RB 2017-01 Guidance on Member Business & Commercial Loans

December 27, 2016

INTRODUCTION

On November 4, 2016, the Credit Union Commission approved certain changes to 7 TAC Section 91.709 concerning the ability of a credit union to make member business loans (MBLs). These amendments to the rule are effective January 1, 2017.

The newly amended rule eliminates the prescriptive underwriting criteria of the existing rule, thereby eliminating the current waiver process. Instead the new rule allows credit unions to implement a principle-based risk management policy related to its commercial and business lending activities. More specifically, the new rule:

- Gives credit unions the ability, under certain circumstances, to not require a personal guarantee;
- Replaces explicit loan-to-value limits with the principle of appropriate collateral and eliminating the need for a waiver;
- Abolishes the 15 percent net worth aggregate limit on construction and development loans; and
- Exempts credit unions with assets under $250 million and small commercial loan portfolios from certain requirements.

The new rule revamps the way that the Department approaches commercial lending, from both a regulatory and supervisory perspective. Currently, Rule 91.709 considers commercial lending as synonymous with the member business lending definition. The new rule distinguishes between the specific category of statutorily defined MBLs and the universe of commercial loans that a credit union may extend to a borrower

for commercial, industrial, agricultural, and professional purposes. As a result, member business loans that are also commercial loans will follow the newly prescribed commercial loan policies. Member business loans that are not commercial loans will follow the credit union's general loan policies. In addition, the new rule delineates which loans are subject to the statutory MBL cap and those which are subject to certain safety and soundness policy and infrastructure requirements.

Although the new rule will give credit unions greater latitude in making commercial loans, it also imposes greater responsibilities. Credit unions will be required to demonstrate sound judgement in originating commercial loans, and control systems will need to be appropriate for the risk inherent in the business loan portfolio.

Type of Loan	**MBL**	**Commercial Loan**	**Subject to Aggregate MBL Cap**
Loan fully secured by a 1 to 4 family residential property (member's primary residence)	No	No	No
Business loan fully secured by a 1- to 4-unit family residential property (not a member's primary residence)	Yes, if the aggregate net business loan balance is equal to or greater than $50,000	No	Yes, if the aggregate net business loan balance is equal to or greater than $50,000
Business loan secured by a vehicle manufactured for household use	Yes, if the aggregate net member business loan balance is equal to or greater than $50,000	No	Yes, if the aggregate net business loan balance is equal to or greater than $50,000

Business loan secured by a vehicle used in a fleet or to carry fare-paying passengers	Yes, if the aggregate net member business loan balance is equal to or greater than $50,000	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000
Business loan with aggregate new member business loan balance less than $50,000	No	No	No
Business loan fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions	No	No	No
Business 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, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000	No

Non-member business loan or non-member participation interest in a commercial loan made by another lender	No	Yes, if the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union is equal to or greater than $50,000	No, if the CU acquired the non-member loan or participation in compliance with applicable laws and the CU is not, in conjunction with one or more CUs, trading MBLs to circumvent the aggregate limit

Exemption for Smaller Credit Unions with Limited Commercial Lending Activities

Rule 91.709 applies to all credit unions; however, smaller credit unions that hold a relatively small amount of commercial loans compared to its net worth and infrequently originates and sells commercial loans is exempt from Sections 91.709(c)(1) [commercial loan policies] and 91.709(c)(2) [qualified staff] of the rule. In order to qualify for the exemption, a credit union must satisfy all of the following conditions:

- Less than $250 million in total assets
- Aggregate amount of outstanding commercial loan balances and unfunded commitments, plus any outstanding commercial loan balances and unfunded commitments of participations sold, plus any outstanding commercial loan balances and unfunded commitments sold and serviced by the credit union total less than 15 percent of the credit union's net worth[i].
- Amount of commercial loans originated and sold (which the credit union does not continue to service) total less than 15 percent of the credit union's net worth in a given calendar year.

All credit unions must have a board-approved loan policy covering their lending activity in general, including those credit unions that qualify for the exemption. A credit union that meets the criteria outlined above is only exempt from the specific policy and infrastructure requirements of Sections 91.709(c) (1) and (2). Exempt credit unions must ensure their general loan policy (required by Rule 91.701) covers the types of commercial loans the credit union makes, including satisfying all other applicable commercial lending requirements in Rule 91.709.

Underwriting Standards

Underwriting standards for commercial loans should be clear, measurable, and reflect the level of risk acceptable to the board of directors. A credit union must establish and maintain prudent credit underwriting practices that provide for consideration, before credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed.

The new rule provides that a credit union's commercial loan policies must address the required analysis and depth of the financial review performed to support a credit decision. The credit union should obtain appropriate financial information on the borrower(s) and guarantor(s), if applicable, including income, liquidity, cash flow, contingent liabilities, and other relevant factors. A borrower should demonstrate the capacity to meet a realistic repayment plan from available liquidity and cash flow. Cash flow from the underlying property or other indicators of borrower capacity should be evaluated to determine whether, and to what extent, the borrower can adequately service interest and principal on a prospective loan.

A credit union's underwriting standards must also address the

quality of the financial information used to make a credit decision and ensure that the degree of verification reflected in the financial information is sufficient to support the financial analysis and the risk assessment of a credit decision. A credit union can determine the quality of a financial statement using the level of assurance provided by a preparer and the required professional standards supporting the preparer's opinion.

Construction and Development Loans

Construction and development lending is a highly specialized field with inherent risk that must be managed and controlled to ensure that this activity remains cost-effective. A credit union's ability to identify, measure, monitor, and control portfolio risk through effective underwriting policies, systems, and internal controls is crucial to a sound construction and development program.

While many of the risks associated with a construction and development lending are beyond the control of the credit union, some can be mitigated by (1) careful scrutiny of the plans and budget; (2) frequent and routine inspections; (3) thoroughly investigating the financial condition and reputation of the borrower; and (4) utilizing effective loan administration procedures. In particular, credit unions are expected to maintain effective policies and procedures governing the loan disbursement process. It is important that any advancement of funds is commensurate with improvements made. Controls should include inspection processes, documentation of construction progress, and exception monitoring and reporting. The credit union should not disburse funds unless the funds are to be used solely for the project being financed and as stipulated in the draw request and governed by the loan agreement.

Risk Rating Commercial Loans

Credit unions are expected to maintain credit risk-management systems that produce accurate and timely risk ratings. Early and accurate risk identification is critical to ensuring problem loans are identified in a timely manner. This enhances flexibility in troubled loan resolution, contributes to the timely recognition of losses, and enables the maintenance of an appropriate ALLL balance. Credit risk rating should be reviewed and updated whenever relevant new information is received.

Periodic independent reviews should be conducted to verify the accuracy of ratings and the operational effectiveness of the credit union's risk-rating processes. Objective reviews of credit risk levels and risk-management processes are critical to effective portfolio management.

Commercial Lending Examination

In addition to the Department's standard loan quality review, a key focus of future commercial lending examinations will be on the effectiveness of a credit union's risk management process and the aggregate risk profile of a credit union's loan portfolio. The Department will be assessing whether a credit union's:

Board of directors understands the risks and provides sufficient oversight;

- Management and staff have appropriate experience, expertise, and resources;
- Commercial loan policy is adequate and complies with Rule 91.709;
- Credit risk ratings are consistent and reliable; and
- Commercial loan risk management is comprehensive and ongoing.

Conclusion

Commercial lending can be an important line of business for a credit union and the new rule provides credit unions with greater flexibility and individual autonomy in safely and soundly making commercial loans to meet the needs of their membership. History has shown that imprudent risk taking and inadequate risk management can lead to significant losses and be a major cause of credit union troubles. This is particularly true during periods of rapid economic growth.

One of the key elements of risk in this type of lending is the cyclical nature of the markets where, as markets peak and decline, credit unions with larger concentrations of commercial loans may suffer considerable distress. While credit unions cannot accurately predict or control the timing of the business cycle, credit unions that demonstrate faithful adherence to prudent lending practices and controls can keep losses from commercial lending to a manageable level, even when markets experience significant stress.

[i]This threshold is measured against all commercial loans in a credit union's portfolio, as well as whole commercial loans or commercial loan participations a credit union has sold but continues to service. For example, a credit union has $20 million in commercial loans including unfunded commitments. In addition, the credit union has sold $10 million in commercial loan participations, including unfunded commitments, and $5 million whole commercial loans, including unfunded commitments with servicing retained. In this example, the aggregate amount of commercial loans that need to be measured against the 15 percent of net worth threshold would be $35 million.

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