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National Association of Federally-Insured Credit Unions

February 28, 2023

Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: RIN 3133-AF49, 3133-AE96. Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions

Dear Ms. Conyers-Ausbrooks:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to you regarding the Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions proposed rule. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 134 million consumers with personal and small business financial services products. NAFCU has consistently encouraged the National Credit Union Administration (NCUA) to eliminate a variety of unnecessarily prescriptive regulations and return key management decisions to credit unions. And NAFCU strongly supports much of the proposed rule that would accomplish that goal. Still, credit unions can prudently engage in a broader range of loan participation and eligible obligation activities than the proposed rule would permit. Therefore, NAFCU encourages the NCUA to not undermine the flexibility and autonomy it intends to provide credit unions by prescriptively defining or otherwise limiting key aspects of loan participation and eligible obligation activities.

Specifically, NAFCU strongly encourages the NCUA to not undertake a separate indirect lending rule; to not define the terms "very soon after" and "empowered to grant"; to not require that a credit union engaged in indirect lending be actively involved or consulted at the time a facilitating partner extends credit to borrowers on the credit union's behalf or limit the number of permissible facilitating partners; to permanently adopt expired section 701.22(e)'s higher loan participation purchasing threshold; and to eliminate section 701.22(b)(5)(iv)'s 15 percent limit. NAFCU also strongly encourages the NCUA to ensure that all safety and soundness standards it codifies are sufficiently flexible to permit credit unions to adopt internal written purchase policy provisions commensurate with the size, scope, type, complexity, and level of risk posed by their individual activities.

General Comments

Credit unions face extraordinary competition from big for-profit banks, droves of online-only banks, and financial technology companies (fintechs). Rapid technological advancements in the last two decades have enabled credit unions' competitors to effectively commoditize traditional consumer and small business financial services products and introduce a dizzying array of new retail banking products. Yet, credit unions, by and large, have weathered these marketplace headwinds well.

Credit unions have expanded their indirect lending, loan participation, and eligible obligation activities significantly in the past seven years while ensuring delinquency rates and net charge-off rates remain low and stable. But in order to remain Americans' best financial institutions, credit unions must have the regulatory flexibility and autonomy necessary to prudently manage their operations in line with their members' needs and their balance sheets in line with their individual risk tolerances.

As the NCUA intends, much of the proposed rule would likely clarify credit unions' loan participation and eligible obligation authorities. This regulatory clarity would benefit not only credit unions but also NCUA examiners, credit union service organizations (CUSO) and non-CUSO fintechs with which credit unions could prudently partner, and other credit union industry stakeholders. But the NCUA must avoid adopting new prescriptive definitions and regulations if the agency is to avoid undermining the proposed rule's potential.

NAFCU also encourages the NCUA to abstain from undertaking an indirect lending rulemaking at this time. A principles-based approach to rulemaking requires that the NCUA only impose additional regulation on the credit union system when it is clear additional regulation is necessary to comply with the Federal Credit Union Act (FCU Act) or some other federal law or the agency identifies a significant, pervasive risk. Much of the proposed rule is aimed at clarifying credit unions' indirect lending authorities. The NCUA should not move forward with a separate indirect lending rulemaking until the agency is able to evaluate and understand how credit unions and other credit unions industry stakeholders react to any Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions final rule the NCUA adopts.

Section 701.21 – Loans to Members and Lines of Credit to Members

Definitions

As the NCUA recognizes, even small, unintended irregularities in its regulations can lead to significant confusion that undermines the credit union system's potential. NAFCU encourages the NCUA to clarify in proposed section 701.21(c)(9)(ii) that:

> *Indirect lending*. A loan acquired pursuant to an indirect lending arrangement, and that meets the requirements of this section **and the Federal Credit Union Act**, is classified as a loan and not the purchase of a loan for purposes of this chapter.

While section 701.21's other requirements generally make this limitation implicit, the NCUA should take this opportunity to easily avoid generating additional, regulatory uncertainties.

Preemption of State Laws

NAFCU also strongly encourages the NCUA to amend section 701.21(b)(1)(i)(C) to also preempt any state law purporting to limit or affect federal credit unions' (FCU) authority to finance "related insurance costs" in loans and lines of credit to members. The NCUA Board has exclusive authority to regulate the rates, terms of repayment, and other conditions of FCU loans and lines of credit to members.[1] FCUs have expanded access to affordable, high-quality credit by making a variety of loan insurance products, including guaranteed asset protection ("GAP") insurance, available to members financing some of life's biggest purchases. Without access to GAP auto insurance, many members would be unable to afford another car if their car is totaled and their regular auto insurance settlement is less than their outstanding auto loan balance.

Yet, California has recently passed laws that altogether prohibit lenders from financing certain forms of GAP insurance and prohibit lenders from perfecting security interests in other loans partially used to finance GAP insurance.[2] Some GAP insurance sellers likely do take advantage of some consumers, but not-for-profit FCUs do not. By prohibiting FCUs from helping members finance cost-effective insurance coverage, laws like these are not protecting consumers but are preventing FCUs from helping members avoid significant financial risks. If subsequent state laws train their focus on private mortgage insurance and the lower downpayment options it supports, many members will be nearly shut out of the housing market. The credit union system is built on the principle that everyone should have access to affordable, high-quality credit. And the NCUA Board has the means to ensure FCUs can continue to fairly and affordably meet their member's borrowing needs while reducing members' financing risks.

Section 701. 22 – Loan Participations

Prefatory Language

Section 701.22's introductory paragraph, like section 701.23's introductory paragraph, currently creates significant confusion. This lack of regulatory clarity discourages credit unions from entering into safe and sound loan participation activities that benefit their members and can lead to credit unions inconsistently reporting their loan participation holdings. NAFCU supports the NCUA's removing both the continuing contractual obligation clause and the clause "where a member is not a member of that credit union" currently in section 701.22's introductory paragraph. These changes will reduce confusion and better enable credit unions to evaluate new loan participation opportunities without reducing credit unions' loan participation authorities or increasing risks to individual credit unions or the National Credit Union Share Insurance Fund (SIF).

Codification of NCUA Legal Opinion 15-0813

NCUA Legal Opinion 15-0813[3] (2015 Opinion) addressed two important issues left open by the NCUA's 2013 Loan Participations; Purchase, Sale and Pledge of Eligible Obligations; Purchase of Assets and Assumption of Liabilities final rule.[4] The NCUA's 2015 Opinion states that, if two conditions are met, a federally insured credit union (FICU) or other eligible organization may be considered the "originating lender" in an indirect lending arrangement, and a FICU may purchase

[1] 12 U.S.C. § 1757(5).
[2] CA AB 2311; CA SB 1311.
[3] NCUA Legal Op. 15-0813 (Aug. 10, 2015).
[4] 78 FR 37946 (June 25, 2013).

a loan participation interest in a loan generated through an indirect lending arrangement. First, the FICU or other eligible organization must make the final underwriting decisions in the indirect lending arrangement. Second, the indirect lending arrangement's retailer or other facilitating party must assign the loans or sales contracts to the FICU or other eligible organization very soon after they are signed by the borrower and the facilitating party.

The NCUA's 2015 Legal Opinion is well-reasoned, has contributed greatly to credit unions' increasing engagement in indirect lending, and remains relevant today. Therefore, NAFCU generally supports its codification.

"Very Soon After"

NAFCU encourages the NCUA to not define the term "very soon after" at this time. Timely assignment of a loan or sales contract by an indirect lending arrangement's facilitating party to the originating FICU or other eligible organization is a factor in ensuring the FICU or other eligible organization is able to prudently engage in the indirect lending arrangement. However, a FICU's or other eligible organization's adherence to relevant safety and soundness standards is far more determinative of any relevant risks that may accrue to a FICU, other eligible organization, or the SIF. If the NCUA establishes a prescriptive loan or sales contract transfer timeline, the agency risks undermining the indirect lending partnerships the agency is intending to promote. FICUs and other eligible organizations could be unnecessarily deprived of prudently underwritten loans while facilitating parties could not be certain originating lenders would be able to accept every loan and sales contract if there is an unforeseen delay in its transfer.

Originating Credit Union's Involvement at Extension of Credit

NAFCU encourages the NCUA to not require that a credit union engaged in an indirect lending arrangement be actively involved or consulted at the time a facilitating partner extends credit to borrowers on the credit union's behalf. Provided a credit union engaged in indirect lending adheres to relevant safety and soundness standards, the credit union's underwriting guidelines and loan portfolio limitations will be sufficiently clear to allow a facilitating party to prudently extend credit on the credit union's behalf without requiring the credit union to be actively involved or consulted when facilitating partner extends credit to borrowers. Well-organized, well-run indirect lending arrangements allow credit unions to quickly offer more members lower rates on a wider array of retail banking products. If a facilitating partner could not extend credit to borrowers on a credit union's behalf without actively involving or consulting the credit union, indirect lending arrangements would be much slower and more expensive, and fewer members would have access to affordable, high-quality credit. Existing loan participation safety and soundness expectations are more than adequate to enable a credit union to identify, isolate, and resolve any issues the credit union may discover during an indirect lending arrangement.

Indirect Lending Arrangements Involving Two or More Facilitating Parties

Relatedly, a FICU or other eligible organization should be considered the originating lender in all indirect lending arrangements that meet the NCUA's 2015 Legal Opinion's two-part test and adhere to relevant safety and soundness standards. Some prudent indirect lending arrangements involve more than one facilitating party, and their performing administrative tasks on credit unions' behalf does not affect the risk profile of the prudent indirect lending arrangements irrespective of how many facilitating parties are involved. If the NCUA adopts prescriptive regulation that disqualifies a FICU or other eligible organization from being considered the originating lender in indirect lending arrangements involving more than one facilitating party, the NCUA will dramatically reduce the number of efficient CUSOs and non-CUSO fintechs with which credit unions could partner without reducing relevant risks to individual credit unions or the SIF.

Prior Expiration of Section 701.22(e)'s Temporary Regulatory Relief

The NCUA's issuing and twice extending the Temporary Regulatory Relief in Response to COVID-19 Interim Final Rule[5] made clear that the NCUA is confident that FICUs can prudently manage their balance sheets beyond certain prescriptive loan participation purchasing thresholds. The NCUA temporarily raised the maximum aggregate amount of loan participations a FICU may purchase from any one originating lender from the greater of $5 million or 100 percent of the FICU's net worth to the greater of $5 million or 200 percent of the FICU's net worth. Despite not identifying any related risks, the NCUA did not propose to permanently adopt this higher threshold.

NAFCU's members report that loan participation agreements generally have high fixed costs and comparatively modest variable costs. Said differently, a $10 million loan participation agreement does not usually require far greater due diligence or post-closing resources from either a loan originator or potential loan participation interest purchasers than does a $2 million loan participation agreement. Therefore, individual loan participation interests tend to represent larger rather than smaller capital commitments.

Adequately capitalized FICUs with total assets of at least $500 million may purchase $4 million loan participation interests and be well below §701.22(b)(5)(iv)'s 15 percent limit. Any well-capitalized FICU with less than $100 million in total assets, on the other hand, would generally violate the same threshold if it acquired any loan participation interest worth as little as $1 million. Effectively, the most modest FICUs, those facing the highest risks that their safety and soundness will be undermined not by mismanagement but by transient imbalances in their deposit-taking and lending activities, are prohibited from using one of the best balance sheet management tools available to the credit union system's larger participants.

NAFCU strongly encourages the NCUA to permanently adopt expired section 701.22(e)'s higher loan participation purchasing threshold and eliminate section 701.22(b)(5)(iv)'s 15 percent limit. As is true for other changes to section 701.22 the NCUA proposes, existing loan participation safety and soundness standards are more than sufficient to ensure every credit union is able to prudently engage in loan participation activities.

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[5] 85 FR 22010 (April 2020).

Reducing Accounting Uncertainty

NAFCU, like the NCUA, believes existing section 701.22(b)(5)'s requirements for purchasing FICUs' internal written loan participation policies and existing section 701.22(d)'s basic requirements for loan participation agreements, alongside other safety and soundness guardrails, are sufficient to ensure FICUs may prudently engage in loan participations. However, the NCUA's loan participation and Call Report regulations and guidance are not adequately aligned with relevant Generally Accepted Accounting Principles (GAAP) standards to which FICUs must also adhere. Among other issues, this misalignment can make it difficult for FICUs to accurately report loan participation purchases and sales. NAFCU encourages the NCUA to seek additional input on and consider how it may better align its loan participation regulations and guidance with relevant GAAP standards.

Section 701.23 – Eligible Obligations

Prefatory Language

Section 701.23's introductory paragraph, like that in section 701.22, creates significant confusion. NAFCU supports the NCUA's removing from section 701.23's introductory paragraph (1) the continuing contractual obligation clause; (2) the referenced exception for certain well-capitalized FICUs; and (3) the prohibition against an FCU purchasing a non-member loan to hold in its portfolio. NAFCU also encourages the NCUA to amend the second sentence of section 701.23's introductory paragraph to clarify that an FCU may purchase certain eligible obligations prior to the borrower becoming a member of the purchasing FCU under both section 701.23(b)(1) and section 701.23(b)(2).

"Empowered to Grant"

NAFCU strongly encourages the NCUA to not define the term "empowered to grant" at this time. The term should remain sufficiently flexible to fully incorporate credit unions' currently recognized lending authorities and all those the NCUA recognizes in the future. Currently, the NCUA may recognize credit unions' lending authorities through formal rulemaking and less formal NCUA Legal Opinions and NCUA Letters to Credit Unions. If the NCUA too prescriptively defines the term "empowered to grant" in this or any other rulemaking, it will be much more difficult for the agency to timely address credit unions' other lending authorities when necessary.

Elimination of CAMELS Rating and Capital Classification Requirements

NAFCU strongly supports the NCUA's proposed elimination of current section 701.23(b)(2)'s CAMELS rating and capital classification requirements. NAFCU agrees with the NCUA that FICUs have generally managed their eligible obligation authorities prudently, and one FICU's purchasing a loan from another FICU generally does not significantly increase risk to the SIF. The proposed change would encourage greater cooperation within the credit union system, support overall higher dividend rates and lower member loan rates, and expand a key credit union system liquidity channel at a time when other liquidity channels are narrowing. Any potential increase in risk to the SIF would be more than offset by the NCUA's proposed codification of prudent due diligence, risk assessment, and risk management standards.

5 Percent of Unimpaired Capital and Surplus Limit

Current section 701.23(b)(4) limits the aggregate unpaid balances of certain eligible obligations purchased by an FCU to a maximum of 5 percent of the FCU's unimpaired capital and surplus. This 5 percent limit applies to an FCU's purchases of notes purchased from liquidating credit unions, certain eligible obligations of its members, student loans, and real-estate secured loans purchased to facilitate the packaging of pooled loans for the secondary market. NAFCU supports the NCUA's proposal to narrow the application of §701.23(b)(4)'s 5 percent limit to apply only to notes an FCU purchases from liquidating credit unions.

The proposed change would better enable FCUs to manage their eligible obligation activities with one another and with CUSOs and non-CUSO fintechs in line with their individual needs and risk tolerance limits. As with the NCUA's proposed elimination of current section 701.23(b)(2)'s CAMELS rating and capital classification requirements, any potential increase in risks to the SIF attributable to this proposed change would be more than offset by the NCUA's proposed codification of prudent due diligence, risk assessment, and risk management standards.

As the NCUA recognizes in the proposed rule, the agency can ensure the credit union system's safety and soundness without resorting to overly prescriptive regulation that greatly exceeds the FCU Act's requirements. NAFCU strongly encourages the NCUA to apply this same principles-based approach to all other parts of its regulations.

Grandfathered Purchases

Current section 701.23(b)(5)'s end date should be extended, as proposed, from July 2, 2012, to the effective date of any Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions final rule the NCUA approves. FCUs that have operated in compliance with the recently expired section 701.23(i) and the NCUA's other regulatory requirements should not be forced to divest from their prudently purchased eligible obligations. During 2020, 2021, and much of 2022, benchmark interest rates were significantly lower than they are now. If FCUs are now forced to divest from eligible obligations purchased during this period, they would almost certainly suffer an unnecessary capital loss on principal because debt prices typically fall as interest rates rise.

Proposed Codification of Due Diligence, Risk Assessment, and Risk Management Standards

The NCUA proposes to codify a range of due diligence, risk assessment, and risk management standards to offset any potential increase in risks to the SIF's attributable to the proposed rule's regulatory relief. Credit unions have grown their eligible obligation activities year-over-year while ensuring purchased eligible obligations' delinquency and charge-off rates remain low and stable. Their success is due in large part to their managers and boards of directors adhering to high-quality due diligence, risk assessment, and risk management standards like those the NCUA proposes to codify in section 701.23(b)(6).

NAFCU generally supports this proposal but encourages the NCUA to ensure that each of these safety and soundness standards is sufficiently flexible to permit credit unions to adopt internal written purchase policy provisions commensurate with the size, scope, type, complexity, and level of risk posed by their individual eligible obligation activities.

Record Retention

Record retention requirements in current subsections 701.23(b)(3)(ii), (c)(2), and (d)(1)(iii) are antiquated and suggest that FCUs must maintain various eligible obligation activity records in their offices in hardcopy. NAFCU supports the NCUA's proposal to align all of these requirements with the electronic record availability and preservation standards outlined in part 749 of the NCUA's regulations.

Conclusion

NAFCU supports the NCUA's continued shift to principles-based regulation, and NAFCU strongly supports much of the proposed rule that would provide credit unions greater regulatory flexibility and autonomy. However, credit unions can prudently engage in a broader range of lending and balance sheet management activities than the proposed rule would permit, and NAFCU strongly urges the NCUA to not undermine the flexibility and autonomy the agency intends to provide credit unions by prescriptively defining or limiting key aspects of loan participation and eligible obligation activities. If you have any questions or concerns, please do not hesitate to contact me at dbaker@nafcu.org or (703) 842-2803.

Sincerely,

Dale Ross Baker

Dale R. Baker
Regulatory Affairs Counsel