

SUPERVISORY LETTER

NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF EXAMINATION AND INSURANCE
1775 DUKE STREET, ALEXANDRIA, VA 22314

DATE: September 2013 **Supervisory Letter No. 13-04**
TO: All Field Staff
SUBJECT: SUPERVISION GUIDANCE ON LOAN PARTICIPATION WAIVERS

To facilitate a more transparent and streamlined participation loan regulation for federally insured credit unions, on June 20, 2013, the NCUA Board approved changes to Part 701 and 741 of the NCUA Rules and Regulations. The final rule, *Loan Participations; Purchase, Sale, and Pledge of Eligible Obligations; Purchase of Assets and Assumption of Liabilities*, is effective on September 23, 2013.

This Supervisory Letter provides information on loan participation waiver, expectations for examiner review of waivers and overall compliance with Part 701.22 of NCUA Rules and Regulations.

The changes reorganized the loan participation rule and focused on the purchase side of loan participation transactions. It will make it easier to understand NCUA's regulatory requirements for loan participations. The changes also enhanced loan participation requirements for federally insured, state-chartered credit unions (FISCUs).

If you have any questions on this supervisory guidance, please direct them to your immediate supervisor or regional management.

Sincerely,

/s/

Larry Fazio
Director, Office of Examination and Insurance



Supervisory Letter



Loan Participation Waiver Guidance

I. Introduction

The information in this document applies the final rule approved by the NCUA Board on June 20, 2013, about *Loan Participations; Purchase, Sale and Pledge of Eligible Obligations; Purchase of Assets and Assumption of Liabilities* (12 CFR Parts 701 and 741). The effective date of the rule is September 23, 2013. The rule applies to all federally insured credit unions.

II. Credit Unions Subject to this Guidance

This Supervisory Letter provides examiners with guidance regarding the interpretation of certain provisions of the final rule relating to loan participation waivers. The rule applies to all federally insured credit unions.

III. Concentration Limits and Loan Participation Waivers Available

Under the revised rule, there are two types of waivers available for loan participations, waiver of the single originating lender concentration limit and waiver of the single borrower concentration limit.¹ These waiver options are discussed below:

Waiver of the single originating lender concentration limit. The final rule limits a federally insured credit union's (credit union) aggregate loan participation purchases from a single originating lender to the greater of \$5 million or 100 percent of the purchasing credit union's net worth.

- Purchases of participations in loans originated by a Credit Union Service Organization (CUSO) will not be aggregated with participation interests in loans originated by the CUSO's owner credit union for the purpose of the single originating lender limit. They will be treated separately and not comingled to determine the concentration level or limit.
- CUSO arrangements must not be used to circumvent the requirements of the final rule. For example, credit unions may not circumvent the rule by establishing "round-robin" participation arrangements.²
- The limit and waiver apply to all loan participations, both member business loan (MBL) participations and non-MBL participations.

¹ 78 FR 37947 (June 25, 2013); 78 FR 40953 (July 9, 2013).

² "Round robin" refers to participation arrangements in which participants would take turns as the originating lender to artificially distribute the single originating lender concentration limit among multiple parties.

Waiver of the single borrower concentration limit. A credit union's purchase of loan participations made to any one borrower or group of associated borrowers cannot exceed 15 percent of the purchasing credit union's net worth. As with waivers of the single originating lender concentration limit, waiver applications of the single borrower concentration limit only include the credit union's participation amount and not the entire loan. Please note that participations involving MBLs are also subject to the limits in Part 723.8 of NCUA Rules and Regulations.

IV. Calculating the Limits, Grandfathering, and Waivers

The single originating lender and single borrower concentration limits are based on a percentage of the purchasing credit union's net worth. To calculate this ratio, the credit union takes the outstanding balance of all loans subject to the limit and divides by the credit union's net worth as defined in Part 702.2(f) of NCUA Rules and Regulations.³ For MBLs, the balance to include in either calculation is the net MBL balance.⁴ If the credit union grants a loan in compliance with the rule when making the loan, a concentration limit exceeded later due to a decline in net worth does not require a waiver.

The rule also grandfathers participations that exceeded the single originating lender or single borrower concentration limit at the effective date of the final rule. Credit unions exceeding the single originating lender or single borrower concentration limit at the effective date of the final rule may not purchase any additional loan participations that are subject to these limits until the credit union's existing balance falls below the concentration limit, unless it receives an approved waiver for a higher limit.

V. Loan Retention Requirements for Originating Lenders

Federal credit unions that serve as the originating lender in a loan participation must retain at least a 10 percent interest in the loan(s) being participated. This is required by the Federal Credit Union Act (12 U.S.C. 1757(5)(E)). Otherwise, all federally insured credit unions may only purchase a participation interest in loans from an eligible originating lender⁵ if the originating lender retains at least a 5 percent interest in the loan(s) being participated.⁶

If an existing loan participation agreement is being renewed or modified after the effective date of the final rule, it may be subject to the regulatory concentration limits and retention requirements. Specifically, if the transaction is considered a new loan under Generally Accepted Accounting Principles (GAAP),⁷ then a credit union may continue the participation in the loan

³ Balances for loans and net worth should be as included in the financial information filed quarterly on the Call Report.

⁴ The net MBL balance is defined in Part 723.21 of NCUA Rules and Regulations.

⁵ An originating lender must meet the definition of an eligible organization established in Part 701.22(a) of NCUA Rules and Regulations

⁶ Federally insured, state chartered credit unions serving as originating lenders may be subject to additional risk-retention requirements per state law.

⁷ See FASB ASC 310-20-35. A "new loan" must generally meet all the following requirements:

- 1) It does not qualify for financial reporting as a Troubled Debt Restructuring (TDR).
- 2) The terms of the restructured loan other than a TDR are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a

only if the originating lender meets the retention requirement and the participation is within the regulatory concentration limits. Conversely, if the transaction does not qualify as a new loan under GAAP, then it is grandfathered for purposes of the retention requirement and does not necessitate a waiver if the credit union's interest is in excess of the regulatory concentration limits.

VI. Types of Waivers Obtained by the Originating Lender and Passed Through to Participating Credit Unions

For borrower or loan level waivers, if the originating lender obtains a waiver for a loan, the participating credit unions **do not** also have to obtain waivers for their participation interests in that loan.⁸ However, if the originating lender **does not** obtain a waiver for a loan, each participant is required to obtain its own waiver for its interest in the participated loan. It is important to remember that a participating credit union's waiver does not pass to other participants—only the originating lender's does. Examiners should confirm participating credit union procedures include obtaining a copy of any waiver approvals from the originating lender prior to purchasing the subject loan participations.

Borrower or loan level waivers may be granted for:

- appraisal requirements,
- minimum borrower equity requirements for construction and development loans,
- loan-to-value ratio requirements, and
- personal liability and guarantee requirements.

Conversely, for credit union level waivers, the participating credit union(s) must obtain its own waiver. Credit union level waivers may be granted for:

- single originating lender concentration limit,
- single borrower concentration limit,
- aggregate construction and development loan limits,
- maximum unsecured business loans to one member or a group of associated members, and
- maximum aggregate unsecured member business loan limit.

VII. One-Time Waivers vs. Blanket Waivers

One-time Waiver. The one-time individual loan waiver is designed to meet a specific need of an individual or small set of borrowers, or a temporary exigent event (such as, a natural disaster

loan with the lender. That is, the new loan's effective yield is at least equal to the effective yield for such loans.

- 3) Restructurings of the original debt instrument are more than minor. That is, if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument.

⁸ For federally insured, state-chartered credit unions, NCUA's approval of the originating lender's waiver request does not release the credit union of its obligation to obtain the necessary approvals from its state supervisory authority.

affecting a service area). For the purpose of participation loans, one-time waivers would predominantly involve the single borrower or group of associated borrowers concentration limit.

Blanket Waiver. A blanket waiver gives the credit union authority to conduct lending activities at limits above those established in the regulation. For the purpose of participation loans, blanket waivers would predominantly involve the single originator concentration limit. Both one-time and blanket waivers should be obtained in advance of a pending loan or situation-specific event to facilitate timely processing of loan applications. Credit unions that plan to pursue interests in participated loans where specific waivers are necessary may wish to seek blanket waiver authority to better expedite the process.

VIII. Waiver Applications – Required Information

In order for a waiver application to be complete, the following information must be included, as applicable:⁹

- Copies of all pertinent lending policies and underwriting standards, including the credit union’s loan participation policy.
- The requested higher limit and an explanation of the need for increasing the limit.
- Documentation supporting the credit union’s ability to manage and monitor the participation loan activity, including risk mitigation measures. The information provided needs to detail any prior experience the credit union has with the type of lending involved. For example, for MBL participation waivers this would include:
 - history of losses and delinquencies,
 - cyclical or seasonal patterns,
 - diversification of risk,
 - underwriting standards and practices,
 - types of loans grouped by purpose and collateral, and
 - qualifications of personnel responsible for underwriting and administering MBLs.
- A copy of the loan participation master agreement, and any related servicing agreements and contracts. These may be included in the form of addendums, exhibits and schedules that are referenced in the contract.
- Documentation supporting the resolution of any material problems identified in the most recent exam report or outstanding administrative actions.

⁹ If the credit union believes certain information is not applicable, it should document the rationale in the application. In the case of a federally insured state chartered credit union, SSA approval/concurrence is required for the application to NCUA to be complete.

IX. Requesting Guidance on Waiver Requests

The preamble to the final rule encouraged credit unions to contact their examiner, respective NCUA Regional Office, or state supervisory authority for federally insured, state-chartered credit unions, for guidance and assistance prior to submitting a waiver application. If contacted, examiners can offer guidance on how the processing office(s) may evaluate a waiver request since the office(s) typically asks for the examiner's input before making a final decision. Examiners will not discourage a credit union from submitting a waiver request and, regardless of the examiner's feedback, it remains a credit union's right to request a waiver. The regional director (and applicable state supervisory authority) makes the decision to approve or disapprove a waiver request.

X. Waiver Request Considerations by NCUA

NCUA will typically only grant loan participation waivers to healthy, well-run credit unions that have sound lending programs. Healthy credit unions are well capitalized in accordance with Section 702 of NCUA Rules and Regulations and generally have composite and Management and Asset Quality component CAMEL ratings of 1 or 2.

Credit unions seeking loan participation waivers must employ strong practices to measure, monitor, and control risk. In acting on the waiver, NCUA will evaluate the following:

- The credit union's financial capacity, management capability, and experience to absorb and manage the type of risk being assumed. This includes the credit union's ability to conduct due diligence tailored to the complexity of the third-party relationships involved.
- The credit union's history of financial and operational performance. Credit unions need to exhibit financial strength and consistent operating performance to warrant a waiver.
- Loan participation policies and procedures that encompass the types of loans the credit union will purchase, underwriting standards, concentration limits for collateral types, geographical locations, and other key risk factors.
- The capability of the credit union's risk management systems and processes including:
 - quality control procedures such as post-closing review of documents,
 - quality and comprehensiveness of the master participation agreement(s),
 - effectiveness of credit administration, and
 - monitoring of the liquidity and financial health of the originating lender, servicer or both.

Credit unions requesting blanket waivers need to meet high standards of lending and management capability. This includes strong loan underwriting and demonstrated portfolio management expertise including:

- Appropriate lending, accounting, and legal expertise.
- Appropriate policies, procedures, quality and internal controls.

- Effective portfolio monitoring techniques, scaled to the size and complexity of the portfolio and types of credit in the portfolio.
- Effective, well developed, corporate governance practices.
- Sufficient levels of net worth consistent with the size, concentrations, and complexity of risks present in the credit unions business model.

In addition to having a strong loan participation program and the financial and managerial characteristics discussed above, NCUA's consideration of applications for waiver of the single borrower concentration limit may include:

- The creditworthiness of the borrower as evidenced by appropriate underwriting and risk evaluation procedures for the type of credit.
- The quality underwriting for loans previously granted to the specified borrower.
- How effectively the credit union appropriately segregates and monitors performance of loans that previously received waivers.

XI. Timing of Waiver Responses and Appeals

NCUA has 45 days to respond after receipt of both a complete waiver request from the credit union and, for federally insured, state-chartered credit unions, concurrence from the state supervisory authority. NCUA will process waiver requests as expeditiously as possible but in no event greater than 45 days from receiving a completed request package including written concurrence from the state supervisory authority where applicable. Credit unions should anticipate the need for waivers as early as possible as NCUA does not retroactively issue waivers for regulatory violations.

A credit union may appeal all or part of the regional director's waiver decision to the NCUA Board. The appeal must be submitted through the regional director within 60 days of the date of determination.

XII. Waiver Violations

Examiners will treat waiver violations identified during an examination or supervision contact as a major concern and require prompt resolution of the violation. Required corrective action will depend on the severity and nature of the violation, including potential divestiture.

In addition, the regional director may revoke a waiver, in whole or in part, at any time for substantive, documented safety and soundness reasons. The regional director must give written notice to the credit union, including the reasons for the revocation. The notice should discuss any treatment or grandfathering of activities conducted while the waiver was in force. Revocation of the waiver is effective upon the credit union's receipt of the letter from the regional director.

NCUA internally reviews outstanding waivers at least once every three years to ensure national consistency in applying authorities under Part 701.22.

XIII. Permissible Loan Participations

Purchasing credit unions may participate in types of loans they do not originate. However, a credit union may only purchase a loan participation if the loan is one the credit union is empowered to grant. “Empowered to grant” refers to a credit union’s authority to make a loan under the Federal Credit Union Act, applicable state law, NCUA Rules and Regulations, and the credit union’s own bylaws and internal policies.

Purchasing credit unions are not required to be in the active business of making the types of loans in which they are purchasing an interest, but management is ultimately responsible for the financial health of the credit union. Credit unions may establish different or even less stringent underwriting standards for loan participations than they use for originating their own loans. Credit unions must have a policy in place for each type of loan participation purchased, and the policy must include underwriting criteria and risk limits. Accordingly, the credit union must have sufficient expertise and understanding of the type of loans involved in the participation to assess the credit, liquidity, interest rate, and operational risks involved.

XIV. Loan Participation Policy Requirements

A credit union’s loan participation policy must at a minimum:

- Establish underwriting standards for loan participations. The final rule permits a credit union to purchase a participation in a loan it is empowered to grant, even if it does not originate that type of loan or if the loan is underwritten using standards other than those it uses when originating similar loans. It does not prevent a credit union from establishing different, or, where appropriate, even less stringent underwriting standards for loan participations than it uses when originating its own similar loans. However, the credit union must demonstrate the varying standards are based on a sound, well-documented analysis of the risks involved.
- Provide for compliance with all applicable laws and rules and regulations, including the concentration limits applicable to loan participations.
- Establish limits on the amount of loan participations by loan type, not to exceed a reasonable percentage of the credit union’s net worth. Reasonable limits should be based on the credit union’s experience with the particular loan type, historical delinquency, and other risk characteristics.

XV. Loan Participation Master Agreement Requirements

The loan participation master agreement must, at a minimum:

- Be properly executed by authorized representatives of all parties. A copy or original must be retained in the credit union’s office.

- Clearly delineate roles, duties, obligations of the originating lender, servicer, and participants with respect to all aspects of the participation including:
 - Servicing;
 - Default;
 - Foreclosure and other real estate owned;
 - Collection; and
 - Other matters involving the ongoing administration of the loan.
- Contain a provision requiring the originating lender to retain at least the minimum required percentage interest in the loan throughout the loan's duration as set forth in Part 701.22(b)(3).
- Identify each participated loan. The agreement shall specify the loan or loans in which the credit union is purchasing an interest and the amount of their interest in that loan. This may be an addendum or schedule to the participation agreement.
- Disclose the location and custodian for the original loan documents.
- Enumerate servicing responsibilities for the loan, circumstances and conditions under which participants may replace the servicer.
- Include disclosure requirements about the ongoing financial condition of the loan, the borrower, and the servicer. This includes the conditions under which parties to the agreement can gain access to financial and other performance information about a loan, borrower, and servicer.