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May 6, 2003

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

Re: National Credit Union Administration; 12 CFR Parts 702, 704, 712, 723  
Prompt Corrective Action; Corporate Credit Unions; Credit Union Service  
Organizations; Member Business Loans; 68 Federal Register 16450, April 4, 2003

Dear Ms. Baker:

The American Bankers Association (“ABA”) is responding to the proposed rule published by the National Credit Union Administration (“NCUA”) concerning amendments to its Member Business Loan regulations. ***ABA strongly opposes the proposed changes in NCUA’s Member Business Loan (“MBL”) rule and believes these proposed amendments are contrary to Congressional intent to limit business lending by credit unions.***

The ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership—which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, and savings banks—makes ABA the largest banking trade association in the country.

### **Background**

NCUA adopted its first MBL rule in April 1987 and has subsequently amended the rule, including the most recent, substantive amendments purportedly to conform to the limitations imposed by the Credit Union Membership Access Act (“CUMAA”). 12 U.S.C. 1757a, Pub. L. 105-219, 112 Stat. 913 (1998).

The NCUA Board (“Board”) is proposing several amendments to revise and clarify certain provisions that, NCUA claims, have caused confusion or created unnecessary regulatory burden. These amendments relate to: the dollar amount that triggers compliance with the rule, the loans-to-one borrower limit, the aggregate MBL limit, loan-to-value requirements, MBL documentation requirements, and the loan loss reserve requirements. The Board also proposes that credit unions that purchase

participation interests in MBLs made to credit union members need not count the purchase against the credit union's own limit.

In addition, the Board is proposing an amendment to the Prompt Corrective Action ("PCA") rule related to business lending. The Board proposes to expand the current, standard risk-based net worth component for MBLs in Part 702.

Finally, the Board proposes to amend the Credit Union Service Organization ("CUSO") rule to permit CUSOs to make business loans. During prior rulemakings, commenters asked the Board to authorize business loan origination as a permissible CUSO activity. 66 FR 40575, Aug. 3, 2001; 63 FR 10743, Mar. 3, 1998. Previously, the Board believed that permitting CUSOs to offer business loans could negatively affect affiliated credit union services. The Board has reconsidered its position and now believes that CUSOs should be authorized to engage in business loan origination.

### **ABA's Position**

NCUA's proposed amendments to its MBL rule significantly erode Congressional intent. Congress in 1998 made it perfectly clear that credit unions should be focused on consumer lending, not commercial lending. Notwithstanding that Congressional directive, this proposed rule will divert credit union resources to financing commercial enterprises, while relaxing safety and soundness regulations associated with member business loans.

ABA's comment letter is organized as follows:

1. The proposed amendments violate Congressional intent to limit the business lending activities of credit unions.
2. NCUA's justifications for the proposed amendments to its Member Business Loan rule are ill founded.

### **The Proposed Amendments to NCUA's Business Loan Rule Violate the Intent of CUMAA.**

The proposed amendments to NCUA's MBL rule will expand the breadth and depth of business lending operations of federally insured credit unions. This will allow a greater portion of credit union resources to be allocated to commercial lending, instead of consumer lending. **However, the clear intent of Congress in enacting Section 203 was to establish limitations on the member business loan activities of federally insured credit unions, based upon the belief that (1) credit unions should maintain their focus on consumer lending – especially to persons of modest means; and (2) continued credit union safety and soundness required restrictions in this area.** The Board has disregarded Congressional intent by issuing the proposed amendments to its MBL rule.

Congress intended that Section 203 serve as the specific framework for imposing limitations on credit union business lending, not as a means of facilitating credit

union entry into such activity. Congress was concerned that credit unions might shift their focus away from the consumer and into commercial lending, a line of business with which credit unions are unfamiliar. As evidence of that intent, one only needs to look at the express language of the statute – **for the first time, Congress imposed an aggregate limit on the amount of commercial lending in which a federally insured credit union may engage.** Clearly, this reflects Congressional desire to restrict credit union business lending activity.

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

In new section 107(a), the Committee imposed substantial new restrictions on business lending by insured credit unions. Those restrictions are intended to ensure that credit unions continue to fulfill their specified mission of meeting the credit and savings needs of consumers, especially persons of modest means, through an emphasis on consumer rather than business loans. The Committee action will prevent significant amounts of credit union resources from being allocated in the future to large commercial loans that may present additional safety and soundness concerns for credit unions and that potentially increase the risk of taxpayer losses through the National Credit Union Share Insurance Fund....<sup>1</sup>

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

...the bill, for the first time, begins to put appropriate limits on the amount of business loans that credit unions can make. There are those who believe, and I happen to be one of them, that credit unions were chartered to provide consumer credit to their members as part of a cooperative effort. A dramatic movement of credit unions into commercial lending would circumvent the whole intent of the credit union movement, and in my opinion, it would be negative factor on the progress of the credit union movement. In this bill, we for the first time set limits on the amount of credit union assets that can go into commercial loans. That is a very positive step.<sup>2</sup>

Moreover, there were some in the Senate that thought CUMAA went too far in allowing credit unions to engage in business lending. Senator Hagel (R-NE), in expressing his views on CUMAA, stated:

I believe the language does not adequately ensure that credit unions remain focused on their primary mission – consumer lending.... The legislation is risky for credit union members who rely on their credit

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<sup>1</sup> *Senate Report* 105-193, pp. 9 - 10.

<sup>2</sup> *Congressional Record*, July 24, 1998, p. S8966.

union for small, consumer loans because it would allow credit unions to shift their focus from consumer service to large-scale commercial lending. **Congress should place limits on commercial lending by credit unions – and those limits should be real.**<sup>3</sup> [emphasis added]

It is clear from the statutory language and the legislative history that Congress intended for credit union business lending activity to be limited.

### ***Specific Comments on the Proposed Member Business Loan Rule***

In discussing the proposed amendments to the rule, ABA's comments are divided into two broad areas: circumvention of the aggregate member business loan cap and activities contrary to safety and soundness standards.

#### **1. Circumvention of the Aggregate Member Business Loan Limit**

In 1998, CUMAA imposed an aggregate limit on credit union member business loans of 12.25 percent of assets. This proposed MBL rule will allow credit unions to circumvent the aggregate member business loan restrictions. The proposed rule will do so by:

- 1) Altering the definition of member business loan to exclude business loans sold as a participation interest without recourse;
- 2) Not counting MBL participations purchased against the aggregate loan limit; and
- 3) Permitting CUSOs to originate business loans.

The MBL rule was put in place to limit the total exposure of the credit union to business loans. Thus, **any** business loan on the books of the credit union must be counted toward that aggregate business loan limitation. It makes no difference whether the business loan was originated and held, or whether it was purchased (as MBL participations, for example) from a selling financial institution. In either case, the credit union accepts the risk of loss – which is greater for business lending than consumer lending – and must hold capital against that possibility.

NCUA proposes to exclude from the aggregate MBL limitations both the sale **and purchase** of business loan participations. This means that those loans are not included in **any** business loan-limit calculation. In the extreme, all business loans could be excluded from the limitation if they were merely bought and sold among credit unions. While the extreme perhaps is unlikely, **any** exclusion of these loans constitutes an **underestimate** of the business loan exposure and gives a false impression that the concentration limits imposed by Congress have been met. Improperly reflecting the total business loan exposure is also counter to proper risk-management oversight expected of a federal financial institution regulator.

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<sup>3</sup> *Senate Report 105-193*, p. 24.

By circumventing the limitations, it also promotes business lending over consumer lending, again, in contradiction to Congressional intent. The proposed loan participation language would effectively shift more credit union resources into commercial lending at the expense of consumer lending.

The subsections below provide greater detail regarding how the proposals effectively circumvent the Congressionally-mandated aggregate loan limit.

*Definition of outstanding member business loan balance violates the Federal Credit Union Act.*

The Board proposes to adopt a new definition of a member business loan that is clearly beyond that expressly stated in the Federal Credit Union Act. The proposed definition for “outstanding member business loan balance”, as defined in the new §723.21 and used in various sections in the rule, including §§723.1, 723.3, 723.8, and 723.16, is:

[T]he outstanding loan balance and any unfunded commitments, excluding any portion of the loan that is secured by shares in the credit union, or by shares or deposits in other financial institutions, or by a lien on the member’s primary residence, or fully or partially insured or guaranteed by any agency of the federal government, a state or any political subdivision of such state, or subject to an advance commitment to purchase by any agency of the federal government, a state or any political subdivision of such state, or ***sold as a participation*** interest without recourse. [emphasis added]

The Federal Credit Union Act clearly defines member business loans for determining the aggregate member business loan limit that does not include participations sold (12 U.S.C. 1757a):

- (c) **Definitions.**—As used in this section—
- (1) the term ‘member business loan’ —
    - (A) means any loan, line of credit, or letter of credit, the proceeds of which will be used for a commercial, corporate or other business investment property or venture, or agricultural purpose; and
    - (B) does not include an extension of credit—
      - (i) that is fully secured by a lien on a 1- to 4-family dwelling that is the primary residence of a member;
      - (ii) that is fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions;
      - (iii) that is described in subparagraph (A), if it was made to a borrower or an associated member that has a total of all such extensions of credit in an amount equal to less than \$50,000;
      - (iv) the repayment of which is fully insured or fully guaranteed by, or where there is an advance commitment to purchase in full by, any agency of the Federal Government or of a State, or any political subdivision thereof; or
      - (v) that is granted by a corporate credit union (as that term is defined by the Board) to another credit union.

When this expanded definition is coupled with NCUA's proposal to **exclude** participation interests from the calculation of the aggregate MBL limit, no MBL loans bought or sold would be included in the aggregate limit. Thus, NCUA has effectively removed a whole class of business lending activity from the computation of outstanding member business loans when calculating the aggregate member business loan limit. This will allow credit unions that originate and sell business loans to game the system and avoid the aggregate loan limit

*Exclusion of purchased participations undermines the aggregate loan limit.*

NCUA's justification for excluding purchased participations makes no economic sense and is contrary to the Congressional intent to limit the aggregate business lending exposure. In fact, the Board proposed exclusion of participation interests from the calculation of the aggregate MBL limit is a **reversal** from its previous position regarding the treatment of loan participations by purchasing credit unions. The Board's justification for the change in position is that the Federal Credit Union Act expressly requires a credit union to include only MBLs it makes to its members in calculating its statutory aggregate MBL limit. 12 U.S.C. 1757a(a). Participation interests purchased by a credit union from an originating eligible organization are not loans made by the participating credit union. The Board, therefore, proposes that these loans need not be included in calculating the participating credit union's aggregate loan limits.

These participations are clearly business loans that pose a risk of loss to the credit union – like any other business loan originated by the credit union. By excluding these loans, the aggregate MBL exposure is understated, as likely would be the capital allocation underpinning this relatively risky line of business. This is doubly troubling, given NCUA's proposal to allow credit unions to hold **less** capital against business loans generally, especially those credit unions that would directly benefit from the loan participation rule. This raises very serious safety and soundness concerns. Thus, ***ABA believes that NCUA should reject this proposal, as adopting it would clearly raise serious safety and soundness issues by encouraging greater business lending without full recognition of the risk exposure and capital adequacy necessary to support it.***

***The proposal should also be rejected as it is in direct contradiction to the intent of Congress to limit such risk taking by circumventing aggregate MBL limits.*** In fact, it would render the limits ineffective. For example, credit union A makes a business loan and sells it to credit union B without recourse. Because credit union A sold the loan, the business loan does not count against the aggregate MBL limit of credit union A. However, since credit union B bought the loan, this loan would also not count against credit union B's aggregate business loan limit. Effectively, NCUA is stating that a member business loan does not count against the aggregate limit for the credit union that originated the loan and sold it without recourse, nor for the credit union purchasing the participation. In theory, this proposal would allow credit unions to hold **only** business loans in their portfolio to the detriment of consumer lending.

In summary, NCUA proposes to permit credit unions to engage in a shell game to circumvent Congressional intent that credit union resources be focused on serving consumer lending, not commercial lending, by evading the aggregate business loan cap. Moreover, safety and soundness concerns are raised as more credit union capital is at risk as financial resources are diverted to business lending.

*Expansion of CUSO authority to originate MBL is contrary to the intent of Congress.*

NCUA seeks to further undermine the Congressionally-mandated limits on business lending by expanding the list of permissible activities for CUSOs. It does this in two ways: First, the Board proposes to add business loan origination to the CUSO list of permissible activities. 12 CFR 712.5. When CUMAA was debated and the limits imposed on credit union MBL in 1998, business loan origination was not a permissible activity for CUSOs. The NCUA Board believes this will allow business loans to be made to credit union members that their individual credit unions may be unable to grant. This clearly acknowledges the limitation imposed by Congress and provides a mechanism to circumvent it. Again, this proposal should be rejected as it is clearly directed toward circumventing the mandated aggregate loan limit, and raises the safety and soundness concerns cited above.

Second, the Congressionally-mandated limits are severely undermined when this proposed expansion of CUSO activities is coupled with the proposal to exclude purchased MBL loans (as discussed in the section above). To illustrate this, consider a CUSO that originates a business loan (perhaps at the request of the credit union for its member) and then ***sells the loan*** to the credit union. The credit union that purchased the loan would not be subject to the aggregate business loan cap according to the proposed rule. ***This potential gaming of the system should not be allowed under any circumstances.***

## **2. Proposed Amendments Are Contrary to Safety and Soundness Standards**

At the same time that NCUA is circumventing Congressionally-mandated limits on member business loans by manipulating what is included in the aggregate MBL limit, it is also relaxing its safety and soundness standards that apply to these loans.

Specifically, NCUA proposes to reduce equity interest held by the borrower in business loans, to abolish loan-to-value requirements for some classes of member business loans, to permit unsecured business lending, and to lower the amount of capital that credit unions need to hold when engaged in business lending. Such a relaxing of regulatory standards will make it easier for credit unions to engage in member business loans. Given the higher relative risk of business lending, these proposals seem contrary to containing risk as Congress intended – in fact, they should be read as encouraging risk-taking. ***There is absolutely no question that these proposals, if adopted, will shift the portfolio of credit unions toward the riskier end of the spectrum.***

The stated motivation for weakening the member business loan rule is regulatory competition from states, which have more lenient business loan requirements than NCUA's standards. It is ironic that NCUA uses this justification when it is NCUA that must approve deviations in state-enacted business loan rules from federal standards. In fact, NCUA, itself, is the culpable agency because it granted exemptions to state member business loan rules in the first place, which gave rise to the purported inequity.<sup>4</sup>

To illustrate the concerns, consider NCUA's proposal in Section 723.7 to exclude MBLs made for the purchase of vehicles from the rule's loan-to-value requirements if the vehicle is a car, van, pick-up truck, or sport-utility vehicle that is used for commercial purposes. The Board's justification is that consumer auto loans are not subject to loan-to-value requirements. However, consumer loans and business loans are not comparable and should not be subject to the same underwriting standards. No credible risk manager would equate the risk of one consumer loan to fleet or smaller commercial loans.

For example, it is not uncommon for credit unions to make auto loans with loan-to-value ratios in excess of 100 percent. In fact, Centris FCU in Nebraska has recently advertised providing financing up to 110 percent of the value of a new vehicle. Such a financing arrangement for a vehicle loan for business purposes is not prudent risk management.

As further illustration of the safety and soundness concerns, consider NCUA's proposal to amend Section 723.7 to permit credit unions to make unsecured member business loans, in addition to credit card line of credit programs offered to nonnatural person members. Under the current rule, all MBLs must be secured by collateral in accordance with the rule's loan-to-value ratios, except for nonnatural person member credit cards. 12 CFR 723.7(a), (c). Under the proposal, a credit union may make unsecured MBLs if: (1) the credit union is "well-capitalized" as defined in 12 CFR 702.102(a)(1); (2) the aggregate of unsecured MBLs to one borrower does not exceed the lesser of \$100,000 or 2.5% of the credit union's net worth; (3) the aggregate of all of the credit union's unsecured MBLs does not exceed 10% of the credit union's net worth; and (4) the credit union addresses unsecured loans in its written MBL policy. The Board also proposes that the rule permit a credit union to apply for waivers from the unsecured loans to one borrower limitation and the aggregate unsecured loan limitation under this section.

Finally, NCUA proposes to reduce the amount of capital (net worth) that credit unions need to hold to support riskier member business loans. Currently, a single threshold is used to determine the risk-based net worth standard for member business loans. If the amount of MBLs is less than or equal to that 12.25 percent of assets threshold, MBLs receive a risk-weight of 6%; the amount in excess of the threshold is risk-weighted at 14%. 12 CFR 702.106(b).

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<sup>4</sup> Section 723.20

NCUA proposes to expand the standard component to three tiers divided by a 15% and a 25% threshold, respectively. The bottom tier, risk-weighted at 6%, would consist of the amount of MBLs less than or equal to 15% of total assets. The middle tier, risk-weighted at 8%, would consist of the amount of MBLs greater than 15%, but less than or equal to 25% of total assets. The top tier, risk-weighted at 14%, would consist of the amount of MBLs in excess of 25% of total assets.

This would mean that credit unions with a larger concentration of business loans would be allowed to hold less capital to absorb losses arising from member business lending. For example, assume a \$100 million credit union has 20 percent of its assets in MBLs. Under current regulations, the credit union would have to hold \$1.82 million in risk-based capital to support \$20 million in business loans. Under the proposed rule, the credit union would only have to hold \$1.3 million in capital to support \$20 million in business loans. This means that the amount of capital a \$100 million credit union would need to hold to support \$20 million in member business loans would have declined by \$520,000.

ABA has serious reservations about the dilution of the regulatory standards for credit union business lending. When combined with other NCUA proposals that would circumvent the business lending restrictions, these proposals give unfettered authority for – and actually encourage – greater business lending. ABA strongly urges NCUA not adopt these proposed changes.

### **NCUA's Justifications for the Modifications to Business Loan Rule Are Ill-Founded.**

As presented above, NCUA's proposals should be rejected as they are contrary to Congressional intent to limit credit union exposure to business lending, increase the risk profile of credit unions generally, raise significant safety and soundness concerns, and shift credit union resources away from consumer lending. Troubling as well, have been the inaccurate and misleading assertions made to justify the modifications.

For example, in a speech before the National Association of Federal Credit Unions on January 24, 2003, NCUA Board Member Deborah Matz commented that the business loans that credit unions wanted to make are not the loans that banks bother to make, because these business loans are too small.

Such assertions have no basis in fact and it is not these small dollar value loans that are at issue with regard to the member business loan cap.

*Such assertions have no basis in fact.*

Banks regularly make small loans to small businesses, especially loans of small dollar value. According to June 2002 Call Report data, banks reported 14.2 million small business and farm loans outstanding worth \$550 billion. In fact, 12 ¼ million small farm and business loans had balances less than or equal to \$100,000.

According to the Federal Reserve System's *Survey of the Terms of Bank Lending to Farmers*, banks made 1.95 million non-real estate bank loans to farmers in 2002.<sup>5</sup> Almost 94 percent of the loans made to farmers were smaller than \$100,000 and almost 57 percent smaller than \$10,000. Moreover, the average size of a non-real estate bank loan to a farmer was \$28,770.

In fact, the evidence shows that banks consistently are making micro-small business loans. If they did not do so, they would not be serving their community.

Here are some examples. Farmers & Merchants State Bank in Boise, Idaho regularly makes business loans as small as \$5,000 and, upon request, will make loans as small as \$2,000. Thirteen percent of the bank's loans are under \$10,000 and almost 30 percent of its small business loans are less \$30,000.

Saline State Bank in Wilber, Nebraska will make business loans as small as \$1,000 and does so on a regular basis.

These are just a few examples of small loans to businesses made by banks. While banks make large business loans, it is incorrect to assume that banks do not also place a high priority on small business loans. Similarly, it must be acknowledged that many credit unions – particularly those most aggressive in business lending – are making high dollar loans. It is these institutions – which compete head-to-head with taxpaying banks – that are most likely to be bumping up against the Congressionally-mandated limits. Examples of this are easily found, as is described in the following section.

*Credit unions that will be the direct beneficiaries of the rule are not making small loans to businesses.*

The credit unions that are approaching the aggregate MBL limit<sup>6</sup> and would be the greatest beneficiaries from the loan participation rule are not on average making small loans to businesses. As of the third quarter 2002, the average MBL balance outstanding per loan for these credit unions exceeded \$200,000. This is hardly the micro-loan to finance a pickup truck or a home cleaning business.

Moreover, NCUA's rhetoric does not correspond with the reality of credit union business loan operations. For example, the average business loan made at California's Arrowhead Credit Union is \$225,000; at Telesis Credit Union, it's \$783,000. Again, these are hardly micro business loans.

Coastal Federal Credit Union with \$1.15 billion in assets advertises on its web site that business loans are available up to \$2 million – hardly a micro loan. OmniAmerican CU has established a \$10.5 million line of credit and \$2 million for working capital to Wide Open Spaces LLC for a real estate development project.

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<sup>5</sup> Non-real estate bank loans to farmers refer to loans used primarily to finance feeder livestock, other livestock, current crop production expenses and the care and feeding of livestock (including poultry), and farm machinery and equipment.

<sup>6</sup> Member business loans are between 6 to 10 percent of the credit union's assets.

## **Conclusion**

NCUA's proposed amendments to its MBL rule are counter to Congressional intent and evade the purpose of the statute through expansive definitions and exemptions. Congress in 1998 made it perfectly clear that credit unions should be focused on consumer lending, not commercial lending. However, this proposed rule would divert credit union resources to financing commercial enterprises, while relaxing safety and soundness regulation associated with member business loans.

Therefore, ABA urges the NCUA to retract this proposed MBL rule until the deficiencies described above are corrected. If you have any questions, please contact Keith Leggett at 202-663-5506.

Sincerely,

Edward L. Yingling  
Executive Vice President