information will be sealed. The public will have full access to the factual assertions in the declarations that are relevant to the merits of ICBA's challenge to NCUA's final rule.

Permitting ICBA to redact only the Individual Identifying Information from the copies of the Member Declarations filed in the public record and filing under seal the unredacted Member Declarations is the least restrictive means of protecting the competitive interests of the ICBA members that have submitted declarations in support of ICBA's Opposition. *See GTSI Corp. v. Wildflower Int'l, Inc.*, No. 1:09-Cv-123, 2009 WL 1248114, at *9 (E.D. Va. Apr. 30, 2009) (Cacheris, J.) (considering "less drastic" alternatives). ICBA is not seeking blanket sealing of

[2] For the same reasons, the Court has good cause to enter an order pursuant to Fed. R. Civ. P. 5.2(e) permitting redaction of the Individual Identifying Information from the copies of the Member Declarations filed in the public record and protecting the unredacted Member Declarations and Individual Identifying Information from disclosure to nonparties.

the Member Declarations. Because no alternative procedure will suffice to protect the competitive interests at stake, good cause exists to permit the sealing of the Individual Identifying Information and to enter a protective order protecting the unredacted Member Declarations and the Individual Identifying Information from disclosure to nonparties.

CONCLUSION

For all of the foregoing reasons, ICBA requests that the Court grant the Motion and enter an order permitting ICBA to file the unredacted Member Declarations containing the Individual Identifying Information under seal and protecting the unredacted Member Declarations and Individual Identifying Information from disclosure to nonparties.

November 16, 2016

Respectfully submitted,

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Attorneys for Plaintiff

* *Pro hac vice*

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on November 16, 2016, I will electronically file the foregoing with the Clerk of Court using the CM/ECF system, which will send the notification of electronic filing to the following:

Andrew M. Bernie (*pro hac vice*)
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IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

[PROPOSED] ORDER GRANTING PLAINTIFF ICBA'S MOTION TO FILE DOCUMENTS UNDER SEAL AND FOR A PROTECTIVE ORDER

Upon consideration of the motion of plaintiff Independent Community Bankers of America ("ICBA") to file documents under seal and for a protective order, the accompanying memorandum, and a review of the materials sought to be sealed (the "Sealed Materials"), it is hereby

ORDERED that the Clerk of the Court shall place and maintain under seal the three unredacted documents for which sealing is sought, and any and all copies of the same, pending further order from the Court. The Court finds that the public was provided with the requisite notice of ICBA's request to seal, which also allowed interested parties a reasonable opportunity to object, and that sealing is necessary and another procedure will not suffice to protect business interests from competitive harm if the individual identifying information redacted from the documents were disclosed to nonparties; and it is hereby further

ORDERED that the parties shall not disclose the sealed documents, or the individual identifying information as described in the memorandum in support of the motion, to nonparties without further leave of Court.

Let the Clerk send a copy of this Order to all counsel of record.

Entered this _____ day of _____, 2016

_____
James C. Cacheris
United States District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF VIRGINIA
ALEXANDRIA DIVISION

INDEPENDENT COMMUNITY BANKERS OF AMERICA, Plaintiff, v. NATIONAL CREDIT UNION ADMINISTRATION, Defendant.	Civil Action No. 1:16-cv-1141 (JCC-TCB)

NOTICE OF FILING A MOTION TO SEAL

Plaintiff Independent Community Bankers of America ("ICBA"), by counsel, has moved the Court to file under seal unredacted versions of Exhibits I, J, and K to the Declaration of Christopher Cole filed in support of ICBA's Response in Opposition to the Motion to Dismiss and to protect from disclosure to nonparties certain individual identifying information in Exhibits I, J, and K.

Parties and nonparties may submit memoranda in support of or in opposition to the motion within seven (7) days after the filing of the motion to seal. All or part of such memoranda may be designated as confidential. Any person objecting to the motion must file an objection with the Clerk within seven (7) days after the filing of the motion to seal.

If no objection is filed in a timely manner, the Court may treat the motion as uncontested.

November 16, 2016

Respectfully submitted,

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Attorneys for Plaintiff

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