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National Association of Federally-Insured Credit Unions

May 26, 2022

The Honorable Todd M. Harper, Chairman
The Honorable Kyle S. Hauptman, Vice Chairman
The Honorable Rodney E. Hood, Board Member
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

RE: Internal Written Loan Participation Policies

Dear Chairman Harper, Vice Chairman Hauptman, and Board Member Hood:

On behalf of the National Association of Federally-Insured Credit Unions (NAFCU), I am writing to you today regarding overly prescriptive internal written loan participation policy requirements contained in the National Credit Union Administration's (NCUA) regulations at 12 CFR §701.22(b)(5)(iv). NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 130 million consumers with personal and small business financial services products. NAFCU urges the NCUA to eliminate the requirement that a federally-insured credit union's (FICU) internal written loan participation policies establish a limit on the aggregate amount of loan participations that may be purchased with respect to a single borrower, or group of associated borrowers, not to exceed 15 percent of the FICU's net worth. Though the NCUA has a responsibility to establish and enforce clear regulatory guardrails that help ensure the safety and soundness of the credit union system, this particular regulatory threshold ignores meaningful differences among individual FICUs and imperils rather than supports the most modest FICUs – those FICUs the NCUA routinely recognizes as facing an uphill battle for survival.

As a direct result of strict field of membership requirements, many FICUs have highly-homogenous, geographically-concentrated memberships. And, as the vicissitudes of the COVID-19 pandemic have made perfectly clear, economic uncertainty can have outsized impacts on the financial health of tightly knit communities. To smooth out transient imbalances between deposit-taking and lending activities, many FICUs use loan participation agreements. A FICU with excess lending opportunities may more confidently serve more of its members knowing other FICUs will ultimately participate in its loans and thereby share in its lending risks and capital commitments. A FICU with excess deposits may continue to offer its members attractive dividend rates even when its self-originated loan interest income falls out of lockstep with its share growth. In the process, both FICUs reduce not only risks to themselves but risks to the National Credit Union Share Insurance Fund (NCUSIF).

Uneven Impact of Regulatory Thresholds

The temporary regulatory relief found at 12 CFR §701.22(e) is evidence that the NCUA is confident that FICUs can prudently manage their balance sheets beyond prescriptive loan participation thresholds. When it issued the Temporary Regulatory Relief in Response to COVID-

19[1] IFR in April 2020, 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. However, for the most modest FICUs, for whom the negative knock-on effects of transient imbalances between deposit-taking and lending activities are the most severe, such regulatory relief, be it temporary or permanent, is largely illusory. These FICUs remain effectively prohibited from acquiring any loan participation interests because other prescriptive loan participation thresholds, including §701.22(b)(5)(iv), remain in force and loan participation agreement transaction costs are substantial.

Though loan participation interests are perhaps the most easily understandable of FICUs' few permissible investment options, individual loan participation agreements involve transaction costs much higher than those typically observed in other debt markets. Both loan originators and potential loan participation interest purchasers expend significant resources conducting financial and legal due diligence before any agreement is entered into, not to mention the resources required post-closing. If a loan participation agreement's transaction costs varied closely in proportion to its size, §701.22(b)(5)(iv)'s effectively prohibiting a FICU from acquiring a loan participation interest valued in excess of 15 percent of its net worth might pose less of a problem for the most modest FICUs. That, unfortunately, is not the case.

NAFCU's members report that loan participation agreements, like many financial instruments and legal endeavors, 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, for loan participation agreements to be an efficient balance sheet tool for both loan originators and loan participation interest purchasers, individual loan participation interests tend to represent larger rather than smaller capital commitments – many, if not most, crossing the seven-figure mark.

In practice, this means that 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 threshold. But any well capitalized FICU with less than $100 million in total assets would generally violate the same regulatory 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 tools available to larger participants in the credit union system.

Eliminating §701.22(b)(5)(iv)

When the NCUA issued the streamlined Supervisory Committee Audit Guide in January 2020, the NCUA recognized that credit unions' supervisory committees are well-positioned to prudently oversee a broad range of risks to their individual credit unions without being cabined by overly prescriptive regulation. And as NAFCU more fully expressed in a letter to the NCUA Board dated March 15, 2022, the NCUA enjoys broad discretion with respect to its loan participation

[1] https://www.regulations.gov/document/NCUA-2022-0035-0001

regulations. The NCUA should exercise this discretion by eliminating §701.22(b)(5)(iv) and returning key capital planning and risk evaluation challenges at individual FICUs to those in the credit union system best-positioned to meet them, FICUs' employees and board members.

The continued application of other relevant regulatory thresholds, including those found in §701.22(b)(5)(ii) and §701.21(c)(5), ensures the NCUA's eliminating §701.22(b)(5)(iv) would not permit the kinds of imprudent investment behavior that gives rise to material safety and soundness concerns. Not only would other clear and meaningful investment thresholds remain in force, but the NCUA's eliminating §701.22(b)(5)(iv) would do nothing to weaken regulatory requirements related to loan participation agreement sufficiency or FICUs' underwriting standards. Additionally, originating lenders would still be required to retain an interest equal to at least 10 percent of the outstanding balance of the underlying loan for the life of the loan.

A FICU's management and its board of directors should be trusted to decide, based on their FICU's individual risk profile, appropriate loan participation policies and limits, if any, on the aggregate amount of loan participation interests their FICU may purchase with respect to a single borrower, or group of associated borrowers. Section 701.22(b)(5)(iv)'s prescriptive 15 percent of net worth threshold no longer serves a meaningful purpose, poses immense, if not insurmountable, challenges for the most modest FICUs, and attracts unnecessary risks to the entire credit union system.

Conclusion

NAFCU urges the NCUA to eliminate the internal written loan participation policy requirements found at §701.22(b)(5)(iv) so as to allow all FICUs to prudently utilize loan participation agreements to meet threats to their safety and soundness posed by transient imbalances in their deposit-taking and lending activities. If you have any questions or concerns, please do not hesitate to contact me at (703) 842-2212 or akossachev@nafcu.org, or Dale Baker, NAFCU's Regulatory Affairs Counsel, at (703) 842-2803 or dbaker@nafcu.org.

Sincerely,

Ann C. Kossachev
Vice President of Regulatory Affairs