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National Association of Federally-Insured Credit Unions

January 17, 2023

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: Part 723 Amendment

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 urge the National Credit Union Administration (NCUA) to reevaluate and amend its regulations in Part 723 addressing the definition of Commercial Loan. NAFCU advocates for all federally-insured not-for-profit credit unions that, in turn, serve over 133 million consumers with personal and small business financial service products. Credit unions have evolved as small business lenders over the past two decades and current NCUA regulations are outdated in their underwriting requirements for small dollar business loans. NAFCU urges the NCUA to recognize that credit unions, and small business borrowers, now more than ever, have a need for flexibility in underwriting small dollar business loans. Specifically, NAFCU requests that the NCUA amend section 723.2 to raise the threshold for net aggregate business loans that are excluded from the definition of a Commercial Loan, and thereby its stringent underwriting requirements, from $50,000 to $250,000. NAFCU hopes that you will work with us to recognize the current economic landscape and the need for increased small business lending by providing credit unions with this much needed flexibility.

Authority to Amend

Section 723.4 requires a federal credit union (FCU) to adopt and implement a comprehensive written commercial loan policy and establish procedures for commercial lending.[1] This commercial loan policy must include underwriting standards commensurate with the size, scope and complexity of the commercial lending activities and borrowing relationships contemplated. Section 723.2 excludes from the definition of commercial loan, any loan that would otherwise meet the definition of commercial loan and which has a net aggregate balance less than $50,000.[2]

[1] 12 CFR 723.4.
[2] 12 CFR 723.2.

Therefore, net aggregate business loans under $50,000 are exempt from the requirements in the written commercial loan policy.

The NCUA has the statutory authority to amend section 723.2 and increase the $50,000 threshold for net aggregate Commercial Loan balances. The Federal Credit Union Act (FCU Act) defines a Member Business Loan (MBL), and excludes from the definition of MBL any loan, line of credit, or letter of credit, if it was made to a borrower or an associated member that has a total of all such loans in an amount equal to or less than $50,000.[3] The FCU Act does not, however, define Commercial Loan.

On March 14, 2016, the Board issued the MBL final rule (MBL Rule) which sought to shift the earlier MBL rule's focus from a prescriptive approach to a more principles-based methodology that emphasizes sound risk management practices for business lending.[4] The MBL Rule also created a new definition for Commercial Loan under section 723.2 to clarify that certain business loans would not count toward the aggregate limit on a FCU's member business loans, but would still be subject to safety and soundness standards. This was intended to delineate which loans are subject to the MBL Cap, which loans are subject to the Commercial Loan Policy provisions of section 723.4, which loans are subject to both, and which are subject to neither. Among those subject to neither the MBL Cap nor section 723.4, are business loans where the aggregate net member business loan balance is less than $50,000.

Although the FCU Act defines MBLs, it does not define commercial loans, nor does it mandate prescriptive safety and soundness standards for FCU business loans. The definition of commercial loan was created by the NCUA Board through the rulemaking process in order to apply safety and soundness standards to a broader array of business loans. These include requirements such as establishing underwriting standards that include loan-to-value (LTV) ratio limits and methods for valuing all types of collateral authorized prior to extending any commercial loans. NAFCU appreciated the Board's efforts in 2016 to provide FCUs with greater autonomy and flexibility to soundly administer, underwrite, and service commercial loans in a manner that is consistent with internal risk management practices. Today, NAFCU and its members still support this principles-based approach; however, given current economic conditions, the increasing costs associated with running a small business, and the emergence of safe, cost-effective alternative underwriting methodologies, NAFCU asks that the definition of commercial loan be updated to exclude those business loans where the aggregate net member business loan balance is less than $250,000.

The United States Supreme Court has held that an "agency, to engage in informed rulemaking, must consider varying interpretations and the wisdom of its policy on a continuing basis."[5] This ability to periodically reevaluate regulations is important to the functioning of federal agencies and is a flexibility that the NCUA Board should exercise now. Accordingly, we urge the agency to

[3] 12 U.S.C. 1757a(c).
[4] 81 FR 13529 (March 14, 2016).
[5] Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

increase the threshold for small business loans that are included in the Commercial Loan definition. Raising this threshold would allow FCUs to stay competitive with other financial institutions in the current environment, have higher loan availability, and strengthen their relationship with small businesses in their community.

Inflation and Credit Access

Inflation impacts most aspects of everyday life, and that is no exception for small business owners. The cost of food, energy, office space, and transportation have all increased dramatically over the last two years. A tight labor market has also driven up wages, further exacerbating the problem. Capital investments, crucial to the functioning and profitability of small businesses, particularly startups, are now more expensive than ever. The U.S. Chamber of Commerce Small Business Index for Q4 2022 found that over half of small businesses said that inflation is the top challenge facing the small business community, a dramatic 30-point increase since the same time in 2021.[6] That marked the fourth consecutive quarter that inflation topped the list of challenges for small businesses. As a result, 40 percent of small business reported taking out a loan.

Unfortunately, access to commercial credit is also in jeopardy. The October 2022 Biz2Credit Small Business Lending Index found that business loan approval rates at big banks dipped to 14.7 percent, a setback for the second month in a row.[7] Even as the economy has steadily rebounded from the impacts of the COVID-19 pandemic, business loan approval percentages are still roughly half of what they were before COVID hit the United States. Additionally, in February 2020, small banks approved more than half of the business funding requests they received. In October 2022, that figure had dropped to only 21.2 percent. Interest rates are higher, and loans are harder to get, in part because cost structures have whittled away the profitability of smaller companies. NAFCU's member FCUs have also reported the high demand for small business lending as costs have increased across the board and businesses need higher-value loans.[8]

Burden of Commercial Loan Policy

Under section 723.4, FCUs are required to adopt and implement a comprehensive, written commercial loan policy and establish procedures for commercial lending.[9] This regulation requires the policies and procedures to address a number of areas, including underwriting standards commensurate with the size, scope and complexity of the commercial lending activities and borrowing relationships contemplated. Although less restrictive than the

[6] U.S. Chamber of Commerce, "Small Business Index, Q4 2022" (December 14, 2022) *available at* https://www.uschamber.com/sbindex/summary.
[7] Biz2Credit, "Small Business Lending Index™" (November 2022) available at https://www.biz2credit.com/small-business-lending-index/november-2022.
[8] NAFCU Small Business Lending Working Group, Q4 Meeting, (December 14, 2022)
[9] 12 CFR 723.4.

requirements for MBLs prior to the MBL Rule, the underwriting standards, which would apply to all commercial loans must, at a minimum, address the following:

> (1) The level and depth of financial analysis necessary to evaluate the financial trends and condition of the borrower and the ability of the borrower to meet debt service requirements;
> (2) Thorough due diligence of the principal(s) to determine whether any related interests of the principal(s) might have a negative impact or place an undue burden on the borrower and related interests with regard to meeting the debt obligations with the FCU;
> (3) Requirements of a borrower-prepared projection when historic performance does not support projected debt payments. The projection must be supported by reasonable rationale and, at a minimum, must include a projected balance sheet and income and expense statement;
> (4) The financial statement quality and the degree of verification sufficient to support an accurate financial analysis and risk assessment;
> (5) The methods to be used in collateral evaluation, for all types of collateral authorized, including loan-to-value ratio limits. Such methods must be appropriate for the particular type of collateral. The means to secure various types of collateral, and the measures taken for environmental due diligence must also be appropriate for all authorized collateral; and
> (6) Other appropriate risk assessment including analysis of the impact of current market conditions on the borrower and associated borrowers.[10]

While NAFCU understands the reasoning behind these underwriting standards for larger, higher-risk loans, their application to all aggregate net business loans over $50,000 is excessive. In practice, these standards require hours of staff work and significantly increase the cost and time expended in originating a business loan. Beyond the underwriting standards, section 723.4(d) requires a FCU to set qualifications and experience requirements for personnel involved in underwriting, processing, approving, administering, and collecting commercial loans. This means that FCUs must employ specialized staff to originate even relatively small, low-risk business loans. Not only are these employees difficult to hire and train, but the number of specialized employees on staff also limits the number of loans that can be originated in a given time period, depending on staff bandwidth. All of these factors result in less loan availability, increased burdens on borrowers, and increased difficulty for FCUs to make these loans.

Additionally, as previously mentioned, the cost of goods has dramatically risen since the start of the COVID-19 pandemic, meaning that $50,000 does not go nearly as far as it once did. In October 2022, the Kelley Blue Book new-vehicle average transaction price (ATP) was $48,281.[11] This means that a small business, for instance a construction company, might just be able to afford a new vehicle before being subject to the same underwriting requirements as a borrower seeking a $750,000 business loan.

NAFCU's members have noted that for loans under $250,000, the underwriting in section 723.4 is unnecessary, as a FCU would easily be able to determine the borrower's ability to repay without

[10] *Id*.
[11] Kelley Blue Book, "New-Vehicle Average Transaction Prices" (October 12, 2022) *available at* https://mediaroom.kbb.com/2022-10-12-New-Vehicle-Average-Transaction-Prices-Fall-for-First-Time-in-Five-Months-After-Recently-Hitting-Record-High,-According-to-Kelley-Blue-Book.

applying the full scope of the standards. Furthermore, for loans of this size, the risk to FCUs and the FCU system is low and if permitted, FCUs would continue to engage in appropriate risk management, while doing so at lower cost to the FCU and borrowers. The feasibility of these alternative underwriting methods has been demonstrated by the many small business lenders that are increasingly utilizing automation and innovative underwriting practices to originate business loans. Confidence in the safety and soundness of these methods has extended to the federal government, with the SBA recently proposing to allow the use of business credit scoring models to aid in commercial loan underwriting.[12] SBA explains that it "believes that allowing Lenders…to use credit scoring models for credit underwriting will result in more lenders making more smaller loans because the costs for making the small loans will decrease."[13] While FCUs would not solely rely on business credit scoring models to underwrite these smaller loans, the ability to use this, or other types of methodologies, in conjunction with other underwriting tools would provide much needed flexibility and increase loan availability and access for Main Street businesses, especially those abandoned by big banks.

Fintech Competition

As big banks originate fewer small dollar business loans and FCUs are frequently hobbled by the costs associated with section 723.4, small businesses have increasingly begun to rely on alternative lenders such as fintechs to fill the demand. In fact, as small business lending has slowly begun to recover from the COVID-19 pandemic, fintechs have increased their small business loan approval percentages at a larger and more consistent rate than large banks, small banks, and even FCUs.[14] Although NAFCU is pleased to see more small businesses have access to credit, there is cause for serious concern when underregulated, fraud-prone fintechs are more easily able to originate business loans than highly regulated and supervised community financial institutions such as FCUs.

FCUs are regulated by the NCUA and subject to supervision and examination. They are also subject to more stringent capital standards than banks, with both a higher statutory leverage requirement and a higher risk weight tier for concentrations of business loans.[15] Fintechs on the other hand, undergo no such supervision or examinations and have little incentive to implement more traditional, costlier underwriting when originating loans. This issue is of particular concern for FCUs as demonstrated by NAFCU's 2022 Report on FCUs, where 89 percent of NAFCU respondents reported that they do not believe their FCU is operating on a level playing field with nonbank small business loan originators.[16] The dangers of this mismatch were recently seen with some fintechs almost exclusively using automated technology to underwrite and screen for fraud

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[12] 87 FR 64724 (November 7, 2022).
[13] *Id*.
[14] Biz2Credit, "Small Business Lending Index™" (November 2022) *available at* https://www.biz2credit.com/small-business-lending-index/november-2022.
[15] 12 CFR 702.102.
[16] NAFCU Report on Credit Unions, 2022.

in Paycheck Protection Program (PPP) lending, with disastrous results.[17] In a damning report released last month by the Select Subcommittee on the Coronavirus Crisis, the true extent of fintech malfeasance in their role as small business lenders was laid bare, and it serves to highlight the danger of allowing fintechs dominate small business lending due to a failure to amend an outdated regulation.

The report found, among other things, that the rate of fraud among fintech PPP loans was disproportionately high, that fintechs were aware of the fraud but did not have the capabilities to detect and respond to this fraud, that billions of taxpayer dollars were lost to fraud, and that fintechs prioritized high-dollar loans, with one fintech executive saying of smaller loan applications, "delete them …[w]e're not the first bank to decline [PPP] borrowers who deserve to be funded…they go elsewhere."[18] Fintechs have shown, to the detriment of deserving small businesses, that they lack the incentives and community focus to make small dollar business lending a priority. They have also shown that they lack the necessary compliance structures, processes, and regulatory oversight to ensure that they can participate in small business lending in a safe, responsible manner. Unfortunately, however, in instances where FCUs are unable to provide more small business loans, fintechs may be the only available option, to the detriment of small business borrowers and the small business system as a whole.

While the PPP served to highlight the flaws of fintech small business lending, it also underscored the capacity, competency, and appetite of FCUs to engage in small business lending. While many big banks would not offer PPP loans in underserved areas, FCUs stepped in, with "719 FCUs with assets less than $1 billion ma[king] $3.1 billion in PPP loans [in 2020 and] 859 FCUs of all sizes ma[king] loans totaling $5.6 billion in 2021."[19] Throughout the PPP, FCUs were quickly able to originate loans and establish relationships with small businesses in their community. As a result, many FCUs that had not previously done so, began to offer SBA loans as well as small business loans more generally. NAFCU urges the NCUA to avoid squandering this opportunity and instead, provide FCUs with the tools to strengthen their relationship with small businesses and solidify the role of FCUs as a source of small business credit.

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[17] *See* Select Subcommittee on the Coronavirus Crisis, "'We are not the fraud police' How fintechs facilitated fraud in the paycheck protection program" (December 1, 2022) available at https://coronavirus.house.gov/sites/democrats.coronavirus.house.gov/files/2022.12.01%20How%20Fintechs%20Facilitated%20Fraud%20in%20the%20Paycheck%20Protection%20Program.pdf
[18] *Id*.
[19] Credit Union Times, "Where Do PPP Loans Fit In The Credit Union Balance Sheet?" (August 2021) *available at* https://creditunions.com/features/where-do-ppp-loans-fit-in-the-credit-union-balance-sheet/.

Benefits to FCUs and Borrowers

Business lending, which was once a secondary product offered by a small number of FCUs has now become, as noted in the MBL Rule "a core service offered by many FCUs as they strive to meet the expanding needs of their small business members. Today, FCUs represent an important source of credit for small businesses."[20] FCUs have steadily gained experience in business lending, spurred on by the retreat of big banks from underserved areas and small dollar loans, as well as FCU's success during the massive undertaking of the PPP.

If the Board were to change the definition of commercial loan to exclude net aggregate loans less than $250,000 it would have tangible positive outcomes for both FCUs and small business borrowers. For these smaller, low-risk loans, FCUs would be able to use existing staff in a normal underwriting process instead of relying on a limited number of specialized staff to comply with more onerous procedures required by section 723.4. Allowing FCUs to utilize innovative underwriting tools and existing staff would reduce wait times and streamline the process for loan applicants. Implementing this change would increase loan availability, reduce burdens on borrowers, and make it easier for FCUs to make these loans.

This is a worthwhile goal that would benefit the individual communities that FCUs serve as well as the U.S. economy as a whole, and as discussed previously, increasing FCU small business lending would help to meet an unmet need. "Empirical results suggest that each dollar of new member business lending by FCUs generated 81 cents of an entirely new credit source for small businesses. In other words, the majority of FCU member business lending is new lending that would not have occurred otherwise. As a whole…findings suggest that credit union lending to small businesses could play an increasingly important role in ensuring the sector has adequate access to credit."[21] There is broad support for the flexibility that would be imparted by this change both within the industry and on the NCUA Board, as noted by Board Member Rodney Hood who stated, "I think it does make sense to raise that threshold…going from $50,000 to $250,000."[22] NAFCU urges the NCUA to take action and amend this regulation to reflect the current economic realities.

Conclusion

NAFCU would like to thank the NCUA for its past willingness to address outdated regulations and encourages the Board to do so here. NAFCU urges the NCUA to provide FCUs with the flexibility to serve their small business members by amending section 723.2 to increase the threshold for net aggregate business loans that are excluded from the definition of Commercial Loan, from $50,000 to $250,000. Thank you for your consideration and we look forward to working with you

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[20] 81 FR 13529 (March 14, 2016).
[21] *Id*.
[22] Glia, "How Uncertainty in the Economy Impacts Credit Unions" (November 2, 2022) *available at* https://www.glia.com/video/how-uncertainty-in-the-economy-impacts-credit-unions.

to attain this crucial flexibility. If we can answer any questions or provide you with additional information, please do not hesitate to contact me at 703-842-2212 or apetros@nafcu.org or James Akin, Regulatory Affairs Counsel, at 703-615-5109 or jakin@nafcu.org.

Sincerely,

Ann C. Petros
Vice President of Regulatory Affairs