NATIONAL CREDIT UNION ADMINISTRATION
WASHINGTON, D.C. 20456

Aug 22, 1991

Thomas A. Olson
Moose Lake Federal Credit Union
301 Elm Avenue
Moose Lake, MN 55767

Re: Unsecured Member Business Loans (Your July 17, 1991 Letter)

Dear Mr. Olson:

You have asked whether all member business loans must be secured. There is no requirement that a member business loan be secured under the current member business loan regulation (Section 701.21(h) of NCUA's Rules and Regulations, 12 C.F.R. 701.21(h)). Thus, a federal credit union may grant a self-employed person unsecured credit even if the proceeds are to be used for business purposes. However, it is important to note that the NCUA has proposed a new member business loan rule (see 56 F.R. 15053, 4/15/91, attached) which would require any business loan, or group of business loans to one borrower, in excess of $25,000, to be secured.

Sincerely,

James J. Engel
Deputy General Counsel

Attachment

GC\MM:sg
SSIC 3501
91-0734

FOIA

Vol. I, C, 20 - Member Business Loans

Proposed Rules

Federal Register
Vol. 56, No. 72
Monday, April 15, 1991

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 701

Organization and Operation of Federal Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Proposed revision to regulation.

SUMMARY: On January 17, 1991, the NCUA Board (Board) approved a request for comment on proposed amendments to §701.21(h) regarding member business loans (See 56 FR 2723, 1/24/91). The comment period closed on March 25, 1991. This proposed rule is a revision of the January 17 proposal and reflects changes and amendments resulting from the comments received. The rule is again being issued as a proposal to give all interested parties an opportunity to comment on those amendments that were not part of the original proposal and also to allow for further comment on all aspects of the rule.

DATES: Comments must be received on or before June 14, 1991.

ADDRESSES: Send comments to Becky Baker, Secretary of the Board, National Credit Union Administration, 1778 G Street, NW., Washington, DC 20456.

FOR FURTHER INFORMATION CONTACT: D. Michael Riley, Director, David M. Marquis, Deputy Director or Timothy P. Hornbrook, Director, Department of Supervision, Office of Examination and Insurance, NCUA, at the above address, or telephone: (202) 682-9640.

SUPPLEMENTARY INFORMATION:

A. Background

These proposed changes have been recommended to the Board on the basis of the history of losses in this area and the experience and information obtained by field staff during the examination process. In summary, member business loans have resulted in extraordinary losses to federally insured credit unions, their members and the National Credit Union Share Insurance Fund (NCUSIF). At the same time, only a very small portion of credit unions are actively involved in making member businesss loans.

The call report information submitted by federally insured credit unions for the period ended December 31, 1990 indicates $1.4 billion in member business loans to 915 credit unions. There was an additional $199.8 million in agricultural loans outstanding, also considered a type of business lending. In total, federally insured credit unions reported $1.6 billion in member business loans. This is a total of .83 percent of total assets which represent an 8.7 percent increase from the prior year.

After a 60-day comment period, a total of 744 comments have been received. A total of 384 comments were received from credit union members. Federal credit unions provided 200 comments and 33 comments came from state-chartered credit unions. Two comments were from national credit union trade associations and ten came from state credit union leagues. Six comments were from state regulators and two comments were from city mayors. Three comments came from law firms. Comments were also received from a credit union sponsor, a farm lobby organization, a state representative and a state legislator.

Forty-one commenters generally supported the proposed regulation. Seven hundred and three commenters opposed one or more provisions of the proposed rule. Numerous commenters stated or implied that NCUA should improve the supervision and examination of credit unions rather than propose a new regulation.

The Board seeks to assure credit unions that it does not intend to prevent well-operated credit unions from continuing to serve their fields of membership. Likewise, there is no intent to proscribe or otherwise limit consumer-type loans to self-employed members. A number of comments tend to imply that increased supervision and education of both examiner staff and credit union staff would result in a lower level of loss and risk without the need to propose changes to the existing regulation. While not disagreeing with the need to provide adequate supervision and increased education, the Board is not convinced that these measures alone will accomplish the desired effect. A continued review of this area will monitor the effect of any final regulation adopted and determine whether restrictions or limits contained therein need to be modified or eliminated.

B. Major Changes From Prior Proposed Rule

Changes incorporated in the January 17 proposed amendment to § 701.21(h) remain unchanged in this current proposal except as noted below.

Definitions—Section 701.21(h)(1)(i). Three hundred and ninety-nine commenters opposed the "source of repayment" clause included in the proposed amendment to § 701.21(h)(1)(i). This was universally believed to limit the ability of credit unions to offer consumer-type loans to self-employed members. In fact, the proposed rule was not intended to include this group of members. This proposed revision was intended to trigger a review of the underlying business in cases where the income from a business would be used to repay a loan, regardless of purpose.

In view of the widespread confusion and ability to achieve similar results in a less burdensome manner, the "source of repayment" language has been deleted from this proposed amendment. The Board expects, however, that all loans be underwritten in accordance with sound lending policies. In cases where business income is used to support repayment of debt, credit unions are expected to verify and analyze the viability of that source of repayment regardless of the amount of purpose of the loan. Failure to perform such analysis shall be considered an unsafe and unsound lending practice by examiners.

Definitions—Section 701.21(h)(1)(i). A number of commenters were apparently unsure of whether mere investment in business or commercial ventures would fall under the general definition of a member business loan. Such investment may include, for example, an investment of a partial interest in a condominium project or similar venture. This type of investment is clearly included within the definition. In addition, examination findings indicate that a number of credit unions fail to properly recognize certain types of member business loans as such. For example, purchase of investment property, e.g., a rental property, is often

improperly classified as a consumer loan. Section 701.21(h)(1)(i) has been modified by adding "investment property or venture" to the definition. At the same time, the Board notes that mere investment in stock of a publicly held corporation would not be considered a member business loan.

Definitions—Section 701.21(h)(1)(i)(A). Eighty-eight commenters specifically requested that loans secured by residential real estate be exempt from the definition of a member business loan. In view of the comments received and upon further review, it does not appear that this type of security has resulted in significant losses, regardless of purpose. Accordingly, an exemption from the definition, for loans secured by a lien on a 1 to 4 family dwelling that is the member's primary residence, has been reinstated in this proposed rule.

Definitions—Section 701.21(h)(1)(i)(C). The minimum loan amount included within the definition of a member business loan was proposed to be lowered from $25,000 to $10,000. One hundred and fifty-six commenters opposed this reduction. After further review of this limit, it does not appear that lowering the amount to $10,000 will provide any significant reduction in losses to credit unions or the NCUSIF. In addition, as noted earlier, credit unions are expected to properly evaluate all requests for loans regardless of amount or purpose. Accordingly, the $25,000 minimum to trigger the requirements of this section is reinstated within this proposed rule. NCUA's call report forms will be revised, however, to collect data on all business-purpose loans, regardless of loan amount.

Definitions—Section 701.21(h)(1)(v). A definition of the "loan-to-value" (LTV) ratio has been added. This defintion was not included in the prior proposal. In view of its importance in other sections, and to clarify this term, this definition has been included. The LTV ratio is defined to mean the ratio of the amount of all funds borrowed from all sources secured by a specific item of collateral divided by the market value of the collateral. Market value, although not redefined in this section will be considered the same as defined in part 722 of these rules (Appraisals).

Experience Requirement—Section 701.21(h)(2)(i)(F). In the January 17 proposal, this provision appeared as §701.21(h)(2)(ii)(D). Forty-four commenters objected to this provision, while thirteen commenters approved. Those objecting indicated that the proposed definition would prove unworkable in practice. In repsonse to these comments, the specificity of the qualifications has been modified. Under the revised proposal, the credit union board of directors shall be responsible for determining the criteria to be used to measure the 2-year direct experience requirement. In addition, for clarity, this provision was incorporated into the section of the regulation addressing written loan policies.

Documentation Requirements—Section 701.21(h)(2)(i)(H). This proposal clarifies the term "income and expenses" by substitution of the term "income statement", which is more commonly used.

Other policies—Section 701.21(h)(2)(i)(A). The January 17 proposal, which contained both (A) and (B) subparts, has been combined into a new § 701.21(h)(2)(ii)(A). The revised section combines both LTV ratio criteria and lien position on security.

Although implicit within the existing rule, this proposed rule clarifies that member business loans shall be granted as secured credit. The Board believes that this change shall have little, if any, impact on credit unions as virtually all members business loans have been granted as secured credit.

Fifty-one comenters pointed out that, especially for self-employed members, a residence is the primary asset to be leveraged in order to finance a business venture. Using built-up equity in this property is crucial to these individuals. Limiting member business loans to first liens would severely limit the ability of credit unions to serve their self-employed members. In addition, a limitation to a first lien could have the effect of consolidating long-term debt with short-term financing in order to meet the first lien requirement of the rule. This is not a prudent lending practice. Accordingly, under circumstances as described below, the use of second liens is permissible.

At the same time, it is important to note that credit unions must verify the amount of equity available, through use of title searches, appraisals and similar means. Failure to verify equity simultaneous with granting the loan will be considered to unsafe and unsound lending practice. In addition, prudent lending practices require that borrowers contribute some equity to business loans. This ensures that borrowers maintain an active interest in the success of their businesses and therefore, responsibly manage these project.

The ability of a credit union to realize on collateral securing loans is dependent upon a number of factors. Collateral risk exists in cases where a market decline in the value of collateral exceeds the equity used to secure loans. For this reason, LTV ratios must reflect this risk and should be limited to a percentage of the current market value of the project. Further, use of subordinate lien positions exposes lenders to additional credit risk. This risk exists in cases where borrowers fail to meet the terms of another lender with a superior lien. Lenders are limited in the ability to monitor this risk, and, therefore, to assess the financial condition of the borrower. Finally, use of subordinate lien positions exposes lenders to a type of liquidty risk. This type of risk occurs when a lender must pay off superior liens in order to realize upon the value of the collateral (through default on any of the liens). In some cases, these superior interests are significant. At times, these interests have exceeded the ability of the credit union to fund them. Accordingly, use of lien positions other than first or second are not considered prudent lending practices for member business loans by credit unions.

For the above reasons, this section is proposed to be modified as follows:

- —A second lien shall be acceptable, provided the LTV ratio does not exceed 70 percent;
- —A first lien shall be acceptable, provided the LTV ratio does not exceed 80 percent;
- —A first lien plus private mortgage or equivalent type insurance, provided by an insurer acceptable to the credit union, or insurance or guarantees by or subject to advance commitment to purchase by, an agency of the federal government or of a state or any of its political subdivisions, shall be acceptable, provided the LTV does not exceed 95 percent.
- —No member business loans shall exceed an LTV of 95 percent.

Signature of Principal—Section 701.21(h)(2)(ii)(B). In the January 17 proposal, this section appeared as § 701.21(h)(2)(i)(C). This provision received a number of comments from credit unions which serve nonprofit corporations. These would include charitable organizations, churches, cooperatives and similar groups. State-chartered credit unions, in some cases, are authorized by state law to lend to these groups in excess of their shareholdings in the credit unions. Federal credit unions are prohibited from lending in excess of their shareholdings to other than natural person members under the standard Federal Credit Union Bylaws. Commenters noted that the corporate structure of such groups does not provide for a natural person who could act as the principal. These commenters

argue that, given the low level of losses with such groups, the provision for requiring the signature of a principal should not be imposed where the borrower is organized or incorporated as a nonprofit corporation. Note that this exception is only relevant to state-chartered credit unions whose state laws permit such activity. The Board seeks additional comments in this area prior to adopting a change from the January 17 proposal. In particular, information is requested concerning the types of loans which might be made, amounts and relative risk involved with this type of loan program.

Loans to One Borrower—Section 701.21(h)(2)(iii)(A). Forty-three commenters objected to this proposal. Many of these commenters expressed the belief that the existing limitation on loans to one borrower of 20 percent of reserves to acceptable. Twenty-three commenters approved of the proposed rule. The proposed rule lowered this amount to 10 percent of reserves, excluding the Allowance for Loan Losses account. This limitation effectively doubles the diversification of concentrations of credit to one borrower. Although the Board continues to believe that this diversification policy is appropriate, this proposed rule places a minimum amount of $75,000. Losses on loans below this threshold amount have been insignificant. Accordingly, the rule is being revised to continue to limit loans to one borrower to 10 percent of reserves or $75,000, whichever is higher. It should be noted that this provision does not amend the statutory requirement of the Federal Credit Union Act which limiting federal credit union loans to one borrower to ten percent of unimpaired capital and surplus.

In addition, this section is clarified to indicate that exceptions to the loans to one borrower rule shall be considered by the regional director responsible for the region where the credit union is headquartered. The existing rule states that the Board is responsible; the Board has subsequently delegated this responsibility to the regional directors. This revision merely clarifies this responsibility.

Aggregate Loan Limit—Section 701.21(h)(2)(iii)(B). The January 17 proposed rule limited the aggregate investment in member business loans to 100 percent of reserves. This proposed change elicited ninety-one comments. Seventy-nine comments opposed the proposed rule and indicated that this limit would have the effect of severely curtailing the ability of credit unions to serve their members. This message was particularly disturbing to those credit unions whose members are primarily self employed or are small business persons. Agricultural credit unions and community credit unions are among the types of credit unions which would appear to be most affected. In addition, there is widespread concern that NCUA is attempting to indirectly curtail member business loans and/or the credit unions involved in this activity. As a result, there is considerable doubt among commenters that exceptions to the aggregate limit will be impartially evaluated by regional directors.

As indicated earlier, the Board seeks to reassure credit unions that it is fully aware that member business loans have been an integral part of credit union lending programs since the early development of credit unions. At the same time, that lending activity has led, in some instances, to loans to finance high risk endeavors, at little or no risk to the borrower. This is fundamentally different from traditional loans to assist members in development family businesses and similar activities. This rule is intended to accommodate the latter, yet imposed certain limits and controls on the high risk activity seen in recent years which is the basis for most of the losses cited in the January 17 proposal.

This section is further modified to exclude from the calculation of the aggregate limit, portions of loans secured by shares in the credit union or deposits in other financial institutions or guaranteed by or subject to advance commitment to purchase by, any agency of the federal government or of a state or any of its political subdivisions. This is similar to the exclusions provided in the loans to one borrower limit. Its inclusion in this section is merely a clarification of policy.

Additionally, this section is proposed to be amended by including language similar to that of the preceding section (§ 701.21(h)(2)(iii)(A)) clarifying notification requirements and guidance on requests for exception to the limit.

Based on the above, the Board requests specific comments regarding the affect of requiring credit unions to request approval to exceed the limit of 100 percent of reserves in aggregate member business loans upon the operations of credit unions. Alternatives and recommendations are solicited.

Exceptions—Section 701.21(h)(2)(iii)(C). A number of commenters were concerned that regional directors would be biased towards nonapproval of requests for exceptions to either the loans to one borrower limit or the aggregate limit. In view of the central role that member business loans play for some credit unions, it is in the best interest of credit unions, their members and the NCUSIF that credit unions which demonstrate the ability to grant and administer such loans in a safe and sound manner continue this activity within parameters acceptable to all parties.

At the same time, recent losses due to member business loans invoke the necessity of requiring a review and approval process when the level of member business loans could result in unacceptable exposure to risks. This is especially true in credit unions which have demonstrated a poor track record in this type of lending or having exhibited problems in other areas of its operations, including failure to adequately analyze or monitor risk in its programs. It is important to note that the Board expects the regional directors to responsibly evaluate requests for exceptions and also expects credit unions to demonstrate through verifiable evidence, its ability to manage larger volumes of member business loans. Credit unions shall be required to apply to their respective regional director for approval to exceed the loans-to-one borrower limit or the aggregate limit. Information to be included in the reques is stated in the rule. In addition, a number of commenters were concerned that prompt action by regional directors would be necessary in order to prevent undue problems in credit unions awaiting waivers. The Board expects regional directors to respond to all requests for exception to the limits in a prompt and expeditious manner. Every effort will be made to provide a response within 30 days of receipt.

Section 701.21(h)(2)(iii)(C) has been clarified to specify what information regional directors shall consider in evaluating requests to exceed the individual or aggregate loan limits stated in the rule. This provision is provided to assist credit unions in understanding what information regional directors will be considering and, therefore, will help expedite this process. At a minimum, regional directors shall review the CAMEL composite rating for the previous 3 years. In addition, the regional directors will review the credit union's experience in making member business loans. Prior to exceeding either limit stated in § 701.21(h)(2)(iii)(A) or (B), credit unions seeking to exceed the limit shall document this experience by submitting the following member business loan information to the regional director:

—The history of loan losses;

—Loan delinquency;

—Volume and cyclical or seasonal variations;
—Diversification by type and purpose;
—Concentrations of credit to one borrower or group of associated borrowers in excess of 10 percent of reserved;
—Underwriting standards and practices;
—Written lending policies;
—Types of loans grouped by purpose and collateral; and
—Qualifications of personnel responsible for underwriting and administering member business loans.

Monitoring—Section 701.21(h)(2)(iii)(E). In view of the extraordinary exposure to loss and the speed with which such losses have been seen to consume credit union retained earnings, it is critical for NCUA regional directors to closely monitor the status of credit unions engaged in making member business loans. Closer supervision, through monitoring, is intended to provide an opportunity for earlier action by NCUA in preventing or reducing losses. A new section, § 701.21(h)(2)(iii)(E), has been added to the proposed rule. Credit unions which have outstanding member business loans in excess of 100 percent of reserves, shall be required to report the status of the member business loan portfolio on a monthly basis. Such reports shall provide a foundation for NCUA to evaluate the condition of the loan portfolio and its potential risk to the credit union's viability. Such evaluations may result in a reconsideration of exceptions to limits provided under § 701.21(h)(2)(iii) (A) or (B) if unsafe or unsound conditions are found to exist.

Monthly reports shall include information pertaining to the total number and amount of member business loans outstanding; member business loan delinquencies which exceed 10 days; allowance for losses or member business loans; status of all concentrations of credit in excess of 10 percent of reserves to one borrower or group of associated borrowers; all loans for construction, development or speculative purposes and any other information pertinent to the safety and soundness of the member business loan portfolio.

Maturity—Section 701.21(h)(2)(iii)(D). One hundred and four commenters opposed this provision. Further analysis has indicated that the proposed 60-month limit on member business loans was inappropriate and could, in some cases, increase the risk of such loans. In some cases, commenters noted that balloon loans which mature in 60 months are difficult to monitor and could expose the credit union to considerable risk in the interim. In addition, forcing lenders to call a loan at 60 months, and then refinance, will add needless costs to borrowers. The prevailing lending practices common to business lenders adequately resolve such issues.

Accordingly, this section is proposed to be revised by clarifying that member business loans shall be granted for terms which call for payment of principal and interest consistent with the purpose, security, creditworthiness of the borrower and sound lending practices. For example, operating loans typically rollover annually. To extend such loans beyond the expected use of the funds will be viewed as an unsafe and unsound lending practice. In any event, member business loans shall be limited to 12 years, the general loan maturity limit stated in the Federal Credit Union Act.

Construction, development and speculative real estate lending—Section 701.21(b)(3). This area elicited a small number of comments, which were divided in their views. In discussions, however, various groups and individuals have suggested that this type of lending be prohibited entirely. It is clear from information developed during recent examinations, and the views of commenters, that this segment of member business lending is significantly higher risk than any other. Although agreeing with the provision, some commenters requested additional clarification, by way of specific example, of types of loans intended to be covered by this section of the rule. Recent examples include loans to finance development of residential real estate projects (*e.g.*, condominiums, single family and multi-family), hotels and commercial real estate (*e.g.*, strip malls, office buildings). While this list is certainly not all-inclusive, this type of lending is generally characterized by projects which rely on anticipated future sale of the project or future cash flow of an uncompleted project in order to repay the debt. Since advance commitments to sell are rare, the value of the project is dependent upon the accuracy of appraisals and projections of the future value of estimated cash flows or market value. Both projections are highly subjective. Failure to accurately analyze such projects, or changes in underlying assumptions, cause this type of lending to be considered high risk. Accordingly, the limitations contained in the January 17 proposed rule, remain unchanged.

Summary

Member business lending is a specialized function which must be analyzed separately from consumer lending. This requires specialized experience and training apart from that traditionally gained through consumer lending. Both credit unions and regulators must understand this type of lending in order to properly evaluate loans and their inherent risk. All loans entail an evaluation and assumption of risk by the borrower. This risk cannot be eliminated short of curtailing this type of lending. Since this alternative is unacceptable, credit unions and regulators need to address the controls and limitations appropriate to maintain safe and sound lending programs while continuing to serve credit union members' needs. This regulation is intended to provide such controls and limitations. Credit unions, for their part, can address risk through appropriate actions regarding interest rates, collateral requirements, qualifications of borrowers and administering effective monitoring and collection programs.

Requirements for Insurance—Section 741.3. No change is being proposed to this section. State regulatory authorities and federally insured state-chartered credit unions are advised, however, that exemptions previously obtained by states under the existing regulations are no longer valid to the extent that existing state regulations are not substantially equivalent to the final regulations adopted by the NCUA Board. Such states must reapply for exemption as provided in this section.

C. Regulatory Procedures

Regulatory Flexibility Act

The Board certifies that the proposed rule, if made final, will not have a significant impact on a substantial number of small credit unions because the rule applies only to the federally insured credit unions which make member business loans. Approximately 27 federally insured credit unions with assets less than $1 million grant member business loans. Accordingly, the Board has determined that a Regulatory Flexibility Analysis is not required.

Paperwork Reduction Act

This proposed rule, if made final, will increase the collection and recordkeeping requirements of the Paperwork Reduction Act. A separate request will be submitted to the Office of Management and Budget for approval prior to the effective date of this regulation.

Executive Order 12612

Executive Order 12612 requires NCUA to consider the effect of its actions on state interests. It states that: "Federal action limiting the policy making discretion of the States should be taken only where constitutional authority for the action is clear and certain and the national activity is necessitated by the presence of a problem of national scope." The issue of member business loans and their risks to federally insured credit unions are concerns of national scope. In order to enable NCUA and the NCUSIF to have an operable mechanism in place to ensure the safety and soundness of federally insured credit unions, this regulation is proposed. This regulation will apply to all federally insured credit unions. The NCUA Board believes that the protection of the NCUSIF warrants these new restrictions and that the increased restrictions in the proposed amendments will not unduly burden federally insured state-chartered credit unions. The NCUA Board, pursuant to Executive Order 12612, has determined that this rule may have an occasional direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. Further, the proposed amendments may supersede provisions of state law or regulations concerning member business loans which do not substantially meet the requirements of § 701.21(h).

List of Subjects in 12 CFR Part 701

Member business loans, Written loan policies, Conflicts of interest

By the National Credit Union Administration Board on April 4, 1991.

Becky Baker,

Secretary of the Board.

For the reasons set forth in the preamble, 12 CFR part 701 is amended as follows:

PART 701—ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS

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

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1787 and 1789 and Pub. L. 101-73. Section 701.6 is also authorized by 31 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 *et seq.*, 42 U.S.C. 1861 and 42 U.S.C. 3601-3610.

2. In § 701.21, paragraph (h) is revised to read as follows:

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

* * * * *

(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, investment property or venture, 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 the member's primary residence.

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

(C) A loan meeting the general definition of "member business loan" under (i) above, and, 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 any undivided earnings or surplus but excluding the Allowance for Loan Losses account.

(iii) *Associated Member* means any member with a shared ownership, investment or other pecuniary interest in a business or commercial endeavor with the borrower.

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

(v) *Loan-to-valve* (LTV) ratio means the quotient of the aggregate amount of all sums borrowed from all sources on an item of collateral divided by the market value of the collateral used to secure the loan.

(2) Requirements. Member business loans, as defined in § 701.21(h)(1)(i), may be made by federal credit unions only in accordance with the applicable provisions of § 701.21 (a) through (g) above, to the extent that they are not inconsistent with this section, 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, subject to the limitations of Section 701.21(h)(2)(iii)(B) and (C);

(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)(iii)(A) below;

(F) Qualifications and experience of personnel involved in making and administering business loans with a minimum of 2-years direct experience with this type of lending.

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

(H) Documentation supporting each request for an extension of credit or an increase in an existing loan or line of credit shall (except where the board of directors finds that such documentation requirements are not generally available for a particular type of business loan and states the reasons for those findings in the credit union's written policies) include the following: balance sheet, cash flow analysis, income statement, 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) Other Policies. The following minimum limits and policies shall also be established in writing and reviewed at least annually for loans granted under this section:

(A) Loans shall be granted on a fully secured basis by collateral as follows:

(1) Second lien for LTV ratios of up to 70 percent;

(2) First lien for LTV ratios of up to 80 percent;

(3) First lien plus private mortgage, or equivalent type, insurance provided by an insurer acceptable to the credit union or insurance or guarantees by or subject to advance commitment to purchase by, an agency of the federal government or of a state or any of its political subdivisions, for LTV ratios of up to 95 percent;

(4) No member business loans shall be granted which exceed an LTV of 95 percent.

(B) Loans shall not be granted without the personal liability and guarantees of the principals (natural person members);

(iii) Loan limits.

(A) Loans to One Borrower. Unless a greater amount is approved by the NCUA regional director, the aggregate amount of outstanding member business loans to any one member or group of associated members shall not exceed 10% of the credit union's reserves, or $75,000, whichever is higher. If any portion of a member business loan is fully secured by shares in the credit union, or deposits in another financial institution, or fully or partially 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 10% limit. On or before the effective date, the federal credit union must notify the NCUA regional director, in writing, of any outstanding member business loans made prior to that date which exceed the 10% limit. Federal credit unions are prohibited from making any further advances beyond the 10% limit to borrowers whose aggregate business loans exceed the limit unless an exception has been approved by the regional director in accordance with § 701.21(h)(2)(iii)(C).

(B) Aggregate Loan Limit. Business loans as defined in this section, excluding any portion of a loan which is secured by shares in the credit union, or deposits in another financial institution, or fully or partially 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, and including any construction, development and speculative loans granted as provided under § 701.21(h)(3) of this part, shall not exceed 100% of a credit union's reserves. On or before the effective date, the federal credit union must notify the NCUA Regional Director, in writing, of any outstanding member business loans made prior to that date which exceed the 100% limit. Federal credit unions are prohibited from making any further advances beyond the 100% limit unless an exception has been approved by the regional director in accordance with § 701.21(h)(2)(iii)(C).

(C) Exceptions. Credit unions seeking an exception from the limits of § 701.21(h)(2)(iii) (A) or (B) must present the regional director with, at a minimum: the higher limit sought; an explanation of the need by the members to raise the limit and ability of the credit union to manage this activity; an analysis of the credit union's prior experience making member business loans; and a copy of its business lending policy. The analysis of credit union experience in making member business loans shall document the history of loan losses, loan delinquency, volume and cyclical or seasonal patterns, diversification, concentrations of credit to one borrower or group of associated borrowers in excess of 10 percent of reserves, underwriting standards and practices, types of loans grouped by purpose and collateral and qualifications of personnel responsible for underwriting and administering member business loans. Regional directors shall consider, in addition to the information submitted by the credit union, the historical CAMEL ratings.

(D) Maturity. Member business loans shall be granted for periods not to exceed 12 years, consistent with the purpose, security, creditworthiness of the borrower and sound lending policies.

(E) Monitoring Requirement. Credit unions with member business loans in excess of 100 percent reserves shall submit the following information regarding member business loans to their respective regional director on a monthly basis: the aggregate total of loans outstanding; the amount of loans delinquent in excess of 10 days; the balance of the allowance for member business loan losses; the aggregate total of all concentrations of credit to one borrower or group of associated borrowers in excess of 10 percent of reserves; the total of all construction, development or speculative loans; and any other information pertinent to the safe and sound condition of the member business loan portfolio.

(iv) 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

(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) Construction, development and speculative real estate lending.

Loans granted under this section to finance the construction or development of a commercial or residential building(s) shall be subject to the following additional provisions:

(i) The aggregate of all such loans shall not exceed 15 percent of reserves;

(ii) The borrower shall have a minimum of 35 percent equity interest in the project being financed;

(iii) Funds for such projects shall be released following on site inspections by independent, qualified personnel in accordance with a preapproved draw schedule.

(4) Prohibitions.

(i) Senior Management Employees. A federal credit union may not make member business loans to the following:

(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 Treasury/Manager).

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

(D) The chief financial officer (Comptroller).

(E) Any associated member or immediate family member of (A)–(D) above.

(ii) "Equity Kicker/Joint Ventures." 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 or sale of the business or commercial endeavor for which the loan is made.

(5) Recordkeeping. All loans, lines of credit, or letters of credit, the proceeds of which will be used for a commercial, corporate, business, investment property or venture, or agricultural purpose, shall be sepatately identified in the records of the credit union and reported as such in financial and statistical reports required by the National Credit Union Administration.

(6) Effective Date.

Section 701.21(h) is effective May 15, 1991. All member business loans made

on or after that date must be in full compliance with Section 701.21(h).

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DEPARTMENT OF COMMERCE

Patent and Trademark Office

37 CFR Part 2

[Docket No. 910364-1064]

RIN 0651-AA47

Amendment to Interrogatory Practices

AGENCY: Patent and Trademark Office, Commerce.

ACTION: Proposed rulemaking.

SUMMARY: The Patent and Trademark Office (PTO) proposes an amendment to § 2.120(d)(1) of the rules of practice in trademark cases, which limits the total number of interrogatories that may be served by one party upon another in a trademark interference, concurrent use, opposition, or cancellation proceeding. The proposed amendment shifts, from the responding party to the inquiring party, the burden of filing a motion to determine whether an assertion of an excessive number of interrogatories is well taken.

DATE: Written comments must be submitted on or before May 30, 1991 to ensure consideration.

ADDRESSES: Address written comments to Box 5, Trademark Trial and Appeal Board, Commissioner of Patents and Trademarks, Washington, DC 20231, marked to the attention of Janet E. Rice.

Written comments will be available for public inspection in room 1008, Crystal Square 5, 1755 Jefferson Davis Highway, Arlington, Virginia 22202.

FOR FURTHER INFORMATION CONTACT: Janet E. Rice by telephone at (703) 557-3551 or by mail marked to her attention and addressed to Box 5, Trademark Trial and Appeal Board, Commissioner of Patents and Trademarks, Washington, DC 20231.

SUPPLEMENTARY INFORMATION: In a notice of proposed rulemaking published in the Federal Register on March 7, 1989, at 54 FR 9514, and in the Patent and Trademark Office Official Gazette of March 28, 1989, at 1100 O.G. 137, the PTO proposed amendments to a number of the rules of practice in trademark cases. One of the proposed amendments pertained to § 2.120(d), which then consisted of a single paragraph relating to document production. It was proposed that the section be amended to include a new paragraph (designated "(1)" limiting the number of interrogatories that might be served by one party upon another in a trademark interference, concurrent use, opposition, or cancellation proceeding.

In response to the notice of proposed rulemaking, the PTO received numerous written comments pertaining to proposed § 2.120(d)(1). One individual commented that a party served with excessive interrogatories might make its own count of the questions, answer as many as were allowed under the proposed rule, and not answer the remainder on the ground that supernumerary questions were not authorized. To remedy this problem, the individual suggested that if the proposed rule were adopted, it might be advisable to add "a provision prescribing that relief for an excessive number of interrogatories is a protective order rather than an incomplete response to the interrogatories."

This suggestion, among others, was adopted in the final rule notice published in the Federal Register on August 22, 1989, at 54 FR 34886, and in the Patent and Trademark Office Official Gazette of September 12, 1989, at 1106 O.G. 26. Thus, final § 2.120(d)(1) included, as its last sentence, the following provision: "If a party upon which interrogatories have been served believes that the number of interrogatories served exceeds the limitation specified in this paragraph, and is not willing to waive this basis for objection, the party shall, within the time for (and instead of) serving answers and objections to the interrogatories, file a motion for a protective order, accompanied by a copy of the interrogatories which together are said to exceed the limitation."

In addition, the final rule notice indicated that the PTO would monitor the impact of § 2.120(d)(1) carefully and further amend the rule if necessary.

The effective date of the rule amendments specified in the final rule notice was November 16, 1989. Since that time, many attorneys have expressed the opinion, in public meetings relating to trademarks, that it is unfair for a party served with excessive interrogatories to have the burden of filing a motion for a protective order. These attorneys have suggested that the better practice would be to allow the responding party to simply object to the interrogatories on the ground of their excessive number, and leave the propounding party with the burden of filing a motion to compel, if it believes that the objection is not well taken.

Accordingly, § 2.120(d)(1) is proposed to be revised to substitute a motion to compel for the motion for a protective order.

Discussion of Specific Section Proposed To Be Changed

In this discussion, "Trademark Trial and Appeal Board" is abbreviated as "Board."

Section 2.120(d)(1) now provides, in part, that if a party upon which interrogatories have been served believes that the number of interrogatories served exceeds the limitation specified in the paragraph, and is not willing to waive this basis for objection, the party shall, within the time for (and instead of) serving answers and objections to the interrogatories, file a motion for a protective order, accompanied by a copy of the interrogatories which together are said to exceed the limitation. The paragraph is proposed to be revised to provide instead that if a party upon which interrogatories have been served believes that the number of interrogatories served exceeds the limitation specified in the paragraph, and is not willing to waive this basis for objection, the party shall, within the time for (and instead of) serving answers and specific objections to the interrogatories, serve a general objection on the ground of their excessive number. The paragraph is proposed to be further revised to add a requirement that if the party serving the interrogatories, in turn, files a motion to compel discovery, the motion must be accompanied by a copy of the set(s) of interrogatories which together are said to exceed the limitation, and must otherwise comply with the requirements of paragraph (e) of the section. Paragraph (e) governs motions to compel discovery in inter parties proceedings before the Board, and requires, inter alia, that a motion to compel be supported by a written statement from the moving party that such party or the attorney therefor has made a good faith effort, by conference or correspondence, to resolve with the other party or the attorney therefor the issues presented in the motion and has been unable to reach agreement.

Environmental, Energy, and Other Considerations

The proposed rule change will not have a significant impact on the quality of the human environment or the conservation of energy resources.

The proposed rule change is in conformity with the requirements of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*), Executive Orders 12291 and