NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

July 12, 1990

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P.O. Box 1600
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Re: Examination of Chetco Federal Credit Union
(Your April 18, 1990, Letter)

Dear Mr. Babin:

This is in response to your letter of April 18, 1990, in which you took exception to an NCUA examiner's findings that eight (8) Chetco Federal Credit Union ("Chetco") loans are illegal. The subject loans and our opinion as to each are discussed below in the order addressed in your letter. Please note that our opinions are solely as to the legality of the loans, and do not address safety and soundness issues, which are of great concern to the NCUA. Any further correspondence concerning these loans should be addressed to the NCUA's Region VI Office, 2300 Clayton Road, Suite 1350, Concord, CA 94520.

I. MEMBERSHIP

Four loans (Hector Brown #22084-90; Joseph Klingensmith #23511-01; Bunia Hampson #22910-1; and Ue Ching Ow #20670-01) were deemed illegal by the examiner on the grounds that the "members" receiving the loans were not within Chetco's field of membership. Essentially, you are seeking a factual determination by this Office as to whether these borrowers were in fact within the field of membership. For the reasons set forth below, we agree with the examiner's determination that all four of these loans were improperly made to persons not within Chetco's field of membership.

Credit union membership is restricted by Section 109 of the Federal Credit Union Act, 12 U.S.C. §1759 (the "Act") to:

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> . . . the incorporators and such other persons and incorporated and unincorporated organizations, to the extent permitted by the rules and regulations prescribed by the Board, as are elected to membership . . . ; except that Federal credit union membership shall be limited to groups having a common bond of occupation or association, or to groups within a well-defined neighborhood, community, or rural district. . . .

This statutory provision has been interpreted by the NCUA in its Interpretive Ruling and Policy Statement ("IRPS") 89-1 (54 Fed. Reg. 31165 et seq. (July 27, 1989)). The NCUA Chartering and Field of Membership Manual ("Chartering Manual") sets forth the IRPS and additional chartering and field of membership information. A credit union defines its field of membership in its charter. The charter must be approved by the NCUA and the field of membership described therein must satisfy the Act and NCUA policy interpreting the Act.

As you noted in your letter, Chetco's charter limits its field of membership:

> to those having the following common bond: 1. Persons who reside or work in Curry County, Oregon or the area extending fourteen (14) miles South of the Brookings Post Office . . . .

This is a standard community-based common bond, discussed in IRPS 89-1 and the Chartering Manual. IRPS 89-1 states that NCUA, in carrying out the Congressional mandate that a community-based federal credit union be tied to "a well-defined neighborhood, community, or rural district," has adopted a policy limiting the community to a single, compact, well-defined area where residents commingle and interact regularly." 54 Fed. Reg. 31170 (July 27, 1989). (Emphasis added.) That policy is reiterated in the Chartering Manual. (See, Chartering Manual, pp.1-3.)

IRPS 89-1 further states that, "Community charter policy stipulates that there be regular contact among persons who live or work within a well-defined neighborhood, community or

rural district in order to satisfy the requirements of the Federal Credit Union Act." 54 Fed. Reg. 31177 (July 27, 1989). (Emphasis added.) From the facts presented in your letter, it appears to us that the "members" in question do not have the type of regular contact required by the statute and by NCUA chartering and membership policy, and that their inclusion in Chetco's field of membership would not further the stated goals or the spirit of the community bond chartering provisions of the Act.

You acknowledge in your letter that none of the loan recipients has a primary residence within the geographical area described in Chetco's charter; in fact, there is no indication that any of the individuals in question maintains any residence within the stated area. As you correctly point out, there is no requirement that an individual have his permanent residence within the geographical area described in Chetco's charter in order to qualify for membership; the charter provides for membership on the basis of work within the area. However, the work relationships described in your letter do not appear strong enough to constitute regular commingling and interaction with the community, and therefore do not qualify the individuals in question for membership in Chetco.

Your letter states that the individuals who received these four loans all "pursue some sort of occupation within the geographical boundaries" of Chetco. The facts you provide are minimal, and do not show that any of these individuals has significant work ties which would result in regular interaction and commingling with the community served by Chetco.

You describe Brown as "a contractor who provides contracting and construction services within the geographical boundaries of the district." Your letter does not furnish any facts as to the frequency of Brown's contact with the Chetco area, or whether he himself in fact has any such contact. Moreover, we note that Brown resides in Crescent City, California, and that the loan proceeds were used to finance construction of an apartment building in Crescent City. These facts do not indicate a regular presence or involvement in the community and do not show the commingling and interaction contemplated by the Act, IRPS 89-1 and the Chartering Manual. In the absence of other evidence supporting your contention that Brown

"works" within the Chetco community, we agree with the examiner that he is outside the field of membership.

You indicate that Klingensmith operates the Harbor Recreational Vehicle Park in Harbor, Oregon. While we assume that Harbor is geographically within the area covered by Chetco's charter, we are unable to determine from the facts you present just what are the nature and extent of Klingensmith's work contact with the Chetco area as a result of his operation of the recreational vehicle park; there is nothing to indicate that Klingensmith maintains the necessary regular contact with the community. Further, the examiner points out that the purpose of the loan to Klingensmith was to purchase a local business. Assuming that the business in question was the recreational vehicle park which forms the basis for your contention that Klingensmith is within the field of membership, the loan obviously was made before Klingensmith came even arguably within the field, since he had no other contacts with the area at that time and did not "work" in the area until after buying the park. We agree that the loan to Klingensmith is illegal.

According to your letter, Ue Ching Ow operates a commercial building as a rental within the geographical boundaries of the credit union. The examiner's report indicates that this borrower lives in San Jose, California, and that his only tie to the Chetco community appears to be the building you refer to, which he purchased with the loan proceeds. Again, the facts are insufficient to show that the borrower actually "works" in the community or that he has regular contact or interaction with the community. Rather, he appears to be simply an outside investor, rather than a member of the community. In any case, even assuming that the borrower now has a right to membership in Chetco based on his "work" of owning the building, he apparently had no contact with the Chetco area prior to obtaining the loan and purchasing the building. Like Klingensmith, he was in no sense a member of the community at the time that he received the loan, and had no right to membership. This loan is also illegal.

The same must be said of the Hampson loan. According to the examiner's report, Hampson lived in Crescent City, California, when the loan was made, and still resides there. She purchased a building in the Chetco area with the loan proceeds but, despite her stated intention to establish a

domicile in the area and start a business, she has done neither. You state in your letter that "while Hampson did not have her residence within the boundaries at the time of the application, she is like many out-of-staters who are moving to this attractive retirement community." That argument is irrelevant. The fact is that Hampson was not entitled to membership in Chetco, with its attendant benefits, unless and until she either resided or worked in the area defined in the charter. It is apparent from the facts presented that Hampson was not eligible for membership at the time that the loan was made; therefore, the loan is illegal.

As to your argument based on the Fifth Amendment to the United States Constitution, we find it unpersuasive. There is no constitutional right to membership in a credit union. Moreover, our interpretation of Section 109 of the Federal Credit Union Act does not limit any citizen's right to live outside the Chetco area and pursue an occupation within the area; the Act and NCUA chartering policy simply preclude anyone from joining a federal credit union who is not within the field of membership described in that credit union's charter and authorized by the Act.

II. HERITAGE GROUP (Loan #22525-1)

As you are no doubt aware, Section 701.21(h)(2)(ii) of the NCUA Rules and Regulations (12 C.F.R. §701.21(h)(2)(ii)) (copy enclosed) states in part:

> 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. . . .

On its face, the regulation appears to require that the loans to the Robert Dunn Trust and Jay Patel be included for the purposes of determining whether the loan to the Heritage Group violates the twenty percent limit. That interpretation is supported by the preamble to proposed Section 701.21(h)(2)(ii) (then numbered §706.2(a)(1)), which states in part: ". . . the aggregate amount of member business loans to any one member or group of associated members is limited

to 10% [now 20%] of reserves. Included in the calculation are all member business loans on which the member or associated member is primarily or secondarily liable." 51 Fed. Reg. 23236 (June 26, 1986).

However, the facts provided in your letter and the examiner's report are insufficient to allow us to determine conclusively whether the Dunn and Patel loans must be included in the Section 701.21(h)(2)(ii) calculation and whether the Heritage loan in fact violates that section. In order to make that determination, we would need to know whether the Heritage Group is itself a member of Chetco, or is a group of associated members. (See, §701.21(h)(1)(iii), enclosed.) We would also need to know the purpose or purposes for which the loans to the Robert Dunn Trust and Jay Patel were obtained and how the proceeds were used, as well as what security, if any, was given for those loans. Should you desire further review of the examiner's decision, please provide the Region with this information.

With regard to your alleged reliance on a telephone opinion from this Office in advising Chetco that the loan to the Heritage Group would not violate the twenty percent limit in Section 701.21(h)(2)(ii), we wish to reiterate that telephone opinions are not official opinions of this Office. You state in your letter of April 6, 1989, to Paul Kowash that you were told in your conversation with this Office that the oral opinion expressed was not an official opinion of the General Counsel, and that the next step would be to request a formal opinion on the issue. You apparently did not request a formal opinion. Your reliance on an unofficial opinion, while regrettable, is not a basis for holding the Heritage Group loan to be legal if in fact it is illegal.

III. C & K MARKET d/b/a RAY'S SENTRY MARKET (Loan #125835)

As you note in your letter, Article XII, Section 1 of the Chetco bylaws does not limit loans to nonnatural persons to the amount of their shareholdings. You indicate that the bylaw in question was adopted by Chetco on June 16, 1988.

The bylaw at issue is neither the standard FCU bylaw promulgated by the NCUA nor the standard amendment to Article XII, Section 1. All nonstandard bylaw amendments must be approved in writing by the NCUA in order to become effective.

(See, Federal Credit Union Standard Bylaw Amendments and Guidelines, p. v, enclosed.) If the amendment enacted by Chetco was approved by the NCUA, the loan to C & K Market is not illegal as violating the Article XII, §1 limitation; otherwise, the standard bylaw controls and the loan is illegal. Neither this Office nor the Region has any record of the NCUA's having approved Chetco's nonstandard amendment to Article XII, §1. Please provide the Region with evidence as to whether the NCUA approved the amendment, so that they may make an appropriate determination.

IV. BLUE MOUNTAIN FOREST

The examiner considered Chetco's participation in this loan illegal under Section 701.22(d)(2) because the borrower is not a member of Chetco. You argue that the loan is authorized by virtue of the fact that the borrower belongs to another credit union, Pendleton FCU ("Pendleton"), which did not participate in the loan. You construe the regulation as permitting an FCU to participate in loans not only to its own members, but to members of any credit union, even if the members' own credit union does not participate in the loan. You also argue that the regulation, if it does limit an FCU's lending authority as the examiner claims, directly contradicts Section 107(5) of the Federal Credit Union Act (12 U.S.C. § 1757(5)). For the reasons discussed below, we agree with the examiner. Moreover, we do not see any conflict between the regulation and Section 107(5).

Section 107(5) empowers credit unions:

> to make loans . . . and extend lines of credit to its members, to other credit unions, and to credit union organizations and to participate with other credit unions, credit union organizations, or financial organizations in making loans to credit union members . . . . (Emphasis added.)

The statute clearly does not state that a credit union may lend to, or participate in lending to, persons who are not its members but are members of nonparticipating credit unions. The legislative history of the Depository Institu-

tions Amendments of 1977 (P.L. 95-22, 91 Stat. 49), which created the participation provision, shows that the statute is intended to limit participation to loans made to persons who are members of either the lending credit union or another credit union that is participating in the loan. (See, Report of the House Committee on Banking, Finance and Urban Affairs, H.R. Rep. 95-23, 95th Cong., 1st Sess. 12, reprinted in 1977 U.S. Code Cong. & Ad. News 105, 115.)

The NCUA, in drafting the regulations on loan participation pursuant to its rulemaking authority under Section 120(a) of the Federal Credit Union Act (12 U.S.C. §1766(a)), recognized the statutory purpose. In the section of the preamble to Section 701.22(d) discussing the "members" to whom credit unions may lend in participation, the NCUA Board said:

> It is not specified that a borrower be a member of every participation credit union, but only that he or she be a "credit union member." In this light, it is proposed that Federal credit unions may participate (as nonoriginators) in immediate participation loans so long as the borrower is a member of a participating credit union. . . . A more restrictive requirement would defeat the purpose of section 107(5) (i.e. by limiting participation among credit unions to those few borrowers who are members of all participating credit unions), while a less restrictive requirement would exceed the purpose. 43 Fed. Reg. 33929 (August 2, 1978). (Emphasis added.)

The final rule (12 C.F.R. §701.22(d)(2)) provides that a participant federal credit union that is not an originating lender shall "participate in participation loans only if made to its own members or members of another participating federal credit union."

The NCUA's interpretation and the regulation not only do not contradict the FCU Act, but in fact are the logical extension of Section 107(5). That section provides that a credit union may make loans to its own members; it does not permit a credit union to originate loans to members of other credit

unions. The right to receive a loan is one of the benefits of credit union membership, and a person has no right or expectation of receiving a loan from any credit union of which he is not a member. The provision for participation between two credit unions is a narrow exception to the express general rule that a credit union may lend only to its own members, created for the purpose of allowing one credit union to assist another credit union in making loans to meet the needs of the second credit union's members. However, as should be clear from the use of the term "participation" the member's own credit union must be a participating lender.

V. WESTBROOK (Loan #18256-93)

The regulation relied upon by the examiner is Section 701.21(h)(2)(ii), which states that the aggregate amount of outstanding member business loans to one member or group of associated members shall not exceed 20% of the credit union's reserves, unless a larger amount has been approved by the NCUA Board. You do not claim that the NCUA Board approved a loan to the Westbrooks in excess of the 20% limit; instead, you appear to seek a factual determination as to whether the loan in question violates that limit. On the facts furnished to us, it seems that the loan does in fact exceed the limit imposed by Section 701.21(h)(2)(ii).

The examiner's report indicates that the amount of outstanding loans to this borrower is more than $1.5 million. You argue that $350,000.00 should be excluded from that amount for purposes of Section 701.21(h)(2)(ii): $100,000.00 which is secured by a certificate of deposit, and $250,000.00 which is secured by one or more one-to-four family dwellings.

Assuming that these amounts are properly excluded under the regulation, it appears that the aggregate amount of outstanding loans to the Westbrooks still exceeds the twenty percent limit. The total aggregate outstanding is more than $1.5 million; leaving out the $350,000.00 allegedly excludable, the aggregate outstanding is over $1,150,000.00. The Regional Office informs us that the credit union's reserves on December 31, 1989, were $4,827,447.00, and that that amount represents a high reserve figure for the year. Twenty percent of $4,827,477.00 is $965,489.40. Clearly, an aggregate outstanding loan amount of over $1,150,000.00

Esq.

nty percent limit imposed by Section
). We agree with the examiner that this loan

y additional information that you believe
idered regarding the questioned loans, it
itted to the Regional Office.

have been of assistance.

Sincerely,

Hattie M. Ulan

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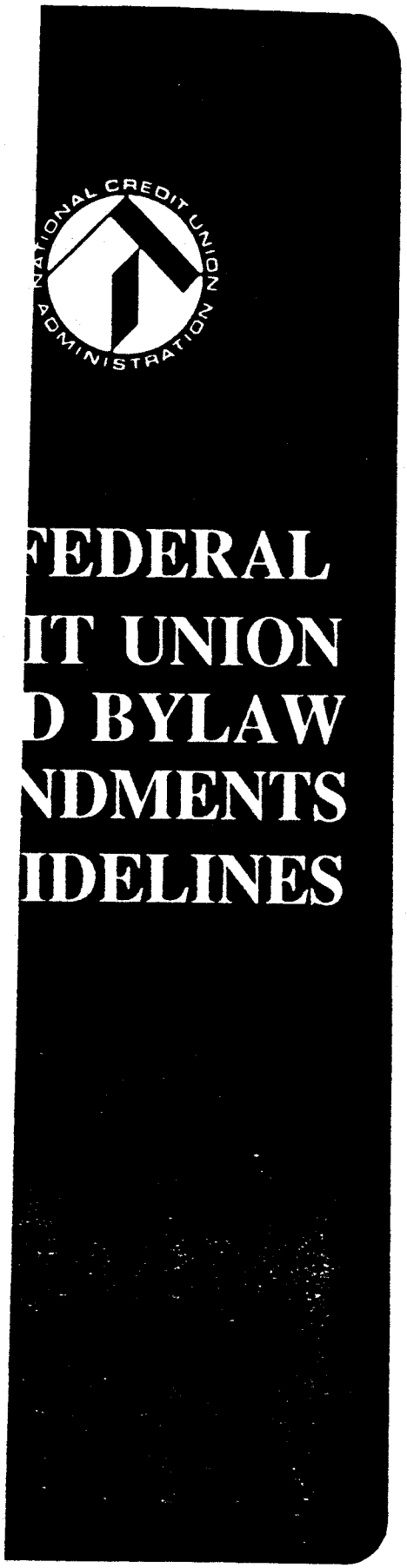
Associate General Counsel

irector
s, Region VI



INSTRUCTIONS FOR ADOPTING NON-STANDARD BYLAW AMENDMENTS

Amendments not included within these guidelines are non-standard bylaw amendments. Non-standard bylaw amendments must be approved in writing by the NCUA Board before they may become effective. Federal credit unions wishing to adopt non-standard bylaw amendments should request such amendments through the regional director of the National Credit Union Administration for the state in which they are located. The request should cover the following information:

a. The section of the bylaws proposed to be amended;

b. The reason why the amendment is considered desirable or necessary;

c. What the proposed amendment will accomplish for the credit union; and

d. The proposed wording of the amendment.

Upon receipt of the above information, the regional director will advise the credit union whether the proposed amendment will be approved.

National Mortgage Association or Federal Home Loan Mortgage Corporation/Federal National Mortgage Association application form. In lieu of use of a standard application the Federal credit union may have a current attorney's opinion on file stating that the forms in use meet the requirements of applicable Federal, state and local laws.

(4) *Security instrument and note.* The security instrument and note shall be executed on the most current version of the FHA, VA, FHLMC, FNMA, or FHLMC/FNMA Uniform Instruments for the jurisdiction in which the property is located. No prepayment penalty shall be allowed, although a Federal credit union may require that any partial prepayments be made on the date monthly installments are due and be in the amount of that part of one or more monthly installments that would be applicable to principal. In lieu of use of a standard security instrument and note, the Federal credit union may have a current attorney's opinion on file stating that the security instrument and note in use meet the requirements of applicable Federal, state and local laws.

(5) *First lien, territorial limits.* The loan shall be secured by a perfected first lien or first security interest in favor of the credit union supported by a properly executed and recorded security instrument. No loan shall be secured by a residence located outside the United States of America, its territories and possessions, or the Commonwealth of Puerto Rico.

(6) *Due-on-sale clauses:*

(i) Except as otherwise provided herein, the exercise of a due-on-sale clause by a Federal credit union is governed exclusively by Section 341 of Public Law 97-320 and by any regulations issued by the Federal Home Loan Bank Board implementing Section 341.

(ii) In the case of a contract involving a long-term (greater than twelve years), fixed rate first mortgage loan which was made or assumed, including a transfer of the liened property subject to the loan, during the period beginning on the date a state adopted a constitutional provision or statute prohibiting the exercise of due-on-sale clauses, or the date on which the highest court of such state has rendered a decision (or if the highest court has not so decided, the date on which the next highest court has rendered a decision resulting in a final judgment if such decision applies state-wide) prohibiting such exercise, and ending on October 15, 1982, a Federal credit union may exercise a due-on-sale clause in the case of a transfer which occurs on or after November 18, 1982, unless exercise of the due-on-sale clause would be based on any of the following:

(A) the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;

(B) the creation of a purchase money security interest for household appliances;

(C) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;

(D) the granting of a leasehold interest of 3 years or less not containing an option to purchase;

(E) a transfer to a relative resulting from the death of a borrower;

(F) a transfer where the spouse or children of the borrower become an owner of the property;

(G) a transfer resulting from a decree of a dissolution of marriage, a legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;

(H) a transfer into an inter vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property; or

(I) any other transfer or disposition described in regulations promulgated by the Federal Home Loan Bank Board.

(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 (iii)), 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 Sections 701.21 (a) through (g) above 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 Section 701.21(h) (2) (ii) below.

(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 for 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 subsection (h)(3) 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 amounts; and