Creating Cooperative Power

February 21, 2023

Ms. Melane Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3428

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

Dear Ms. Conyers-Ausbrooks,

On behalf of its member credit unions, the Cooperative Credit Union Association, Inc. ("Association") appreciates the opportunity to comment on the National Credit Union Administration's (NCUA) proposed rule on Financial Innovation: Loan Participations, Eligible Obligations and Notes of Liquidating Credit Unions that would amend Sections 701.21 ("Loans and Lines of Credit to Members"), 701.22 ("Loan Participations"), and 701.23 ("Eligible Obligations") of NCUA rules. The Association is the state trade association representing approximately 200 state and federally-chartered credit unions located in the states of Delaware, Massachusetts, New Hampshire, and Rhode Island, which further serve over 3.6 million consumer members. The Association has developed these comments in consultation with our members.

<u>The Association's High-Level Comments</u>

- The Association strongly supports the NCUA Board's proposal to liberalize its Section 701.23 eligible obligations regulation by moving to a more principles-based rule. The Board should finalize these amendments as proposed.

- The Association supports the Board's proposal to incorporate its indirect lending provision into Section 701.21(c)(9), and to codify NCUA Office of General Counsel Legal Opinion 15-0813. We believe a credit union should be considered to make the "final underwriting decision" as the "originating lender" even if an indirect lender applies additional, more restrictive underwriting standards than the credit union requires. Assignment of a loan to the credit union should occur before the first payment is due.

- We urge the Board to level the playing field between federal credit unions (FCUs) and federally insured state-chartered credit unions (FISCUs) by lifting the Section 701.22

loan participation regulation's "membership requirement" FCUs to invest in a loan participation. The FCU Act does not limit FCUs to investing solely in loans made to credit union members and NCUA's Section 741.225 regulation already exempts FISCUs from this requirement.

- The Association urges the Board to clarify in the final rule that investing FICUs have discretion to classify a partial interest in a loan as either a Section 701.22 loan participation or as a Section 701.23 eligible obligation if the transaction meet both rules' requirements.

<u>The Association's Comments in Response to NCUA's Questions</u>

1. The Board Should Finalize the Amendments to the Section 701.23 Eligible Obligation Rule as Proposed

The Association strongly supports the NCUA Board's proposal to liberalize its Section 701.23 eligible obligations regulation for FCUs by moving to a more principles-based rule, including lifting the inflexible 5 percent of paid-in-capital and shares limit found in the existing regulation as well as eliminating minimum CAMELS ratings.

The proposal correctly interprets Section 107(13) of the Federal Credit Union Act so that the 5 percent limit applies only to notes of liquidating credit unions, as Congress intended. We also support the proposed due diligence, risk management, internal underwriting standards, and legal review requirements for loan purchases. These procedures should help limit prudential risks associated with FCUs' investments in eligible obligations in a safe and sound manner and make unnecessary the 5 percent limit and other requirements of the existing regulation the Board proposes to discontinue.

In addition to FCUs, most FISCUs should also benefit from this rule pursuant to state credit union act "wildcard" parity statutes. *See, e.g.*, Mass. Gen. Laws ch. 171, § 6A; N.H. Rev. Stat. Ann. § 383-E:4-411; R.I. Gen. Laws § 19-5-25.

We urge the NCUA Board to finalize the amendments to Section 701.23 as proposed.

2. The Board Should Clarify that a Credit Union is the "Originating Lender" in an Indirect Lending Relationship When an Indirect Lending Partner Applies Additional, More Restrictive Underwriting Standards than the Credit Union Requires, and Delivery of the Loan to the Credit Union Occurs Before the First Payment is Due

The Association supports the Board's proposal to incorporate its indirect lending provision into Section 701.21(c)(9) of NCUA Rules, which applies to FCU lending activities in general, as well as the Board's proposal to codify NCUA Office of General Counsel Legal Opinion 15-0813, including the proposed definition of "originating lender" in Section 701.22(a). These amendments are consistent with longstanding NCUA policy. We urge the Board, however, to clarify the terms "final underwriting decision" and "assigned to the purchaser very soon after inception…" of the loan or lease in the final version of Section 701.21(c)(9).

a. FCU Makes "Final Underwriting Decision" Even When Indirect Lending Partner Applies Additional, More Restrictive Underwriting Criteria

The Board specifically "invites comments on what it means for the credit union to make the final underwriting decision regarding making the loan in an indirect lending relationship" including "[w]ould a credit union still be making the final underwriting decision if a third party includes significantly more underwriting criteria that are more restrictive, for example, than the credit union requires?"

The Board should answer this question affirmatively in the final version of the rule because third parties that apply additional, more restrictive underwriting criteria than the credit union requires help to promote safety and soundness by reducing credit risk. This is effectively an administrative, loan processing function where the indirect lender is acting as a facilitator on behalf of the credit union to provide credit enhancements because it is working within credit union's underwriting criteria to improve credit qualify by being more stringent than the credit union requires.

The final rule should clarify that the credit union in this scenario continues to make the "final underwriting decision" when a third-party provides such credit enhancing services because all loans the credit union acquires through such an indirect lending arrangement meet the credit union's pre-approved underwriting criteria. The third party's use of its own underwriting judgment with respect to processing loan applications that already would be approved based on the credit union's underwriting parameters does not create an underwriting exception that would increase credit risk. To the contrary, an indirect lending partner adding additional, more restrictive underwriting criteria than the credit union requires serves as a credit enhancement that decreases risk to the credit union.

Prior to the 1990s, all credit union indirect lending arrangements involved natural person individuals working for the indirect lending partner who would process loan applications that adhered to the credit union's underwriting standards, often using pen and paper.

In 1997, the NCUA Office of General Counsel issued Legal Opinion 97-0546[1] opining on the use of CUNA Mutual Group's "point of purchase lending (POPLS) program," which was an early computerized underwriting program that facilitated credit union members financing auto purchases at the point of sale using credit union auto loans. To use POPLS, a representative of the indirect lender would input data points such as the borrower's income into the underwriting program and it would either approve or deny the application based on the credit union's pre-approved underwriting criteria.

While the preamble to the proposed rule cites this 1997 Legal Opinion letter to state that an "eligible organization may use an automated scoring system so long as the 'score' obtained from

[1] "Indirect Lending," Letter of Sheila A. Albin, Associate General Counsel, NCUA, to Linda J. Lehnertz, Associate General Counsel, CUNA Mutual Group (Aug. 6, 1997), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/1997/indirect-lending.

the automated system is the sole determinant for granting credit," in the context of the 1997 Legal Opinion about POPLS this simply meant that the third-party indirect lender should not be able to exercise judgment that created an exception to the credit union's underwriting standards to approve a loan that did not meet the credit union's pre-approved underwriting criteria loaded into POPLS. Significantly, the 1997 Legal Opinion did not address a third-party providing credit enhancements by applying additional, more restrictive underwriting criteria or judgment that went above and beyond the credit union's minimum underwriting standards to reduce risk.

Technology has also changed significantly since 1997, which later NCUA legal opinions reflect. In 2010, the Office of General Counsel opined in Legal Opinion 09-1044[2] that it was "permissible" for a federal credit union to bring in new members using a fully automated loan underwriting and funding system similar to how today's fintech indirect lenders' technology operates in practice. The 2010 letter, however, did not prohibit natural persons' involvement in the loan underwriting process so long as there was a separation of duties where individual disbursing the funds did not have authority to approve the loan as a "loan officer." Similarly, as the NCUA's Office of General Counsel noted in its June 16, 2020 Legal Opinion ("Automated Loan Underwriting System - Segregation of Duties for Loan Officers"), the use of ALUS has become increasingly common to help credit unions obtain computer generated loan decisions.[3]

The Board should clarify in the final rule that the FCU is making the "final underwriting decision" even when an indirect lender employs an ALUS and/or natural person individuals to add additional, more restrictive underwriting criteria that reduces credit risk by helping to weed out potentially bad loans. Specifically, the Board should make clear in the final rule that the FCU makes the "final underwriting decision" so long as:

i. The FCU establishes by contract that the indirect lending partner must adhere to the underwriting standards set forth in the indirect lending agreement; these underwriting standards are typically included as an appendix or exhibit to the master agreement for the indirect lending relationship; and

ii. The indirect lending partner can apply additional, more restrictive underwriting criteria that go above-and-beyond the FCU's underwriting requirements, whether those additional underwriting criteria are part of an ALUS and/or are performed by a natural person individual who is not involved in the disbursement of loan funds.

Indirect lending partners that apply additional, more stringent underwriting criteria than the credit union requires help promote safety and soundness by reducing credit risk. These third parties are simply acting as a facilitator on behalf of the credit union to provide credit

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[2] See "Automated Loan Underwriting and Funding," Letter of Hattie M. Ulan, Assistant General Counsel, NCUA, OGC Legal Op. No. 09-0944 (October 2010), available at https://www.ncua.gov/regulation-supervision/legal-opinions/2010/automated-loan-underwriting-and-funding.

[3] "Automated Loan Underwriting System - Segregation of Duties for Loan Officers," Letter of Frank Kressman Acting General Counsel, NCUA (June 2020), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2020/automated-loan-underwriting-system-segregation-duties-loan-officers.

enhancements because they do not override the credit union's underwriting criteria but instead weed out potentially problematic loans.

b. "Very Soon" Should Mean Before the Due Date of the First Loan Payment (Other than a Downpayment)

The proposal asks "[s]hould the Board consider providing additional clarity such as adding some parameters around the meaning of 'very soon after' for the assignment of the loan or contract to the credit union? Examples could be within seven days of the borrower executing the loan or contract, or assignment prior to the first loan payment."

The Association urges the Board to clarify that "very soon after" means "assignment prior to the due date first loan payment other than any downpayment." We also urge the Board to clarify that the assignment can involve more than one party, such as if a fintech indirect lending partner uses one or more agents or subsidiaries to facilitate its operations prior to the loan being delivered to the credit union.

Many credit unions have assignment processes that involve multiple steps. As an example, a fintech lender may use an FDIC-insured bank as its agent to fund the loan, following which the loan is assigned to a trust at the fintech and the trust then assigns it to the credit union. As long as the whole process completes the assignment in a timely manner, the functional steps the process undergoes should not disqualify it from meeting the definition's "very soon after" requirement.

Defining the time period to mean "assignment prior to the due date of the first loan payment other than any downpayment" would provide credit unions with sufficient flexibility to respond to the operational realities of modern indirect lending arrangements without compromising safety and soundness because the assignment would occur prior to loan payments being due.

An additional new paragraph (B) should be added directly after the above proposed new paragraph (A) to § 701.21(c)(9)(i) as follows:

> "The requirement that the loan be assigned to the purchaser very soon after the inception of the obligation to extend credit may be satisfied regardless of whether the assignment process undergoes multiple functional steps, with multiple entities, and including where the assignment is processed as part of a batch of loans, on a cyclical cadence or otherwise, so long as assignment occurs before the due date of the first loan payment following any downpayment."

3. The Final Rule Should Eliminate Section 701.22's Requirement that FCUs Can Only Invest in Loan Participations Made to Credit Union Members

The Association urges the Board to level the playing field between FCUs and FISCUs by removing the limitation on FCUs investing in loan participations to non-member borrowers from the final version of Section 701.22(b)(4). FISCUs are already exempt from this limitation pursuant to Section 741.225 of NCUA rules. 12 C.F.R. § 741.225. The Board should establish parity between FCUs and FISCUs by similarly eliminating the membership requirement from 701.22(b)(4). It is clear from the plain language of Section 107(5)(E) of the Federal Credit Union

Act and its context within the structure of Section 107(5) that Congress did not intend to limit FCUs to participate only in loans made to credit union members.

Although the phrase "loans to credit union members" is included in the umbrella provision of Section 107(5), it is clear from Section 107(5)(E) being read in context with other subsections of Section 107(5)—especially the Section 107(5)(C) authorization for FCUs to lend to other credit unions and the Section 107(5)(D) authorization for FCUs to lend to CUSOs—that a borrower's membership in a credit union is not a per se requirement for the FCU to exercise any these three authorities in Section 107(5).

As a threshold matter, within Section 107(5) only subsection 107(5)(A)—the general FCU statutory lending power—states that it applies to "loans to members." By omitting the "loans to members" requirement from the latter subsections of 107(5), Congress clearly intended for the credit union membership requirements to apply only to loans made by FCUs pursuant to its Section 107(5)(A) lending powers, and not to FCUs' authorities under the other subsections of Section 107(5).

Traditional cannons of statutory construction support this reading including *expressio unius est exclusio alterius* ("the expression of one thing is the exclusion of others") and the rule against surplusage, as do NCUA's regulations concerning loans to other credit unions and loans to CUSOs. An FCU can lend to another credit union pursuant to Section 107(5)(C) without the borrowing credit union joining the FCU, and an FCU can lend to a CUSO pursuant to Section 107(5)(D) without the CUSO becoming a member of the credit union. *See* 12 C.F.R. § 701.25 ("Loans to credit unions."); 12 C.F.R. part 712 ("Credit Union Service Organizations").

In addition to being the most logical interpretation of Section 107(5)(E), discontinuing the limitation on FCUs investing in loan participations originated by non-credit-unions will reduce regulatory burdens on FCUs, help level the playing field between FCUs and FISCUs, improve liquidity in the loan participations market, and reduce risk to the credit union system in general by diversifying FCUs' investment options without lowering underwriting standards.

4. **Credit Unions Should have Discretion to classify a Transaction as Either a Section 701.22 Loan Participation or as a Section 701.23 Partial Interest in an Eligible Obligation When the Transaction Meets Both Rules' Requirements**

The Board noted in the preamble to the rule that it intends a number of its proposed rule changes to "clarify the distinction between transactions treated as loan participations and those treated as eligible obligations." Under the current versions of Sections 701.22 and 701.23, as well as under the proposed amendments to both rules, there are scenarios where a FICU's investment in a partial interest in a loan could qualify as either a "loan participation" under 701.22 or as an "eligible obligation" under 701.23 based on the transaction's terms and conditions.

In line with this goal, the Board should clarify the final versions of the loan participation and eligible obligation rules so that investing FICUs have discretion to classify a partial interest in a loan under either Section 701.22 or Section 701.23 when its terms and conditions meet the requirements of both rules.

The Association urges the Board to add the following language to the final versions of the loan participation rule (at new paragraph Section 701.22(e)) and the eligible obligation rule (at new paragraph Section 701.23(i)):

> "Each FICU that is party to a transaction may choose to categorize it as either a transaction under this rule [§ 701.22 or § 701.23], or alternatively as a transaction under [§ 701.22 or § 701.23], and may designate it as such as necessary (for example on a call report). FICUs that are party to the same transaction do not have to categorize or designate the transaction in the same manner, and FICUs retain discretion to recategorize and redesignate the transaction from time to time."

The Association appreciates the opportunity to comment on the NCUA's proposed rule on Financial Innovation: Loan Participations, Eligible Obligations and Notes of Liquidating Credit Unions. If you have any questions about our comments or require further information, please do not hesitate to contact the Association at govaff-reg@ccua.org.

Sincerely,

Ronald McLean
President/CEO
Cooperative Credit Union Association, Inc.
rmclean@ccua.org