NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

July 27, 1987

GC/JT.39
4660

Office of General Counsel

Mr. Roy D. High
Administrator
Credit Union Division
North Carolina Department of Commerce
430 North Salisbury Street
Raleigh, North Carolina 27611

Dear Mr. High:

This is in response to your letters of March 2, 1987, and May 28, 1987, in which you questioned whether the NCUA has the authority to apply the proposed rule on member business loans to federally-insured state credit unions (FISCU's).

On April 9, 1987, the NCUA adopted final rules concerning business loans and preferential treatment and prohibited fees on business and other loans made by federally-insured credit unions. Enclosed is a copy of the final rules.

The preamble to the final member business loan rule, 52 Fed. Reg. 12365, April 16, 1987, addresses the issue of applying the rules to FISCU's. It provides that:

> Some commenters have questioned NCUA's authority to extend the rule to federally-insured state credit unions. They argue that the Board's general rulemaking authority in Section 209(a)(11) of the FCU Act (12 U.S.C. Section 1789(a)(11)) does not empower NCUA to promulgate a rule such as this. The Board does not agree. The objective of these rules is to ensure that lending practices are conducted in a safe and sound manner. Unsafe business lending practices by federally-insured state credit unions directly affect the risk of loss to the NCUSIF and in fact have resulted in many millions of dollars of losses in the last several years. Similarly, instances of preferential and substandard lending to insiders have resulted in very severe losses. Thus the application of these

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> rules to federally-insured state credit unions is not a matter of unconstitutional overreaching, but instead is simply a matter of meeting certain minimum standards as a condition of Federal insurance. In this connection, Section 201(b)(9) of the Act (12 U.S.C. 1781(b)(9)) provides that insured credit unions agree "to comply with the requirements of [Title II of the FCU Act] and of the regulations prescribed by the Board pursuant thereto." The record reflects that NCUA has used this authority only when necessary to establish minimum safety and soundness standards as a condition of Federal insurance.

Under Section 741.3 of the final rules, a state regulatory authority that adopts regulations which are substantially equivalent to the NCUA final rules may be exempted from Sections 701.21(c)(8), (d)(5), and (h).

You have taken the position that Title II of the Federal Credit Union Act (FCU Act), which is contained in Sections 201 thru 211 of the FCU Act, 12 U.S.C. §§1781-1790, does not provide the NCUA with the statutory authority to issue a business loan rule that would apply to FISCU's. You further argue that the rules violate the principles of federalism, and may also violate Executive Order No. 12291 and Office of Management and Budget Circular A-19.

As stated in the preamble to the rule, the statutory basis for extending the rules to FISCU's is Sections 209(a)(11) and 201(b)(9) of the FCU Act, 12 U.S.C. Sections 1789(a)(11) and 1781(b)(9). Section 1789(a)(11) provides that the NCUA Board may prescribe such rules and regulations as it may deem necessary or appropriate to carry out Title II of the FCU Act. As you know, Title II contains the provisions regarding share insurance.

Section 201(a) of the FCU Act, 12 U.S.C. Section 1781(a), a Title II provision, states that:

> The Board, as hereinafter provided, shall insure the member accounts of all Federal credit unions and it may insure the member accounts of (1) credit unions organized and operated according to the laws of any State, the District of Columbia, the several territories, including the trust territories, and possessions of the United States, the Panama Canal Zone, or the Commonwealth of

> Puerto Rico, and (2) credit unions organized and operating under the jursidiction of the Department of Defense if such credit unions are operating in compliance with the requirements of Title I of this Act and the regulations issued thereunder.

Section 201(c)(2) of the FCU Act, 12 U.S.C. Section 1781(c)(2) provides that:

> The Board shall disapprove the application of any credit union for insurance of its member accounts if it finds that its reserves are inadequate, that its financial condition and policies are unsafe or unsound, that its management is unfit, that insurance of its member accounts would otherwise involve undue risk to the fund, or that its powers and purposes are inconsistent with the promotion of thrift among its members and the creation of a source of credit for provident or productive purposes.

Pursuant to Section 1781(a) as cited above, the Board is authorized to insure credit union member accounts under the prescribed statutory and regulatory requirements. However, as stated in Section 1781(c)(2) above, the Board cannot insure a credit union if it finds that its financial policies are unsafe or unsound, or that insurance of its member accounts would involve an undue risk to the NCUSIF. The NCUA Board determined that, due to the losses sustained by the NCUSIF as a direct or indirect result of business lending and preferential and substandard lending to insiders, regulation was required to protect the NCUSIF. Therefore, consistent with its authority to insure credit unions and the prohibition against insuring credit unions that would create an undue risk to the NCUSIF, the NCUA Board adopted the subject rules. The rules were promulgated under the Board's Section 209(a)(11), 12 U.S.C. §1789(a)(11), rulemaking authority with the purpose of fulfilling its responsibilities under Section 201 of the FCU Act, 12 U.S.C. §1781.

You further argue that the final rule violates principles of federalism. NCUA is not attempting to regulate all state-chartered credit unions. Instead, the rule provides for minimum safety and soundness standards for state-chartered credit unions that have contracted with the NCUA for Federal insurance. As stated in the preamble, this is not a question of constitutional overreaching, but rather is a contract question.

State-chartered credit unions are not required by NCUA or Federal law to have Federal insurance. If they apply to be federally insured, there are certain conditions they must meet. Pursuant to 12 U.S.C. §1781(b)(9), as a prerequisite to obtaining Federal insurance, they must comply with Title II and the regulations prescribed thereto.

You relied on Executive Order No. 12291 and Office of Management and Budget (OMB) Circular A-19 in support of your federalism argument. Executive Order No. 12291 pertains to the procedural requirements certain agencies must follow in issuing a regulation. It does not apply to the NCUA. OMB Circular A-19 pertains to the procedures for the coordination and clearance by the OMB of agency recommendations for proposed, pending, and enrolled legislation. Legislation is not at issue here.

As stated previously, the final rules provide an exemption for FISCU's in states that adopt substantially equivalent regulations. The NCUA Board will make the determination as to whether the state regulations are "substantially equivalent." The guidelines the NCUA Board will look to in making this determination are set forth in the preamble to the final rules. On June 30, 1987, the NCUA Board was presented with the State of North Carolina's proposed rules on prohibited fees, nonpreferential treatment, and member business loans. The Board delegated to the Regional Director, Region III, the authority to grant to North Carolina's state-chartered federally-insured credit unions an exemption from Sections 701.21(c)(8), 701.21(d)(5), and 701.21(h) of NCUA's Rules and Regulations, provided any required reviews are made and approvals granted only after consultation with NCUA. The exemption will take effect on the effective date of final rules that are consistent with the proposed rules submitted to NCUA.

We trust this has been of assistance.

Sincerely,

STEVEN R. BISKER
Assistant General Counsel

Enclosure

JT:sg

c.c E&I
RD, Region III (Atlanta)

PART 73—PHYSICAL PROTECTION OF PLANTS AND MATERIALS

1. The authority citation for Part 73 continues to read as follows:

Authority: Sec. 161, 68 Stat. 948, as amended (42 U.S.C. 2201); sec. 201, 88 Stat. 1242, as amended (42 U.S.C. 5841).

2. In § 73.55, paragraph (e)(1) is revised to read as follows:

§ 73.55 Requirements for physical protection of licensed activities in nuclear power reactors against radiological sabotage.

* * * * *

(e) *Detection aids.* (1) All alarms required pursuant to this part must annunciate in a continuously manned central alarm station located within the protected area and in at least one other continuously manned station not necessarily onsite, so that a single act cannot remove the capability of calling for assistance or otherwise responding to an alarm. The onsite central alarm station must be considered a vital area and its walls, doors, ceiling, floor, and any windows in the walls and in the doors must be bullet-resisting. The onsite central alarm station must be located within a building in such a manner that the interior of the central alarm station is not visible from the perimeter of the protected area. This station must not contain any operational activities that would interfere with the execution of the alarm response function. Onsite secondary power supply systems for alarm annunciator equipment and non-portable communications equipment as required in paragraph (f) of this section must be located within vital areas.

* * * * *

Dated at Bethesda, Maryland this 8th day of April, 1987.

For the Nuclear Regulatory Commission.

Victor Stello, Jr.,

Executive Director for Operations.

[FR Doc. 87-8607 Filed 4-15-87; 8:45 am]

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NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 701 and 741

Organization and Operations of Federal Credit Unions; and Requirements for Insurance and Voluntary Termination of Insurance

AGENCY: National Credit Union Administration.

ACTION: Final rule.

SUMMARY: The NCUA Board has adopted final rules concerning business loans made by federally-insured credit unions and concerning preferential treatment and prohibited fees on business and other loans. These final rules are based on a proposed rule issued by the NCUA Board on June 19, 1986 (*see* 51 FR 23234, June 26, 1986), and a revised proposed rule issued by the NCUA Board on December 17, 1986 (*see* 51 FR 46869, December 29, 1986). These final rules incorporate many of the recommended changes and amendments submitted by commenters on the prior proposals. Major revisions involve the definition of member business loans (§ 701.21(h)(1)(i)), written business loan policies (§ 701.21(h)(2)), prohibited fees and preferential loan treatment (§ 701.21(c)(8) and (d)(5)), and minimum loan policy requirements for federally-insured credit unions (§ 741.3).

EFFECTIVE DATE: July 1, 1987.

ADDRESS: National Credit Union Administration, 1776 G Street, NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: J. Leonard Skiles, Regional Director, Region V (Austin), 611 East 6th Street, Suite 407, Austin, TX 78701; or D. Michael Riley, Director, Office of Examination and Insurance, or Steven R. Bisker, Assistant General Counsel, 1776 G St., NW., Washington, DC 20456, or telephone: (512) 482-5131 (Mr. Skiles); (202) 357-1065 (Mr. Riley); or (202) 357-1030 (Mr. Bisker).

SUPPLEMENTARY INFORMATION:

Background and General Comments

Approximately 350 comment letters were submitted on the June 1986 proposal and approximately 85 letters were submitted on the December proposal. A majority of the commenters on the second proposal either expressed support for the rules, or expressed appreciation of NCUA's responsiveness and recommended additional changes. Some of the commenters, although recognizing the present need for a rule, urged the NCUA Board to commit to review the rule in one to two years. NCUA has already begun to collect data on business loans in conjunction with the Semiannual Report (Form 5300) and will review the data over a period of three years or less. This process will help the NCUA Board determine the effectiveness of and the continued need for this final rule.

While the process of public debate and comment on this rule has been relatively long, with numerous discussions, lectures, and articles addressing the subject, there continues to be some misunderstanding about the objectives of the provisions concerning member business loans. The Board wants to stress that it is *not* its intent to prohibit commercial lending. Rather, the objective of the rule is to help establish a framework to ensure that business loans are made in a way that will reduce the risk inherent in such loans and provide for adequate financial backup (reserves) in the event that losses are incurred. The Board's goal is to provide the basis for a system of business lending that is consistent with safe and sound practices and that will help to reduce losses to federally-insured credit unions and the National Credit Union Share Insurance Fund ("NCUSIF"). This is the principal reason for bringing *all* federally-insured credit unions within the scope of the rule.

Some commenters have questioned NCUA's authority to extend the rule to federally-insured state credit unions. They argue that the Board's general rulemaking authority in section 209(a)(11) of the FCU Act (12 U.S.C. 1789(a)(11)) does not empower NCUA to promulgate a rule such as this. The Board does not agree. The objective of these rules is to ensure that lending practices are conducted in a safe and sound manner. Unsafe business lending practices by federally-insured state credit unions directly affect the risk of loss to the NCUSIF and in fact have resulted in many millions of dollars of losses in the last several years. Similarly, instances of preferential and substandard lending to insiders have resulted in very severe losses. Thus the application of these rules to federally-insured state credit unions is not a matter of unconstitutional overreaching, but instead is simply a matter of meeting certain minimum standards as a condition of Federal insurance. In this connection, section 201(b)(9) of the Act (12 U.S.C. 1781(b)(9)) provides that insured credit unions agree "to comply with the requirements of [Title II of the FCU Act] and of the regulations prescribed by the Board pursuant thereto." The record reflects that NCUA has used this authority only when necessary to establish minimum safety and soundness standards as a condition of Federal insurance.

Further, the Board, in this instance, has provided exemptions for federally-insured state credit unions in states that adopt rules "substantially equivalent" to NCUA's rules. (*See* discussions under "Applicability of Rules to Federally-Insured State Credit Unions," below.)

The most frequently received comments and the changes that have been made in the final rule are detailed below.

Prohibited Fees (Section 701.21(c)(8))

This is one of two sections of the rules that apply to *all* loans to members by Federal and federally-insured state credit unions. This Section of the proposal would have prohibited all officials and employees, and their immediate family members, from receiving loan-related commission and fee income. "Immediate family member" was very broadly defined. Many commenters expressed concern about the breadth of this prohibition. In response to the comments, the final rule narrows the prohibition to directors, committee members, loan officers, and senior management employees (defined essentially to include the CEO and his or her top assistants), and narrows the definition of "immediate family member" to the spouse and other relatives living in the same household.

The conflicts of interest sought to be eliminated by this Section of the rule exist principally where the person involved is in a position of authority in the credit union so as to influence or make decisions that can affect their pecuniary interest. Non-senior employees, therefore, need not be included in the prohibition.

The definition of "immediate family member" was amended because many commenters expressed concern that relatives of directors, committee members, and employees, previously included in the definition, were unwarrantedly precluded from doing business (providing services in connection with underwriting, insuring, servicing, or collecting loans or lines of credit) with the credit union. The Board agrees that the prohibition may have been unnecessarily broad and, therefore, has limited the definition. It is expected, however, that any such dealings will be at arm's length and in the best interest of the credit union.

Nonpreferential Treatment (Section 701.21(d)(5))

This is the second provision of the lending rules that applies to both member business and nonbusiness loans. This section prohibits preferential loans to directors and committee members and to their immediate family members and business associates. As in the case of the provisions on prohibited fees, the definition of immediate family member is limited to the spouse and other family members living in the same household. This change has also been made in § 701.21(h)(1)(iv) (prohibiting certain business loans to senior management employees, discussed below), and it is noted that the Board will, in the near future, review other provisions in NCUA's Rules and Regulations where the term appears and will consider consistent revisions to those Sections as well (*see* e.g., § 701.27(c)(3) concerning "credit union service organizations," § 701.36(b)(6) concerning fixed-assets, § 703.2(l) concerning investment activities, and § 721.2(c) concerning insurance and group purchasing).

Definition of Member Business Loan (Section 701.21(h)(1)(i))

A recommendation contained in several comment letters was that the exception from the definition of member business loans in paragraph (A), for loans fully secured by a lien on a 1 to 4 family dwelling, *not* be limited to the member's primary or secondary residence. The proposed rule was limited because it was not the Board's intention to except out from the definition real estate investment loans fully secured by such property. The commenters believed that the proposed rule was overly restrictive. The Board has reconsidered its position and has amended the rule to expand the exception to include a loan or loans fully secured by (1) the member's primary residence, or (2) the member's secondary residence, or (3) one other 1 to 4 family dwelling owned by the member. The change will permit a member to have a total of three fully secured loans (primary residence, secondary residence and one other) that would not otherwise be subject to § 701.21(h). This change should accommodate those instances where a member purchases a new primary residence and does not sell his prior residence but, instead, rents it to a family member or other person. In many cases, the motivation to maintain the old residence is not investment oriented but rather to provide a home for a family member.

Some commenters asked whether loans fully secured by condominium or cooperative apartments or townhouses were included in the exception. The Board interprets 1 to 4 family dwelling as including these kinds of residential properties.

The Board also received several comments asking that paragraph (B), the exception for loans fully secured by shares in the credit union, be broadened to include deposits in other financial institutions such as banks, savings and loan associations, and other credit unions. The Board's initial reason for limiting the exclusion to shares in the credit union was its concern that credit unions would fail to take the steps necessary to properly obtain a fully secured interest in deposits held at other financial institutions. The Board has amended the rule to include deposits in other financial institutions but cautions credit unions that, for the exception to apply, they must have completed all necessary agreements, filings, notifications, etc., required under state law to fully secure (perfect) their interest in such deposits.

A number of commenters urged the Board to raise the $25,000 trigger amount specified in paragraph (C) (loans less than $25,000 are *not* subject to § 701.21(h)) to $50,000. The Board has not increased the trigger amount because it would remove many loans from coverage under § 701.21(h) that, for safety and soundness reasons, need to be underwritten, monitored, and serviced in conformance with this rule. It is apparent from some of the comments that there is still confusion as to the effect of the $25,000 trigger amount. Simply stated, paragraph (C) excludes all loans under $25,000 that, but for the amount of the loan, would otherwise be subject to the member business loan rule § 701.21(h)). It is *not* a ceiling on the dollar amount that can be extended for a business loan. Further, the fact that a loan is excluded from coverage under § 701.21(h) does not mean that the loan is not subject to other applicable provisions of § 701.21 or other applicable sections of the NCUA Rules and Regulations and the FCU Act.

The Board received a comment letter from the Small Business Administration ("SBA") concerning the exclusion in paragraph (D) for loans fully insured or guaranted by an agency of the Federal government. The SBA stressed that the requirements in § 701.21(h) are consistent with the types of requirements followed by lenders participating in SBA's business loan guaranty program. Any credit union that is not conforming to these standards will likely not be approved by SBA. Therefore, while paragraph (D) provides credit unions with an exclusion for mandatory coverage under the rule, the provisions in the rule would generally need to be followed to satisfy SBA requirements.

Lastly, the Board notes that in each instance in the rule where the term "fully secured" appears, it means interests obtained by a credit union in the specific collateral sufficient to give the credit union an unimpaired right, free from the right of subsequent creditors, lienholders, receivers, trustees in bankruptcy, etc., to foreclose (take) the collateral in the event of default by the borrower.

Written Loan Policies (Section 701.21(h)(2)(i))

Paragraph (H) in § 701.21(h)(2)(i) of the proposed rule generated many comments. This provision required that financial statements and other documentation, including tax returns be updated on an annual or more frequent basis. Several of the commenters stated that because of the size of certain loans and the types of small businesses involved, the cost to the borrower to provide the required updated reports and documentation would be prohibitive. The same concern was expressed by the commenters as to the requirements in paragraph (G) which call for, among other things, balance sheet, trend and structure analysis; ratio analysis of cash flow, income and expenses, and tax data. Commenters also argued that these analyses were unnecessary where the income flow relied upon to repay the loan is not from the business.

In response to these concerns, the Board has combined parts of paragraphs (G) and (H) to form a new paragraph (H). The new paragraph states that a credit union's written loan policy shall provide for the analysis and updating of documentation specified in the paragraph *unless* the credit union's board of directors finds that it is not appropriate for a particular type of business loan and states the reasons for those findings in the credit union's written policies. These reasons must be based on sound business lending practices and be clear as to the basis for excepting out a particular type of business loan. NCUA examiners will be instructed to carefully review the credit union's board of directors findings in this regard. Lastly, the new paragraph requires "periodic" updating instead of yearly or more frequent updating. The larger and the more complex the loan, the more documentation is required and the more frequently it must be updated.

Paragraph (L), which had required the periodic disclosure to members of the number and aggregate dollar amount of business loans made to officials, and employees, has been amended to require only the periodic disclosure of the number and aggregate dollar amount of member business loans. Commenters stressed that the privacy of credit union officials and employees could be infringed by such disclosures. The Board believes that there are sufficient safeguards in the final rule to protect against insider dealing and conflicts of interest. The Board has determined that these additional disclosures are not necessary and has amended the final rule.

Loans to One Borrower (Section 701.21(h)(2)(ii))

Several commenters ought to have the 20% (of reserves) loan-to-one-borrower limit increased and to have the rule specify the criteria to be evaluated by the Board in considering whether to approve a credit union's request to raise the limit. Additionally, some commenters sought an exception from inclusion in the 20% limit of that portion of a member business loan that is fully secured by a 1 to 4 family dwelling that is the member's primary residence, secondary residence, or one other such dwelling owned by the member.

The Board continues to believe that the 20% limitation is necessary for safety and soundness reasons and is comparable to limits established by other Federal financial institution regulators. The 20% limit remains unchanged in the final rule. However, the exclusion for portions of loans fully secured by the member's 1 to 4 family dwelling has been added to the rule.

The final rule contains a list of what the Board will require, at a minimum, in evaluating a request to raise the limit. The rule states that credit unions seeking an exception must present the Board with: the higher limit sought; an explanation of the need to raise the limit; an analysis of the credit union's prior experience making member business loans; and a copy of its business lending policy. As an example, in explaining the need to raise the limit, an agricultural type credit union might note that almost all of the loans it normally makes would fall within the coverage of the rule and that they are usually quite large (e.g., for the purchase of tractors, combines, etc.). The credit union would need to support this with actual statistics and provide the Board with the other items noted in the rule.

Allowance for Loan Losses (Section 701.21(h)(2)(iii))

Some commenters continued to voice objection to the classifying of loans that are not delinquent, if the analysis and documentation of the loan is inadequate. Also, the commenters expressed their uncertainty as to who makes the initial determination on the classification of loans.

Although a loan may be current, there is no assurance that payments will continue, especially if the business falls upon hard times. Only through proper analysis and documentation can the loan be properly evaluated. Without that, the potential for loss increases. It is for this and other reasons that the Board has not amended this provision. The Board does want to stress that, although the criteria for classifying member business loans is somewhat different from that for other credit union loans, the procedure by which loans are classified was not intended to be changed by this rule. Credit unions will continue to make the initial determination and the examiner will review the classification.

Prohibition on Loans to Senior Management Employees (Section 701.21(h)(3))

This Section of the rule generated the most comments. Many of the commenters urged the Board to exclude loans to family members of salaried management from the prohibition. As previously discussed, the Board has amended the definition of "immediate family member" (*see* § 701.21(h)(1)(iv)). Therefore, the prohibition would now apply only to the individual's spouse or other family member living in the same household.

It should be recognized that the prohibition is *not* an absolute ban on loans to nonvolunteer senior management employees. These individuals are still eligible for consumer loans, including mortgage, automobile, credit cards, etc. Further, they may receive loans for business purposes that are less than $25,000.

A few FISCU commenters noted that, pursuant to state law, otherwise uncompensated directors are authorized to receive a small stipend for attending each board meeting, in addition to their reimbursement for expenses. These stipends, although small, would cause those directors to lose their status as volunteers for purposes of the prohibition. Therefore, if a director desires to obtain a business loan from his/her credit union he/she should forego the stipend.

Reporting of Nonconforming Member Business Loans (Section 701.21(h)(4)(ii))

The proposed rule required that credit unions report to the NCUA Regional Director, on or before the effective date of the rule, all business loans that do not satisfy any of the requirements of the rule. To alleviate unnecessary confusion and work, the final rule requires the reporting of only those loans that are in excess of the loan-to-one-borrower limit contained in § 701.21(h)(2)(ii).

Applicability of Rule to Federally-Insured State Credit Unions (Section 741.3)

Several commenters recommended that this Section be amended to provide some flexibility to allow a state regulatory authority that has, for

example, certain provisions in its state code which depart from those in the FCU Act, to adopt *substantially* equivalent regulations as determined by the NCUA Board. The Board agrees that such an amendment is warranted and has amended the final rule.

Depending on the circumstances, an exemption may be granted for one or more of the sections of NCUA's lending regulations that will now apply to federally-insured state credit unions (§ 701.21(c)(8) concerning prohibited fees, § 701.21(d)(5) concerning nonpreferential treatment, and § 701.21(h) concerning member business loans).

In determining whether a state's regulations are "substantially equivalent," and whether to exempt the state's credit unions from § 701.21(c)(8), (d)(5), or (h), the NCUA Board will review the regulations to determine whether they minimize risk and accomplish the overall objectives of the otherwise applicable NCUA Rules and Regulations. In the case of the member business loan rule, the Board will be particularly concerned with the provisions in the state's rules that address the scope of the rule, diversification (i.e., loan-to-one-borrower limits), written loans policies, and loans to senior management. Further, states that are exempted will need to provide for a system in which any required reviews and approvals, (e.g., approval to an individual credit union to exceed the 20% loan-to-one-borrower limit) although ultimately approved by the state, are decided only after consultation and coordination with NCUA. This would be the same type of procedure as contained in Section 741.3 for nonexempt states, where NCUA coordinates with the state supervisor.

Standard Bylaw Amendment—Loans to Nonnatural Persons (Article XII, Section 1)

In conjunction with the promulgation of these final rules, the NCUA Board has also approved a standard bylaw amendment for Federal credit unions concerning loans to nonnatural person members. Pursuant to Article XII, Section 1 of the FCU Bylaws, loans to a member other than a natural person cannot be in excess of its shareholdings in the credit union. The standard bylaw amendment, if adopted by an FCU, would permit the loan to exceed shares if the loan is made jointly to one or more natural person members and a business organization in which they have a majority ownership interest, or, if the nonnatural person is an association, the loan is made jointly to a majority of the members of the association and to the association in its own right.

Regulatory Procedures

Regulatory Flexibility Act

The NCUA Board has determined and certifies that the final rule will not have a significant economic impact on a substantial number of small credit unions (primarily those under 1 million dollars in assets). According to information available to the NCUA, business loans are not made by a significant number of small credit unions. Accordingly, the Board has determined that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

The Board submitted the information collection requirements of the first proposed business lending rule and received conditional approval from the Office of Management and Budget (OMB). (*See* (51 FR 23234, June 26, 1986.) The information collection requirements of this final rule have been modified from the June proposed rule. The written loan policy requirement is now found at § 701.21(h)(2)(i). Certain collections that were required in all situations under the proposed rule are now only required when appropriate. One additional requirement has been addded. Section 701.21(h)(4)(ii) requires that a one-time notification to the appropriate NCUA Regional Director be made.

Since the collection requirements have been modified, they will be resubmitted to OMB for approval with publication of this final rule. OMB action on the requirements will be published in the Federal Register when it is received by NCUA.

Written comments and recommendations regarding the collection requirements should be forwarded directly to the OMB desk officer at the following address:

OMB Reports Management Branch, New Executive Office Building, Room 3208, Washington, DC 20503, ATT: Robert Neil.

List of Subjects in 12 CFR Parts 701 and 741

Credit unions, Member business loans.

By the National Credit Union Administration Board on April 9, 1987.

Becky Baker,

Acting Secretary of the Board.

PART 701—[AMENDED]

Accordingly, NCUA amends its regulations as follows:

1. The authority citation for Part 701 continues to read as follows:

Authority: 12 U.S.C. 1757, 1766(a) and 1789(a)(11).

2. Section 701.21(a) is revised to read:

§ 701.21 Loans to members and lines of credit to members.

(a) *Statement of scope and purpose.* Section 701.21 complements the provisions of section 107(5) of the Federal Credit Union Act (12 U.S.C. 1757(5)) authorizing Federal credit unions to make loans to members and issue lines of credit (including credit cards) to members. Section 107(5) of the Act contains limitations on matters such as loan maturity, rate of interest, security, and prepayment penalties. Section 701.21 interprets and implements those provisions. In addition, § 701.21 states the NCUA Board's intent concerning preemption of state laws, and expands the authority of Federal credit unions to enforce due-on-sale clauses in real property loans. Also, while § 701.21 generally applies to Federal credit unions only, its provisions may be used by state-chartered credit unions with respect to alternative mortgage transactions in accordance with Title VIII of Pub. L. 97-320, and certain provisions apply to loans made by federally-insured state-chartered credit unions as specified in § 741.3. Finally, it is noted that § 701.21 does not apply to loans by Federal credit unions to other credit unions (although certain statutory limitations in section 107 of the Act apply), nor to loans to credit union organizations (which are governed by section 107(5)(D) of the Act and § 701.27 of this Part).

* * * * *

3. Section 701.21(c)(5) is revised to read:

* * * * *

(c) * * *

(5) *Ten percent limit.* No loan or line of credit advance may be made to any member if such loan or advance would cause that member to be indebted to the Federal credit union upon loans and advances made to the member in an aggregate amount exceeding 10% of the credit union's total unimpaired shares and surplus. In the case of member business loans as defined in § 701.21(h)(1)(i), additional limitations apply as set forth in § 701.21(h)(2)(ii).

* * * * *

4. Section 701.21(c)(8) is revised to read:

* * * * *

(c) * * *

(8) *Prohibited fees.* A Federal

credit union shall not make any loan or extend any line of credit if, either directly or indirectly, any commission, fee or other compensation is to be received by the credit union's directors, committee members, senior management employees, loan officers, or any immediate family members of such individuals, in connection with underwriting, insuring, servicing, or collecting the loan or line of credit. However, salary for employees is not prohibited by this Section. For purposes of this Section, "senior management employees" means the credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager), any assistant chief executive officers (e.g., Assistant President, Vice President or Assistant Treasurer/Manager) and the chief financial officer (Comptroller), and "immediate family member" means a spouse or other family member living in the same household.

* * * * *

5. Section 701.21(d)(5) is revised to read:

* * * * *

(d) * * *

(5) *Nonpreferential treatment.* The rates, terms and conditions on any loan or line of credit either made to, or endorsed or guaranteed by—

(i) An official,

(ii) An immediate family member of an official, or

(iii) Any individual having a common ownership, investment or other pecuniary interest in a business enterprise with an official or with an immediate family member of an official,

shall not be more favorable than the rates, terms and conditions for comparable loans or lines of credit to other credit union members. "Immediate family member" means a spouse or other family member living in the same household.

6. A new § 701.21(h) is added to read:

* * * * *

(h) *Member Business Loans*—(1) *Definitions.* (i) "Member business loan" means any loan, line of credit, or letter of credit, the proceeds of which will be used for a commercial, corporate, business, or agricultural purpose, except that the following shall not be considered member business loans for the purposes of this section:

(A) A loan or loans fully secured by a lien on a 1 to 4 family dwelling that is:

(*1*) The member's primary residence; or

(*2*) The member's secondary residence; or

(*3*) One other such dwelling owned by the member.

(B) A loan that is fully secured by shares in the credit union or deposits in other financial institutions.

(C) A loan, the proceeds of which are used for a commercial, corporate, business, or agricultural purpose, made to a borrower or an associated member (as defined in paragraph (h)(1)(iii) of this section), which, when added to other such loans to the borrower or associated member, is less than $25,000.

(D) A loan, the repayment of which is fully insured or fully guaranteed by, or where there is an advance commitment to purchase in full by, any agency of the Federal government or of a state or any of its political subdivisions.

(ii) "Reserves" means all reserves, including the Allowance for Loan Losses account, and undivided earnings or surplus.

(iii) "Associated Member" means any member with a common ownership, investment or other pecuniary interest in a business or commercial endeavor.

(iv) "Immediate Family Member" means a spouse or other family member living in the same household.

(2) *Requirements.* A Federal credit union may make member business loans only in accordance with the applicable provisions of § 701.21 (a) through (g) and the following additional requirements:

(i) *Written loan policies.* The board of directors must adopt specific business loan policies and review them at least annually. The policies shall, at a minimum, address the following:

(A) Types of business loans that will be made.

(B) The credit union's trade area for business loans.

(C) Maximum amount of credit union assets, in relation to reserves, that will be invested in business loans.

(D) Maximum amount of credit union assets, in relation to reserves, that will be invested in a given category or type of business loan.

(E) Maximum amount of credit union assets, in relation to reserves, that will be loaned to any one member or group of associated members, subject to § 701.21(h)(2)(ii).

(F) Qualifications and experience of personnel involved in making and administering business loans.

(G) Analysis of the ability of the borrower to repay the loan.

(H) The following considerations shall be addressed unless the board of directors finds that they are not appropriate for a particular type of business loan and states the reasons for those findings in the credit union's written policies: balance sheet, trend and structure analysis; ratio analysis of cash flow, income and expenses, and tax data; leveraging; comparison with industry averages; receipt and periodic updating of financial statements and other documentation, including tax returns.

(I) Collateral requirements, including loan-to-value ratios; appraisal, title search and insurance requirements; steps to be taken to secure various types of collateral; and how often the value and marketability of collateral is reevaluated.

(J) Appropriate interest rates and maturities of business loans.

(K) Loan monitoring, servicing and follow-up procedures, including collection procedures.

(L) Provision of periodic disclosure to the credit union's members of the number and aggregate dollar amount of member business loans.

(M) Identification, by position, of those senior management employees prohibited by paragraph (h)(3) of this section from receiving member business loans.

(ii) *Loans to one borrower.* Unless a greater amount is approved by the NCUA Board, the aggregate amount of outstanding member business loans to any one member or group of associated members shall not exceed 20% of the credit union's reserves. If any portion of a member business loan is fully secured by a 1 to 4 family dwelling that is the member's primary residence, secondary residence, or one other such dwelling owned by the member, or by shares in the credit union, or deposits in another financial institution, or insured or guaranteed by, or subject to an advance commitment to purchase by, any agency of the Federal government or of a state or any of its political subdivisions, such portion shall not be calculated in determining the 20% limit. Credit unions seeking an exception from the 20% limit must present the Board with, at a minimum: the higher limit sought; an explanation of the need to raise the limit; an analysis of the credit union's prior experience making member business loans; and a copy of its business lending policy.

(iii) *Allowance for loan losses.* (A) The determination whether a member business loan will be classified as substandard, doubtful, or loss, for purposes of the valuation allowance for loan losses, will rely on factors not limited to the delinquency of the loan. Nondelinquent loans may be classified, depending on an evaluation of factors, including, but not limited to, the adequacy of analysis and documentation.

(B) Loans classified shall be reserved as follows:

(1) Loss loans at 100% of outstanding amount;

(2) Doubtful loans at 50% of outstanding amount; and

(3) Substandard loans at 10% of outstanding amount unless other factors (e.g., history of such loans at the credit union) indicate a greater or lesser amount is appropriate.

(3) *Prohibitions*—(i) *Senior management employees.* A Federal credit union may not make member business loans to the following non-volunteer, senior management employees, or to any associated member or immediate family member of such employees:

(A) Any member of the Board of Directors who is compensated as such.

(B) The credit union's chief executive officer (typically this individual holds the title of President or Treasurer/Manager).

(c) Any assistant chief executive officers (e.g., Assistant President, Vice President, or Assistant Treasurer/Manager).

(D) The chief financial officer (Comptroller).

(ii) *"Equity kickers."* A Federal credit union shall not grant a member business loan where a portion of the amount of income to be received by the credit union in conjunction with such loan is tied to the profit to the business or commercial endeavor for which the loan is made.

(4) *Effective dote.* (i) Section 701.21(h) is effective July 1, 1987. On and after that date, a Federal credit union may make member business loans only after adopting and implementing written loan policies as required by § 701.21(h)(2)(i). All member business loans made on or after that date must be in full compliance with § 701.21(h).

(ii) On or before July 1, 1987, a Federal credit union must notify the NCUA Regional Director, in writing, of any outstanding member business loans made prior to that date that do not satisfy the requirements of § 701.21(h)(2)(ii).

Appendix to § 701.21(h)—Classifications

Substandard. Loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the credit union will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual loans classified substandard.

Doubtful. A loan classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include: proposed merger, acquisition, or liquidation actions, capital injection, perfecting liens on additional collateral, and refinancing plans.

Loss. Loans classified loss are considered uncollectible and of such little value that their continuance as loans is not warranted. This classification does not necessarily mean that the loan has absolutely no recovery or salvage value, but rather, it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future.

PART 741—[AMENDED]

7. The authority citation for Part 741 is revised to read as follows:

Authority: 12 U.S.C. 1757, 1766(a), and 1781 through 1790.

8. Sections 741.3 through 741.9 are redesignated as §§ 741.4 through 741.10 respectively.

9. A new § 741.3 is added to read:

§ 741.3 Minimum loan policy requirements.

Any credit union which is insured pursuant to Title II of the Act must adhere to the requirements stated in § 701.21(h) concerning member business loans, § 701.21(c)(8) concerning prohibited fees, and § 701.21(d)(5) concerning nonpreferential loans. State-chartered, NCUSIF-insured credit unions in a given state are exempt from these requirements if the state regulatory authority for that state adopts substantially equivalent regulations as determined by the NCUA Board. In nonexempt states, all required NCUA reviews and approvals will be handled in coordination with the state credit union supervisory authority.

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12 CFR Part 708

Mergers of Federally-Insured Credit Unions; Voluntary Termination or Conversion of Insured Status

AGENCY: National Credit Union Administration.

ACTION: Final rule.

SUMMARY: The Federal Credit Union Act empowers the NCUA Board to prescribe rules regarding mergers of federally-insured credit unions and changes in insured status, and requires written approval of the Board prior to the termination of Federal insurance or conversion of Federal insurance to non-Federal insurance. These revised rules address the treatment of the one percent NCUSIF deposit in mergers and shortening of the time permitted between the approval of a merger by NCUA and its presentation for a membership vote by the merging credit union. These rules also add new provisions regarding the termination or conversion of Federal insurance and set forth the forms to be used in obtaining membership approval of those actions. These rules do not affect the normal day-to-day operations of credit unions.

EFFECTIVE DATE: May 18, 1987.

ADDRESS: National Credit Union Administration, 1776 G Street NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: James J. Engel, Deputy General Counsel, at the above address, or telephone: (202) 357-1030.

SUPPLEMENTARY INFORMATION:

Background

On November 20, 1986, (See 51 FR 43377, December 2, 1986) the NCUA Board issued proposed amendments to Part 708 of its Rules and Regulations. Part 708 currently deals only with mergers involving at least one federally-insured credit union. Due to the fact that mergers can also involve the termination or conversion of Federal insurance, the November proposal added new provisions addressing those areas. As issued, the proposed rule was organized into three distinct subparts: Subpart A contained merger procedures; Subpart B set forth the procedures and notice requirements for termination of Federal insurance or conversion of Federal insurance to insurance provided by private or cooperative insurers; and Subpart C contained the forms to be used for terminating or converting Federal insurance, with or without a merger. This same format is followed in the final rule.

A total of nine public comment letters were received on the proposal. Comment letters were received from: one national credit union trade association; one credit union league; two Federal credit unions; 3 share (deposit) insurance corporations; one share insurance corporation trade association; and one state credit union supervisor trade association. The particular comments are addressed below.