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NATIONAL CREDIT UNION ADMINISTRATION
Washington, D.C. 20456

December 29, 1988

Office of General Counsel

Mr. Harry Baram
Treasurer/Manager
Local 102 Federal Credit Union
234 McLean Boulevard
Route 20
Patterson, New Jersey 07504

Re: Modified Balloon Loan Program (Your August 18, 1988 Letter)

Dear Mr. Baram:

You have asked whether it is permissible for a Federal credit union ("FCU") to participate in a "modified balloon loan program with a third party guarantor on the balloon" (the "Program"), and whether a non-FCU member can act as the guarantor. The Program, while legally permissible for an FCU, raises significant safety and soundness concerns beyond those normally present in more conventional new auto loan financing arrangements. We would expect an FCU to resolve the safety and soundness concerns discussed herein before becoming involved in the Program.

The Program

Under the program, the FCU makes a car loan to a member. As described in your letter, the repayment schedule consists of two components: a non-balloon part that is paid off monthly over a number (usually 48) of equal payments, and a balloon payment. The balloon payment is due within 30 days after the due date of the final monthly payment. The balloon payment is in an amount equal to 90% of the residual value of the car securing the loan. Residual value is determined by the ALG Residual Percentage Guide published by First National Lease Systems of Santa Barbara, California. The balloon is for principal only. Interest on the entire loan is paid off in full in equal amounts as part of the non-balloon payments on the loan.

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The car will be titled in the member's name. The FCU will maintain physical possession of the title and will have a lien on the car. The FCU will be named as loss payee on the member's car insurance policy.

A third party will guarantee the balloon payment of the loan. The third party (the "guarantor") will not be a member of the FCU. The guarantor will also be responsible for: (1) providing residual value insurance for the balloon portion of the note[1]; (2) monitoring the member's car insurance coverage and notifying the FCU in the event of a lapse or cancellation; (3) locating cars for members to purchase and assisting in the negotiation of the purchase price; and (4) assisting the FCU in disposing of a car in the event of default. The guarantor may also provide repossession and collection assistance to the FCU.

After the non-balloon portion of the loan has been paid off, the borrower has two options: (1) keep the car and pay off the loan in full or, depending upon the condition of the car, refinance the balloon payment; or (2) transfer possession of the car to the guarantor who will then pay off the loan in full to the FCU. If the second option is chosen, the member has responsibility for reimbursing the guarantor for any excess wear and tear not covered by the residual value insurance policy.

ANALYSIS

Balloon Loans

A conventional balloon loan differs from a traditional loan in that there is a lump sum (balloon) payment due at the end of the financing period. FCU's can make balloon loans pursuant to Section 107(5) of the FCU Act [12 U.S.C. 1757(5)] and Section 701.21 of NCUA's Rules and Regulations [12 C.F.R. 701.21]. Conventional balloon loans are subject to the same requirements as other FCU loans.

The balloon loan to be used in your program differs from a conventional loan in that, in addition to a lump sum (balloon) payment being due at the end of the financing period, the member has the option of transferring the property (car) to the guarantor for a predetermined residual value in lieu of the balloon payment. Since the guarantor is required to pay the balloon payment to the FCU, the Program is, in our opinion, substantially similar to a conventional balloon loan, and therefore permissible for an FCU as long as the nonmember guarantor complies with the requirements set forth below.

[1] It is unclear whether the cost of the residual value insurance will be borne by the guarantor or passed through to the member.

Permissibility of Nonmember Guarantor

Section 107(5) of the FCU Act [12 U.S.C. 1757(5)] authorizes FCU's to make loans to their members. This Office has long taken the position that some nonmember participation in member loans is permissible. The issue is at what point does nonmember involvement in the loan so substantially distort the direct lending relationship between the FCU and the member so as to render the transaction an impermissible loan to a nonmember in violation of Section 107(5) of the FCU Act. When the nonmember guarantor (or a comaker, endorser, etc.) becomes indistinguishable from the member loan recipient, the nonmember guarantor is an impermissible participant and the transaction would violate Section 107(5). The elements that we have looked to in analyzing this issue are: (1) the loan size (or amount of the credit limit on the line) vis-a-vis the ability of the member to repay; (2) whether the nonmember pledged collateral; (3) which party has the primary liability for repayment; and (4) who has the use and benefit of the proceeds.

Under your Program, the nonmember guarantor does not pledge collateral. The collateral will be the purchased vehicle. The member will have sole responsibility for payment of the non-balloon portion of the loan. The guarantor will only be responsible for the balloon payment if the member transfers the car to the guarantor. The member will have the use and benefit of the loan proceeds, i.e. the car, during the term of the loan. Provided that the FCU looks to the member's ability to repay the loan in determining whether to grant the loan, and does not rely solely upon the guarantor's ability to make the balloon payment, we believe that the Program's use of a nonmember guarantor is permissible.

Safety and Soundness Concerns

We believe that the Program presents certain safety and soundness concerns above and beyond those normally present in more conventional new auto loan financing arrangements. Those concerns should be resolved before FCU participation in the Program. Our concerns are as follows.

1. You forwarded an agreement to us (the "Comaker Agreement") that establishes the guarantor's liability on the balloon payment. The Comaker Agreement is entered into between the member and the "comaker" (guarantor). The FCU is not a party to the agreement. To adequately protect the FCU's rights against the guarantor, we would encourage the FCU to modify the agreement so that the FCU is also a party to it, or alternatively, to modify the member's loan agreement with the FCU so that the guarantor's liability is evidenced and acknowledged on the member's loan.

2. In your letter and in the Comaker Agreement, the terms "comaker" and "guarantor" are used interchangeably. Legally, these terms may have a different meaning under state law. Generally, a comaker is jointly and severally liable on the obligation. When the maker defaults, the creditor can proceed directly against the comaker. Under many state laws, a creditor would have to exhaust its remedies against the maker before proceeding against the guarantor. In this instance, the third party appears to be acting in the capacity of a guarantor, and the agreement should be modified accordingly.

3. The functions of the guarantor in this transaction are an important risk consideration to the FCU. That is, failure of the guarantor to meet its responsibilities according to the Comaker Agreement present a risk of loss to the FCU. The risks in this relationship are far greater than in a typical comaker or guarantor arrangement in that this guarantor will be liable for many, if not most, of the new cars financed at the FCU. The possibly close arrangements developing between dealer(s) and guarantor could present some risk of dealer kickbacks or other improper arrangements by a guarantor. In addition, the Comaker Agreement provides numerous opportunities for the guarantor to declare the agreement null and void for any of a number of actions on the part of the borrower. Finally, the borrower puts up only one monthly payment as security versus the normal 20 percent or more downpayment required under most conventional new car financings. All of the above present increased risk on the part of the FCU to accept this type of contract versus conventional new car financing. In view of the above, we recommend that the FCU take steps to recognize and minimize these risks by the following:

a. Make the FCU a party to the Comaker Agreement or otherwise ensure that the guarantor's liability is evidenced or acknowledged.

b. Clarify whether the third party is a comaker or a guarantor.

c. Ensure that the guarantor is capable of performing according to the terms of the agreement, i.e., require financial statements, audit reports, irrevocable letter of credit or other evidence of ability to meet contingent liabilities.

d. Require the guarantor to provide evidence that residual value insurance has been acquired on each loan.

e. Prohibit or limit the role of the guarantor in arranging for the purchase from dealers, i.e., prohibition of dealer kickbacks, insider dealing and other potential abuses.

f. Require the borrower to assume a greater equity in the property, i.e., increased downpayment requirement.

g. Modify the agreement to require the guarantor to retain liability where the basic terms of the contract are being met, i.e., prevent cancellation of contract for minor or temporary defaults.

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Acting Assistant General Counsel

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