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Filed Electronically
Melanie Conyers-Ausbrooks
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

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

Dear Ms. Conyers-Ausbrooks:

I appreciate the opportunity to comment on the National Credit Union Administration's (NCUA) proposal that would amend the NCUA's rules regarding the purchase of loan participations and the purchase, sale, and pledge of eligible obligations and other loans (including notes of liquidating credit unions).[1] By way of background, I am an attorney with over fifteen years of experience practicing credit union regulatory law. I regularly advise credit unions, credit union service organizations, and financial technology companies concerning loan participations, eligible obligations, indirect lending arrangements, and other legal matters.

I support most aspects of this proposal because it would provide additional flexibility for federally insured credit unions (FICUs) to make use of advanced technologies and opportunities offered by the financial technology (fintech) sector as well as clarify ambiguities in existing NCUA rules. My high-level comments are:

- **Board Should Finalize Proposed Amendments to Section 701.23 Eligible Obligations Rule as Proposed:** I strongly support the NCUA Board's proposal to liberalize its Section 701.23 eligible obligations regulation by moving to a more principles-based rule. The Board should finalize these amendments as proposed.

- **Board Should Remove CU Membership Requirement for Loan Participation Interests Purchased from Non-CUs:** I urge the NCUA Board to lift the Section 701.22

[1] Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions, 87 Fed. Reg. 80,479 (Dec. 30, 2023), *available at* https://www.federalregister.gov/documents/2022/12/30/2022-27607/financial-innovation-loan-participations-eligible-obligations-and-notes-of-liquidating-credit-unions.

loan participation regulation's "membership requirement" for federal credit unions (FCUs) to be able to invest in a loan participation when the originator is not a credit union. Eliminating the requirement for a borrower to be a member of a credit union when the originator of the loan is a bank, CUSO, or other non-credit-union "eligible organization" is consistent with both the FCU Act and with NCUA regulations' current treatment of federally insured state-chartered credit unions (FISCUs).

- **CUs Should Have Discretion to Classify an Investment as Either a Loan Participation or an Eligible Obligation:** I urge the Board to clarify in the final rule that investing FICUs have discretion to classify a partial interest in a loan acquired under either Section 701.22 or 701.23 when its terms and conditions meet both rules' requirements.

- **Loan Participations Structured as "Partial Assignments" Better Protect CUs Investing in these Items:** The final rule should clarify that Section 701.22 loan participations can be structured as purchases of an economic participation interest in a loan or as a partial assignment of the loan. While I support giving FICUs the discretion to purchase either types of loan participation structure, as is current NCUA policy, purchases of "partial assignments" typically give credit unions better claims to these loans if the originator liquidates, is put into receivership, or declares bankruptcy.

- **NCUA Should Regulate FICUs Selling Loan Participations:** The final version of the loan participation regulation should apply to NCUA-regulated sellers, not just purchasers, when NCUA has jurisdiction over the seller.

- **Final Rule Should Clarify that Sections 701.22 and 701.23 Apply Through the Life of the Loan:** The final rule should codify NCUA Office of General Counsel Legal Opinion 18-0133, which clarified that these rules' compliance obligations apply for the lifetime of the transaction, not just at the time of purchase, and that each separate loan participation or eligible obligation must be treated independently. Unless each loan is accounted for individually as a continuing compliance requirement for the servicer, FICUs purchasing (or even selling) loan participations may be short-changed and struggle to correctly account for the participations.

- **Board Should Finalize Proposed Definition of "Originating Lender" With Clarifications:** I strongly support the Board's proposal to incorporate its indirect lending provision into Section 701.21(c)(9), which applies to FCU lending activities in general, as well as the Board's proposal to codify NCUA Office of General Counsel Legal Opinion 15-0813, including the proposed definition of "originating lender" in Section 701.22(a). These amendments are consistent with longstanding NCUA policy and should be finalized as proposed with the following clarifications:

- **FCU Makes "Final Underwriting Decision" Even When Indirect Lending Partner Applies Additional, More Restrictive Underwriting Criteria:** The purchasing FCU should be considered to have made the "final underwriting decision" so long as the loan conforms to the FCU's pre-approved underwriting criteria even when a fintech company or other indirect lending partner adds additional, more restrictive underwriting criteria than the FCU requires. Indirect lending partners weeding out bad loans in this fashion promotes safety and soundness by reducing credit risk to FCUs, whether or not the indirect lender uses an algorithm and/or uses natural persons' judgment to provide such credit enhancements.

- **"Very Soon" Should Mean Before the First Loan Payment (Other than a Downpayment):** Regarding the requirement that a loan be assigned to the purchaser "very soon after" the inception of the obligation to extend credit, to limit compliance burdens on FICUs by reducing regulatory uncertainty, I urge the Board to define "very soon after" to mean prior to the due date of the member's first loan payment (other than any downpayment).

Detailed Comments

1. Section 701.23 Eligible Obligation Rule Amendments Should be Finalized as Proposed

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

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

In addition to FCUs, most federally insured, state-chartered credit unions (FISCUs) should also benefit from this rule pursuant to state credit union act parity statutes.

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

2. The loan participation regulation's "membership requirement" for FCUs should be removed

The FCU Act's provision governing loan participations codified in Section 107(5)(E) of the Act, 12 U.S.C. § 1757(5)(E), is best read to permit FCUs' participation in loans that are originated by

non-credit-union financial organizations without regard to the borrower's membership in a credit union. It is clear from the plain language of Section 107(5)(E) and its context within the structure of Section 107(5) that Congress did not intend to limit FCUs to participate only in loans made to credit union members.

I urge the Board in the final rule to delete the membership requirement from Section 701.22(b)(4). FISCUs are already exempt from this limitation pursuant to Section 741.225 of NCUA rules and the Board should level the playing field for FCUs for the reasons explained below. *See* 12 C.F.R. § 741.225.

A. The Act's loan participation provision is a "good hands" requirement, not a risk retention requirement

A principal objective of Section 107 of the Act, 12 U.S.C. § 1757, is largely to protect credit union members by restricting how the FCU may do business with them in a manner consistent with its tax-exempt "purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." 12 U.S.C. § 1752. Section 107(5)(A)(vi), for example, serves as a consumer protection provision limiting the permissible interest rates that FCUs' may charge their members on loans. 12 U.S.C. § 1757(5)(A)(vi).

The usury limit in Section 107(5)(A)(vi) is clearly a consumer protection "good hands" provision intended to protect members, rather than a safety and soundness requirement, because usury caps protect borrowers from being charged high rates of interest. From a prudential regulatory perspective, however, such interest-rate caps actually increase interest rate risk to FCUs by limiting their ability to respond to interest rate increases in a rising-rate environment.

Similarly, Section 107(5)(E), in relation to loan participations, establishes requirements for when an FCU participates in (or sells) loans made to its own members. In such a situation, to protect those credit union member borrowers, Section 107(5)(E) requires that the originating credit union retain a 10% interest in the participated (or sold) loan. This requirement is most appropriately read as a consumer protection "good hands" provision much like the Section 107(5)(A)(vi) interest rate ceiling: when the borrower of a participated loan is a credit union member, the Act protects that borrower to a certain extent by guaranteeing at least 10% of the loan is in the "good hands" of an originating FCU that is directly regulated under the Act (while participations in the remainder of the loan can be held by other financial organizations not regulated under the Act).

Although the Section 107(5)(E) "good hands" requirement provides consumer protections for credit union members whose loans are sold in participations, the Act should not be read to foreclose an FCU's ability to participate in a loan made to a borrower who is *not* a credit union member. Such an exclusive reading in fact runs contrary to the ordinary meaning of the statutory language. Section 107(5)(E) reads as follows:

> "Participation loans with other credit unions, credit union organizations [i.e. CUSOs], or financial organizations shall be in accordance with written policies of the board of directors: Provided, That a credit union which originates a loan for which participation arrangements are made in accordance with this subsection shall retain an interest of at least 10 per centum of the face amount of the loan;" 12 U.S.C. § 1757(5)(E).

FCU membership is not required by the plain language of Section 107(5)(E), nor did Congress intend for FCUs purchasing loan participations to be limited to purchasing interests only loans made to credit union members. Although the phrase "loans to credit union members" is included in the umbrella provision of Section 107(5), it is clear from Section 107(5)(E), read in context with other subsections of Section 107(5)—especially Section 107(5)(C) authorization for FCUs to lend to other credit unions and Section 107(5)(D) authorization for FCUs to lend to CUSOs—that a borrower's membership in a credit union is not a requirement for the FCU to exercise any of these three authorities in Section 107(5).

As a threshold matter, only Section 107(5)(A) states that it applies to "loans to members" and Congress omitted the "loans to members" requirement from the latter subsections of 107(5). This means that Congress intended for the credit union membership requirements to apply only to loans made by FCUs pursuant to its Section 107(5)(A) lending powers, and not to FCUs' lending powers under the other subsections of Section 107(5).

This reading is supported by traditional cannons of statutory construction including *expressio unius est exclusio alterius* ("the expression of one thing is the exclusion of others") and the rule against surplusage, as well as consistent with long-standing credit union practice and statutory interpretation concerning loans to other credit unions and loans to CUSOs. An FCU can lend to another credit union pursuant to Section 107(5)(C) without the borrowing credit union joining the FCU, and an FCU can lend to a CUSO pursuant to Section 107(5)(D) without the CUSO becoming a member of the credit union. *See* 12 C.F.R. § 701.25 ("Loans to credit unions."); 12 C.F.R. part 712 ("Credit Union Service Organizations").

Similarly, the Section 107(5)(E) "good hands" requirement only applies where the statutory language and purpose (i.e. consumer protection for credit union members) is directly at issue, such as when the FCU sells participation interests in its own loans. Not only does this interpretation reflect the ordinary meaning of the Act's statutory language, it is also sound policy that will reduce regulatory burdens on FCUs as well as reduce risk to the credit union system by diversifying FCUs' investment options without reducing underwriting standards.

B. The Act's loan participation provision is not a "risk retention" requirement

As explained above, interpreting Section 107(5) as a "risk retention" provision intended to mitigate risk to the purchaser (as opposed to a "good hands" measure protecting credit union member borrowers) contradicts the ordinary meaning of the language and renders the section logically inconsistent. Notably, Section 741.225 of NCUA rules already allow a FISCU to

purchase participations from a non-NCUA regulated or supervised financial organization **without** any risk retention requirement (and consistent with that statutory interpretation, the current regulatory framework provides for a reduced retention requirement). *See* 12 C.F.R. § 741.225. On the other hand, if the FISCU purchases a participation in an FCU-originated loan, that FCU (which is directly regulated and supervised by the NCUA) must retain at least 10% of the loan. From the standpoint of mitigating the risk to the purchaser, the opposite should be the case; there should be more risk retention where the seller is *not* regulated and supervised by the NCUA.

Limiting FCU's discretion to purchase loan participations originated by non-credit unions also creates safety and soundness risks (which increases the risk to the Share Insurance Fund as well). Such a prohibition increases credit risk on the FCU's balance sheet by reducing the type of loan assets the FCU can buy and denies it opportunities for geographic and product diversification.

Interpreting the relevant language as a "good hands" provision avoids misinterpreting the Act in this logically inconsistent manner. It is also directly in line with the NCUA's goal of "strik[ing] a balance between mitigating risk to the [Share Insurance Fund], protecting credit union members and fostering growth and stability in the credit union system." 87 Fed. Reg. at 80840.

C. In line with the Act's intention, § 701.22(b)(4)'s "membership requirement" for FCUs should be discontinued

For the above reasons, Section 701.22(b)(4)—requiring borrower membership at a credit union—conflicts with the ordinary reading of the Act's language and increases risks to FCUs by reducing opportunities for balance sheet diversity. FISCUs currently are exempt from this limitation pursuant to Section 741.225 of NCUA rules and currently are permitted (and widely engage in) more diverse purchasing options than FCUs. I urge the Board to level the playing field for FCUs by returning to the ordinary reading of the Act's loan participation provision, and delete paragraph § 701.22(b)(4) from the final version of the regulation.

3. The Board should make additional clarifications to the differences between loan participations and eligible obligations

The Board has noted that a number of its proposed rule changes are intended to "clarify the distinction between transactions treated as loan participations and those treated as eligible obligations." 87 Fed. Reg. at 80481. Under the current versions of Sections 701.22 and 701.23, as well as under the proposed amendments to both rules, there are scenarios where a FICU's purchase of a partial interest in a loan could qualify as either a "loan participation" under 701.22 or as an "eligible obligation" under 701.23 based on the transaction's terms and conditions.

In line with this goal, the Board should clarify the final versions of the loan participation and eligible obligation rules so that purchasing FICUs have discretion to classify a partial interest in

a loan under either Section 701.22 or 701.23 when the terms and conditions of the purchase meet the requirements of both rules.

A. CUs should have discretion to change the classification of a transaction as a loan participation or as a partial interest in an eligible obligation

The Board should clarify that even if credit unions are obligated to designate a transaction as a loan participation or eligible obligation at or near the time of the sale/purchase (for example on a subsequent call report), credit unions retain the discretion to change that designation at a later time if they so choose so long as the terms and conditions of the purchase meet the requirements of both rules.

This is in line with how other financial regulatory bodies allow their regulated entities to identify after-the-fact which specific regulation they choose to categorize a past transaction (for example, a private placement of securities can meet a number of different and overlapping exceptions to registration with the U.S. Securities and Exchange Commission). Additionally, this approach recognizes the reality that many transactions involve (frequently many) more than one credit union, and that given their respective internal priorities and processes they may not all choose to designate the transaction the same way at the same time. Lastly, affirming a credit union's discretion to move an investment from one transaction designation "bucket" to another supports the NCUA's goals of "removing certain prescriptive limits and other qualifying conditions" on credit unions' ability to structure their transactions, allowing them "to innovate how they manage their balance sheets…" 87 Fed. Reg. at 80480.

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

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

B. The Board should establish a risk retention requirement for eligible obligations when servicing is retained

To the extent that the Board keeps a risk retention provision in its Section 701.22 rule, as discussed in Section 2 of this letter, above, the Board should also consider adding a risk retention requirement for eligible obligation transactions where the servicing rights are retained by the seller (an ability that would be possible for eligible obligation sellers pursuant to proposed subsection 701.23(b)(6)(iv)(D), if finalized). As discussed in Section 2, above, currently only the

rule governing loan participations (which are typically servicing retained transactions) has a requirement that the loan originator retain a certain amount of interest in the loan–10 percent if the originator is an FCU and 5 percent if it is another type of eligible organization. *See* 12 C.F.R. § 701.22(b)(3).

If the Board chooses to keep the risk retention requirement applying to Section 701.22 loan participations, safety and soundness policy considerations militate in favor of an equivalent risk retention requirement applying to Section 701.23 eligible obligations when the seller has retained the servicing rights. This approach would be consistent, for example, with Dodd-Frank, which establishes a certain amount of risk retention for securitizations because there is a separation between servicing and principal risk. This risk retention requirement would be distinguishable from eligible obligations where the transaction is "servicing released," and the purchasing credit union ultimately controls the servicing of the purchased asset.[2]

If the Board retains the Section 701.22 risk retention requirement, the following language should be added as a new paragraph in the final version of Section 701.23(b)(6)(vii):

> "In the case of an eligible obligation transaction where the seller retains servicing, the seller shall retain the same percentage of principal as is required of the originating lender in § 701.22(b)(3)."

Absent a parallel risk retention provision for servicing retained eligible obligations, FICUs would be strongly incentivized to structure all future transactions to include either no risk-retention or, at least, less risk-retention than required under the loan participation regulation, to avoid the limits of the loan participation regulation. Given the additional incentive to avoid the limitations as to source resulting from the loan participation's membership requirement (discussed above), it is, simply put, highly likely that FICUs would mostly cease to use the loan participation regulation.

C. The Board should clarify the contractual terms and conditions that distinguish Section 701.22 Loan Participations from Section 701.23 Eligible Obligations and allow credit unions discretion to classify investments in partial loan interests in either category when the terms and conditions of the investment meet the requirements of both rules

As part of the Board's effort to clarify the distinctions between loan participations and eligible obligations, it should take this opportunity to further clarify the differences in what is required in the legal agreements regarding each transaction. Some of the requirements in the respective provisions (Section 701.22(d) for loan participation agreements and the new proposed Section 701.23(b)(6)(iv) for eligible obligation agreements) are similar and yet worded differently (for

[2] A servicing released transaction, and the requirements thereunder, should also include the ability for the purchasing credit union to then sub-service the loans to another entity, including the original seller. Under such circumstances, the purchasing credit union would still be the ultimate servicer.

example, the requirements at Sections701.22(d)(4)(i) and 701.23(b)(6)(iv)(A) to identify the specific loans being purchased). Other requirements appear in only one regulation; for example, the requirement in the loan participation rule at Section 701.22(d)(1) that the agreement be properly executed under applicable law does not appear at all in the proposed eligible obligation rule's new language, although it does require a legal review of the eligible obligations purchase.

It makes sense that a number of the requirements for loan participations and eligible obligations overlap, which supports giving a credit union discretion to classify a purchase of a partial interest in a loan under either Section 701.22 or Section 701.23 if its terms and conditions would allow it to fit into either category. Additionally, there may be different requirements for eligible obligation transactions depending on whether the transaction is one in which servicing is retained or servicing is released. Since the Board is already proposing entirely new language for the provision on eligible obligation agreements, it would help to clarify both the identical and the differing requirements that distinguish a "loan participation" from a partial interest in an "eligible obligation" to limit confusion on this issue.

I urge the Board to clarify in the final rule: (i) which of the loan participation agreement requirements also apply to eligible obligations (depending on whether servicing is retained or released), and (ii) specify whether there are additional (or fewer) obligations that apply to loan participations versus eligible obligations, including specifically what those differences are. At the moment, it is unclear whether there are meaningful rationales that explain the differences in how these respective sections are organized and worded. Clarification would reduce compliance burdens on credit unions by helping them choose between the two transaction options and by reducing regulatory uncertainty.

I urge the Board to clarify Section 701.23(b)(6)(iv) as follows:

- "Require that the written purchase agreement include, in the case of a servicing released transaction:
    - The following requirements referenced in the loan participation rule (§ 701.22): [_____].
    - The following additional requirements not referenced in the loan participation rule (§ 701.22): [_____].
- "Require that the written purchase agreement include, in the case of a servicing retained transaction:
    - The following requirements referenced in the loan participation rule (§ 701.22): [_____].
    - The following additional requirements not referenced in the loan participation rule (§ 701.22): [_____].

4. The loan participation regulation should be clarified to address conducting the transaction as either an economic participation or as a partial assignment of the loan

The definition of "loan participation" in Section 701.22(a) ("Loan participation means a loan where one or more eligible organizations participate pursuant to a written agreement with the originating lender…"), should be clarified to note that a loan participation agreement can be legally structured as either: (i) an economic participation; or (ii) a partial assignment of a loan. Additionally, the regulation's requirements regarding a FICU's internal loan participation policy (at Section 701.22(b)(5)) should include an obligation to establish rationales and guidelines for conducting a transaction under the regulation as either one or the other.

While I support giving FICUs discretion to purchase either type of loan participation, as is current NCUA policy, credit unions should in fact have a preference for partial assignments for safety and soundness reasons. Structuring loan transactions governed by this rule as partial assignments rather than economic participations generally results in less risk for the purchasing FICU. While both forms expose the purchaser to the standard risk of the borrower not being able to repay the loan ("borrower risk"), with an economic participation the purchaser is exposed to additional risk related to the financial performance of the seller ("counterparty risk"). With the purchase of a partial assignment, however, the purchaser is not exposed to counterparty risk because it has a direct claim on the borrower rather than a contract right with the seller.

Notably, under FDIC receivership, for example, the FDIC could elect to disclaim the "participation" contract to protect deposits and thereby keep all future borrower payments. The FDIC does not have such statutory authority with respect to a partial assignment because there is no contract to disclaim, i.e., the purchaser of a partial assignment of the loan is a shared lender to the borrower. NCUA has similar authorities to disaffirm or repudiate contracts when acting as the conservator or receiver of a FICU pursuant to Section 207(c) of the Act. 12 U.S.C. § 1787(c). As credit unions expand the number of institutions that they partner with in loan participations, it is important that they mitigate their risk exposure. Part of this can be accomplished by mitigating their exposure to unnecessary counterparty risk. The NCUA, to promoting safety and soundness, can encourage this by requiring credit unions to establish rationales and guidelines for structuring their transactions as either economic participations or partial loan assignments.

For these reasons, I urge the Board to add the following as a second sentence to the definition of "loan participation" in Section 701.22(a):

> "The legal form of the participation may be either as a partial assignment or an economic participation."

Additionally, the following should be added as a new paragraph at § 701.22(b)(5)(v):

> "Establish rationales and guidelines for conducting a transaction under this Section 701.22 as an economic participation and/or as a partial assignment."

5. The loan participation regulation should apply to NCUA-regulated sellers, not just purchasers

As currently written, the Section 701.22 regulation governing loan participations only directly applies to purchasers. *See* 12 C.F.R. § 701.22 ("This section establishes the requirements a federally insured credit union must satisfy to *purchase* a participation in a loan.") (emphasis added). Many of the obligations in the regulation, however, are on the seller (for example Section 701.22(b)(3) requiring that "[t]he originating lender retain an interest in each participating loan.").

Not all sellers are FICUs regulated by the NCUA but, when they are, it is logical for the NCUA to supervise sellers' compliance with this rule both at the time the transaction occurs and over the lifetime of the relationship. NCUA supervision of sellers' compliance should help protect the interests of FICUs purchasing these participations who, without NCUA oversight, may be getting shortchanged vis-à-vis their contractually mandated cash flows (or struggle to properly account and report on their transactions). In the absence of NCUA supervision, these purchasing FICUs must bear the financial and reputational costs of resorting to the courts or commercial arbitration to enforce their rights, which is oftentimes not cost effective unless the potential damages exceed several hundred thousand dollars or more.

I urge the Board to clarify in the final rule that FICUs selling their loans as participations are bound to the same extent as the rule currently binds purchasers by adding the following clause to the second sentence of the umbrella part of Section 701.22:

> "... as well as the requirements a federally insured credit union must satisfy to sell a participation in a loan."

The regulation's current formulation puts purchasing FICUs in a difficult position. The purchasing FICU can attempt to contractually bind its seller to adhere to the seller's obligations–many of which are ongoing–but the purchaser faces limited choices if the seller fails to comply.

The purchaser can bring a cause of action to enforce compliance by the seller in court or arbitration, but the burden, cost, time for judicial action and potential reputational damage in the credit union community that can come with this approach make it an unrealistic option unless hundreds-of-thousands or millions of dollars at stake.

I urge the Board to remedy this situation by increasing supervision of FICUs that sell participations. Adding the above suggested language to Section 701.22 in the final rule will promote better compliance with the regulation's requirements in the ordinary course of its supervision of credit unions, as well as deter regulated sellers from reneging on their contractual obligations to purchasers.

6. The regulations should codify and clarify the principles enumerated in Legal Opinion 18-0133

The final rule should codify NCUA Office of General Counsel Legal Opinion 18-0133, which clarified that the Section 701.22 loan participation rule's and Section 701.23 eligible obligations rule's compliance obligations apply for the lifetime of the transaction, and that each separate loan participation or eligible obligation must be treated independently. Unless each loan is accounted for individually as a continuing compliance requirement for the servicer, FICUs purchasing loan participations may be short-changed or struggle to properly account and report on their transactions.

Since the Board is already taking the opportunity to codify principles enumerated in other past Legal Opinions (for example, codifying its Legal Opinion 15-0813 in § 701.22), it should do so as well for Legal Opinion 18-0133, which has been on the public record for several years.

In order to reduce compliance burdens on FICUs by reducing regulatory uncertainty, Legal Opinion 18-0133's principles should added to both Section 701.22 and Section 701.23. I urge the Board to modify these provisions as follows:

- The first sentence of Section 701.22(b) should be rewritten as: "A federally insured credit union may purchase a participation interest in a loan from an eligible organization only if the loan is one the purchasing credit union is empowered to grant and the following additional conditions are satisfied at the time of purchase and throughout the lifetime of the loan, as applicable:"

- The first sentence of Section 701.22(d) should be rewritten as: "A loan participation agreement must meet the following requirements and obligations at the time of purchase and throughout the lifetime of the loan:"

- The first sentence of Section 701.23(b)(6) should be rewritten as follows: "Purchases of eligible obligations and notes of liquidating credit unions must comply with the purchasing federal credit union's internal written purchase policies, at the time of purchase and throughout the lifetime of the loan, which must:"

Additionally, I urge the Board to clarify that the requirements of both regulations must be met throughout the lifetime of the loan, including any standard compliance and due diligence obligations, as well as the obligation to monitor the performance of the loan (for example to evaluate the ongoing performance against the initial expectations for the loan).

While proposed Section 701.23(b)(6) sets out some of these requirements regarding ongoing monitoring of borrower creditworthiness, and mentions conducting due diligence prior to the purchase, the scope of these ongoing responsibilities appears more limited than Legal Opinion 18-0133 sets forth.

Clearer language concerning FICU compliance expectations would support the NCUA Board's policy goal of clarifying ambiguities related to credit unions' responsibilities and help them maintain a framework for their ongoing operations as well as reduce examiner confusion.

For this reason, I urge the Board to add the following language to the loan participation regulation (at new paragraph Section 701.22(f)) and eligible obligation regulation (at new paragraph Section 701.23(j)):

> "Ongoing Compliance. Certain obligations for transactions under this rule are ongoing in nature and must be met throughout the lifetime of the transaction, including (but not limited to) the obligations to treat each independent loan separately and to conduct ongoing due diligence. Such ongoing due diligence includes monitoring the performance of the loan transaction over time and comparing it to the initial performance expectation for the loan at the time of purchase."

7. The proposed new definition of "indirect lending arrangement" should be clarified

I strongly support the Board's proposal to incorporate its indirect lending provision into Section 701.21(c)(9), which applies to FCU lending activities in general, as well as the Board's proposal to codify NCUA Office of General Counsel Legal Opinion 15-0813, including the proposed definition of "originating lender" in Section 701.22(a). These amendments are consistent with longstanding NCUA policy and should be finalized. I urge the Board, however, also to clarifying two elements of its proposed new definition of "indirect lending arrangement" in Section 701.21(c)(9)(i); namely, the requirements that the purchaser make the "final underwriting decision" regarding the loan, and that the loan is assigned to the purchaser "very soon after" the inception of the obligation to extend credit.

A. Credit unions still make the "final underwriting decision" when third-party indirect lending partners apply additional, more restrictive underwriting criteria than the credit union requires, which promotes safety and soundness by reducing credit risk

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

The Board should answer this question affirmatively in the final version of the rule because third parties that apply additional, more restrictive underwriting criteria than the credit union requires help to promote safety and soundness by reducing credit risk. This is effectively an administrative, loan processing function where the third party is acting as a facilitator on behalf

of the credit union to provide credit enhancements because it is not overriding the credit union's underwriting criteria.

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

I urge the Board to clarify that the credit union makes the "final underwriting decision" when its third-party indirect lending partner adds additional, more stringent underwriting criteria to help the credit union reduce credit risk by weeding out riskier loans that the credit union would have made without the assistance of the third-party's credit-risk-mitigation services. The credit union should be considered to have made the "final underwriting decision" whether the third party uses an automated loan underwriting system (ALUS) and/or a natural person individual performs this additional level of credit-enhancing underwriting on top of the credit union's pre-approved underwriting criteria.

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

In 1997, the NCUA Office of General Counsel issued Legal Opinion 97-0546[3] opining on the use of CUNA Mutual Group's "point of purchase lending (POPLS) program," which was an early computerized underwriting program that facilitated credit union members financing auto purchases at the point of sale using credit union auto loans. During this dial-up internet era, a representative of the indirect lender would input data points such as the borrower's income into the POPLS program, and the program would either approve or deny the application based on the credit union's pre-approved underwriting criteria.

While the preamble to the proposed rule cites this 1997 Legal Opinion letter to state that an "eligible organization may use an automated scoring system so long as the 'score' obtained from the automated system is the sole determinant for granting credit," in the context of the 1997 Legal Opinion about POPLS this simply meant that the third-party indirect lender should not be able to exercise judgment that created <u>an exception</u> to the credit union's underwriting criteria to

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

approve a loan that did not meet the credit union's pre-approved underwriting criteria. Significantly, the 1997 Legal Opinion did not address a third-party providing credit enhancements by applying additional, more restrictive underwriting criteria or judgment that went above and beyond the credit union's minimum underwriting standards to reduce risk.

Technology has also changed significantly since 1997, which later NCUA legal opinions reflect. In 2010, the Office of General Counsel opined in Legal Opinion 09-1044[4] that it was "permissible" for a federal credit union to bring in new members using a fully automated loan underwriting and funding system similar to how today's fintech indirect lenders' technology operates in practice. The 2010 letter, however, did not prohibit natural persons' involvement in the loan underwriting process so long as there was a separation of duties where individual disbursing the funds did not have authority to approve the loan as a "loan officer."

According to the 2010 letter,"[t]he key issue under the FCU Act is its prohibition against a loan officer who has approved a loan also being permitted to disburse funds," which the Act prohibits as an anti-corruption measure to prevent insider abuse through the separation of duties. *See* 12 U.S.C. § 1761c ("No individual shall have authority to disburse funds of the Federal credit union with respect to any loan or line of credit for which the application has been approved by him in his capacity as a loan officer.").

Similarly, as the NCUA's Office of General Counsel noted in its June 16, 2020 Legal Opinion ("Automated Loan Underwriting System - Segregation of Duties for Loan Officers"), the use of ALUS has become increasingly common to help credit unions obtain computer generated loan decisions.[5] This 2020 Legal Opinion opined that a member service representative (MSR) can disburse loan funds approved by an ALUS as long as the MSR did not have discretionary authority to override an ALUS's underwriting decision to make an exception the way a "loan officer" can. This means that the credit union needed to have policies and procedures "to prevent fraud and errors in the loan processing context by separating the loan approval and disbursement functions if certain safeguards were in place to assure that the MSR is not functioning as a 'loan officer.'"

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

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

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

Although the preamble to the proposed rule seems to imply that a 1997 NCUA legal opinion letter limited natural person individuals' involvement in indirect lending—even though the preamble says FCUs "*may* use an automated credit scoring system to make its final underwriting decision as long as the 'score' obtained from the automated system is the sole determinant for granting credit," 87 Fed. Reg. 80486 (emphasis added)—I urge the Board to clarify in the final rule that use of ALUS or similar system is permissive rather than mandatory so long as the Act's separation of duties requirement for "loan officers" is met.

All that should matter with respect to the FCU making the "final underwriting decision" is that the loan made fits within the parameters of the FCU's pre-approved underwriting criteria, whether or not the score from an ALUS is the sole determinant and/or whether human judgment was applied that resulted in more restrictive underwriting. Indirect lenders applying more restrictive underwriting than the FCU's minimum requirements improves the credit quality of credit union loans by going above and beyond the credit union's standard underwriting criteria, which enhances the safety and soundness of the credit union system by reducing credit risk.

Specifically, the Board should add a new paragraph (A) to Section 701.21(c)(9)(i) in the final rule that makes clear that the FCU makes the "final underwriting decision" so long as:

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

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

Indirect lending partners that apply additional, more stringent underwriting criteria than the credit union requires help promote safety and soundness by reducing credit risk. These third parties are simply acting as a facilitator on behalf of the credit union to provide credit enhancements because they do not override the credit union's underwriting criteria but instead weed out potentially problematic loans.

B. The "very soon" requirement should be satisfied so long as assignment of the loan occurs before the first loan payment following any downpayment

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

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

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

The time period itself should be clarified to allow for credit unions to process the assignments in cyclical batches. Many credit unions maintain a regular cadence of processing assignments in batches–whether monthly or otherwise–in a manner that is more efficient than processing each assignment on a one-by-one basis. The regulation's language should recognize this efficiency and allow for batch assignment processing at a reasonable cadence that does not disrupt operations on either side of the transaction.

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

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

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

Both of these clarifications suggested here to the proposed definition of "indirect lending arrangement" would align with the NCUA's stated goal of providing a "framework for a credit union to determine how to structure its operations" while continuing to prioritize safety and soundness considerations. 87 Fed. Reg. at 80480.

I appreciate the opportunity to comment on the proposal that would amend the NCUA's rules regarding the purchase of loan participations and the purchase, sale, and pledge of eligible obligations and other loans (including notes of liquidating credit unions).

Please feel free to contact me at 240-685-1480 or by email at medwards@creditunionslaw.com should you have any questions about my comments or would like any additional information.

Respectfully submitted,

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