

SUBJECT: Business Loans

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INTRODUCTION

This release applies to all credit unions, state and federal. It summarizes state and federal compliance requirements for commercial lending.

EXECUTIVE SUMMARY

In 2017, the NCUA overhauled its member business lending (MBL) rules. The changes did away with the former MBL rules’ “prescriptive” limits – such as collateral and security requirements, equity requirements, and loan limits – and thus eliminated the ability of covered credit unions to seek waivers from those limits when appropriate. The current NCUA rules are designed to give covered credit unions more flexibility and autonomy, shifting the rules’ focus to a “principles-based methodology” that emphasizes sound risk management practices for business lending. The changes have expanded the requirements for FCUs pertaining to MBL policies, procedures and oversight by credit union management and credit union directors.

The changes did not affect most MBL programs in Wisconsin, because state-chartered credit unions must comply with Wisconsin’s own MBL rules. (Nearly all Wisconsin credit unions are state-chartered.) Wisconsin’s MBL rules retain the “prescriptive requirements” (such as collateral and security requirements, equity requirements, and loan limits), and they preserve the ability of state-chartered credit unions to seek available waivers and exemptions.

Under §723.10 of the NCUA rules:

- Federally insured, state-chartered credit unions (FISCUs) are exempt from the NCUA’s MBL rules if the state adopts appropriate MBL rules that the NCUA approves. The NCUA will grandfather the seven states with pre-approved MBL rules. The NCUA approved Wisconsin’s MBL rules in 2002, thus exempting Wisconsin’s FISCUs from the NCUA MBL rules.

- The Wisconsin Office of Credit Unions (OCU) may continue to administer Wisconsin's MBL rules in their current format. The OCU can modify the state's MBL rules, but only in ways that are consistent with the NCUA's new MBL rules.

When Wisconsin adopted its MBL rules in 2002, they were largely patterned after the NCUA's rules for federal credit unions (FCUs). The federal rules were amended over the years, though the Wisconsin regulations have been updated only in limited ways.

For instance, effective June 1, 2025, the state followed the NCUA's example and amended its MBL rules to reflect the NCUA's definition of what is and is not an MBL.

In many other ways, however, the state and federal MBL rules are quite different. This release includes separate sections that summarize the OCU's rules for Wisconsin state-chartered credit unions and the NCUA's rules for FCUs. Take care to review the appropriate section, depending on your credit union's charter.

Exhibit A to this ii Release is an MBL sample policy that Wisconsin state-chartered credit unions can consider using as a template to help them develop an MBL policy that complies with Wisconsin law. Each credit union must review this sample thoroughly and edit it as needed to match the credit union's actual practices and procedures. Language that appears in brackets and in bold should be changed as needed. Consider deleting material that is not relevant to the credit union's member business lending process.

In addition to the MBL regulations, credit unions must keep in mind that other state and federal regulations may or may not apply to a business purpose loan. For example, whether Truth in Lending applies to a loan on a rental property can depend on several factors.

Lenders must be familiar with Article 9 of the Uniform Commercial Code (UCC), which governs transactions between a creditor and debtor where the creditor takes a security interest in certain personal property as collateral. The law addresses not only how a creditor obtains a valid security interest against collateral owned by the debtor, but also how the creditor establishes its priority in relation to other creditors.

Even lenders with properly perfected security interests in a business' assets may still find themselves in second place behind unpaid workers if the business fails. For that reason, it is important for credit unions that engage in business lending to understand Wisconsin law on wage lien priority. Employees and the Wisconsin Department of Workforce Development can assert a lien on an employer's assets in Wisconsin to secure claims for unpaid wages earned by its workers. Wisconsin law gives the wage lien "super-priority," meaning that it cuts to the head of the line in front of many other kinds of liens, even if they were filed before the wage lien.

Environmental liability concerns are heightened with commercial lending. The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) is intended to facilitate the cleanup of hazardous waste sites. Wisconsin also has environmental liability laws that apply to state and federal credit unions. A credit union could be vulnerable under these laws when foreclosing on secured property that is contaminated, but it can take some steps to limit its liability.

The NCUA Examiner's Guide points out that not all credit unions should engage in commercial/business lending:

Commercial lending is not appropriate for all credit unions. This type of lending is complex, and involves different risks than consumer lending. Managing commercial lending generally involves a greater cost to a credit union than consumer lending. If a credit union's leadership (board and management team) does not have the experience, skills, and resources to manage commercial lending, the institution should refrain from making such loans.

To properly manage the risk associated with commercial lending, a credit union should have staff with expertise and more specialized risk management experience. A credit union that offers commercial loans should maintain prudent risk management practices and sufficient capital that is commensurate with the risks associated with its commercial lending activities at all times.

COMMON TYPES OF LOANS & BUSINESS ENTITIES

The NCUA Examiner's Guide Chapter on "Commercial and Member Business Loans" includes helpful information for any credit union that engages in business lending, including a list of many typical types of commercial loans.

Credit unions should also clearly understand the business structure of an organization. There are many different types of legal entity structures, and each has its own rights and privileges. From a business and taxation perspective, each business entity type has specific advantages and disadvantages. In addition, please see The League's *ii Release No. 0161 – "Organization Accounts"* – which includes information on business organization types, including their definitions under Wisconsin law.

COMPLY WITH THE RIGHT RULES

Wisconsin state-chartered credit unions must comply with the state's MBL regulations (Wis. Admin. Code Ch. DFI-CU 72, available at www.wdfr.org).

Federal credit unions (FCUs) must comply with the NCUA's MBL and commercial lending rules (Part 723 of the NCUA regulations, available at www.ncua.gov). The NCUA rules generally apply to federally insured, state-chartered credit unions; however, in 2002, the NCUA approved Wisconsin's MBL regulations. As a result, state-chartered credit unions in Wisconsin are exempt from the NCUA rules.

It is important for credit unions to comply with the right regulations. A state-chartered credit union that follows the NCUA rules instead of the state rules may make some critical compliance errors.

This release summarizes the Wisconsin and the NCUA MBL rules. Please refer to the rules themselves for specifics.

WISCONSIN MBL RULES (FOR STATE-CHARTERED CREDIT UNIONS)

DFI-CU Regulations, Ch. 72

This section summarizes the Wisconsin Office of Credit Union's MBL rules for Wisconsin state-chartered credit unions. For complete details, credit unions must consult the regulations directly.

Applicability

The Wisconsin MBL rules, found in *Chapter 72 of the Office of Credit Union regulations*, apply to all Wisconsin state-chartered Wisconsin credit unions.

FCUs must comply with the NCUA's MBL rules (Part 723 of the NCUA regulations, available at <http://www.ncua.gov>). The NCUA rules generally apply to federally insured, state-chartered credit unions; however, in 2002, the NCUA approved Wisconsin's member business lending regulations, exempting Wisconsin state-chartered credit unions from the NCUA rules.

"Member Business Loan" Definition

DFI-CU §72.02

"Member business loan" means a loan, line of credit, letter of credit including unfunded commitments, and any interest a credit union obtains in such loans made by another lender to individuals, sole proprietorships, partnerships, corporations, or other business enterprises for commercial, industrial, agricultural, or professional purposes.

The rules make several exceptions. The following types of loans are not considered member business loans, even if they are for a business purpose:

- a) Loans for personal expenditure purposes.
- b) Loans made by a corporate credit union.
- c) Loans made by a federally insured credit union to another federally insured credit union.
- d) Loans made by a credit union to a credit union service organization.
- e) Loans secured by a one- to four-family residential property.
- f) Loans fully secured by shares in the credit union making the extension of credit or deposits in other financial institutions.
- g) Loans secured by a vehicle manufactured for household use, except that such loans will be considered member business loans if they will be used for a purpose set forth in sub. (1) and the outstanding aggregate net member business loan balance is \$50,000 or greater.
- h) Business purpose loans that are equal to or less than \$50,000 after calculating the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union held by the borrower or an associated borrower.

- i) Loans for which a federal or state agency fully insures repayment, fully guarantees repayment, or provides an advance commitment to purchase the loan in full.
- j) Any non-member business purpose loan or non-member participation interest in a business purpose loan made by another lender, provided the credit union acquired the loan or interest in compliance with all relevant laws and regulations and the credit union is not, in conjunction with another credit union, trading member business loans to circumvent the aggregate limit.

Wisconsin's MBL rules do not use the "commercial loan" definition found in the NCUA rules.

DFI interpretations of MBL exceptions

The previous subsection of this Release listed 10 loan types that are exempt from the state's MBL definition. In 2025, The League consulted with the OCU and the DFI's Chief Legal Counsel about how far certain exceptions extend and other aspects of business lending compliance. While their comments are not official legal opinions or guidance, the DFI attorney said that The League's compliance materials could summarize and quote his responses.

Participation loans

Participation loans are exempt from the definition of an MBL, and so those loans (like other types of exempt loans) do not count toward the state's MBL caps. However, participation loans are still subject to two key MBL rule requirements. This is because of a provision in the Wisconsin's credit union statutes (Wis. Stats. §186.098(9m)), which says: "A credit union may participate with other lenders in a loan of any type that the credit union may otherwise make."

That provision means that credit unions wishing to participate in business loans may only do so if they could have made the loans themselves – and that means the participating credit union must comply with what the DFI attorney described as two "basic eligibility requirements to make loans of that 'type'" under the state's MBL rules:

1. The participating credit union's board of directors must "adopt a specific member business loan policy and review it at least annually." DFI-CU 72.05(1). The credit union can tailor its policy to its activities, the DFI attorney said: "The scope of that policy could be limited to participation loans if that is the only business lending activity in which the credit union plans to engage."
2. The participating credit union must "utilize the services of an individual with at least 2 years direct experience with the type of lending in which it will engage." DFI-CU 72.05(2). The participating credit union need not have that person on staff. The rules allow them to rely on an originating credit union, CUSO, or other third party to provide the needed experience.

The DFI attorney explained: "A credit union that participates in a member business loan issued by a Wisconsin credit union in compliance with DFI-CU ch. 72 would presumably satisfy that requirement, because (1) the issuing Wisconsin credit union would necessarily have the expertise required under DFI-CU 72.05 (or else it couldn't issue the loan); and (2) the participating credit union would be relying upon, and have access to, that expertise when opting to participate in the loan."

Credit unions that work with REACH Business Lenders, LLC, may be able to rely on their staff for the experience needed. "If Reach has the necessary expertise and makes it available to credit unions that participate in the loan, the expertise prong of DFI-CU 72.05 would be satisfied for the participating credit unions," the DFI attorney wrote.

Participations in construction & development loans

As with other participation loans, credit unions participating in construction and development loans must have an appropriate policy in place. They must also rely on someone with at least five (not just two) years' experience in this type of lending. Again, the DFI attorney said, they may rely on an originating credit union, CUSO, or another third party to provide the needed experience. He also confirmed that, like any loans which are exempt from the MBL definition, participation interests in construction and development loans do not count toward the state's MBL caps.

Loans secured by multiple 1- to 4-family residential properties

"Loans secured by a one- to four-family residential property" are not considered MBLs under the Wisconsin rules. However, a loan secured by multiple one- to four-family residential properties is an MBL – a position taken by both

the DFI's attorney and the NCUA. Such a loan does not fit the state's (or the NCUA's) exemption, which only applies to a loan secured by "a" (singular) one- to four-family residential property.

The NCUA Examiners' Guide section on "Member Business Loans," under the subheading, "Commercial Loan Definition," explains how credit unions should address the risks involved in making business purpose loans secured by multiple residential properties.

Definition of "residential property"

The state's revised rules do not define the term "residential property." The DFI attorney confirmed that credit unions can look to the NCUA's definition for the meaning:

Residential property means a house, condominium unit, cooperative unit, manufactured home (whether completed or under construction), or unimproved land zoned for 1- to 4-family residential use. A boat or motor home, even if used as a primary residence, or timeshare property is not residential property.

Note that a boat, motor home, or timeshare is not a "residential property," and so business purpose loans secured by those assets do count toward the state MBL caps.

Periodic loan reviews

Wisconsin credit unions must monitor the MBLs they make. Our state MBL rules require a credit union's MBL policy to address, among other things, "General loan procedures, including all of the following: (a) Loan monitoring. (b) Servicing and follow-up. (c) Collection."

The DFI attorney offered these insights about the loan reviews:

- This monitoring requirement applies to a credit union participating in a business loan that another lender originated. Although participation interests are exempt from the definition of an MBL, participating credit unions must still have a business loan policy (as explained above), and it must address loan monitoring.
- How detailed should loan reviews be? Wisconsin's rules do not offer specifics, but the DFI attorney confirmed for us that OCU examiners follow NCUA guidance on loan reviews.

The NCUA requires that a covered credit union's commercial loan policy must address (among other things): "Risk management processes commensurate with the size, scope and complexity of the federally insured credit union's commercial lending activities and borrowing relationships. These processes must, at a minimum, address the following: ... Periodic loan review, consistent with loan covenants and sufficient to conduct portfolio risk management. This review must include a periodic reevaluation of the value and marketability of any collateral ..."

The NCUA Examiner's Guide materials on commercial loan policies expands on this requirement, saying: "The credit union loan policy must set forth the requirements for periodic loan relationship review. The periodic review requirements should include frequency of site visits, periodic financial reporting, and comprehensive review of the relationship."

This section of the Examiner's Guide goes into much more detail on periodic reviews. Wisconsin credit unions should review this material and ensure that their business lending policies and procedures comply with it.

- Participating credit unions may rely on third parties to perform business loan reviews. The DFI attorney wrote: "Under the circumstances described in my prior emails (i.e., participations in MBLs issued by Wisconsin CUs in compliance with DFI-CU ch. 72, where the participating CU is relying upon – and has access to – the lending CU's expertise), the participating CU could also rely on the lending CU's monitoring, provided such reliance is reasonable under the circumstances." Presumably, participating credit unions might be able to rely on REACH Business Lenders, LLC, to provide these reviews, as well, though the DFI attorney did not address this specifically.
- The Wisconsin rules do not say how often loan reviews should be done, and the NCUA rules only call for "periodic" reviews. However, the NCUA Examiner's Guide explains that "It is a standard practice to review the commercial relationship at least annually (more frequently if there is a change in the risk)."

The League cautions against explicitly requiring reviews every 12 months in your business loan policies. That's because in some situations, such as where a business borrower has been given an extension, it might make sense to delay the review for a time.

Prohibited MBLs*DFI-CU §72.03*

A credit union may not grant business loans to:

- Its chief executive officer (such as its president, treasurer or manager);
- Any of its assistant chief executive officers (such as assistant president, vice president, or assistant treasurer/manager); or
- Its chief financial officer or comptroller.

The credit union also cannot make an MBL to an immediate family or to an “associated member” of anyone listed above. “Associated member” means anyone associated with one of these people “by means of a shared ownership, investment or other pecuniary interest in a business or commercial endeavor.”

MBLs can be granted to a credit union director only if the credit union board of directors approves the loan and the director is recused from the board’s decision-making process.

Additionally, the credit union cannot grant an MBL if any additional income received by the credit union or its senior management employees is tied to the profit or sale of the business for which the loan is made.

Member Business Loan Policy*DFI-CU §§72.05 & .06*

To engage in business lending, a credit union’s board of directors must adopt a business loan policy and review it annually. The policy must address:

- The types of business loans that will be made.
- The trade area.
- The maximum amount of assets in relation to net worth that will be:
 - Invested in business loans;
 - Invested in a given category or type of MBL; and
 - Loaned to any one member or group of associated members (subject to restrictions discussed later in this release).
- The qualifications and experience of personnel involved in making and administering business loans.
- A requirement to analyze and document the ability of the borrower to repay the loan.
- A requirement for the receipt and periodic updating of financial statements and other documentation, including tax returns.
- A requirement for documentation sufficient to support each request to extend credit, or increase an existing loan or line of credit, including all of the following:
 - Balance sheet;
 - Cash flow analysis;
 - Income statement;
 - Tax data;
 - Analysis of leveraging;
 - Comparison with industry average or similar analysis.
- The rule allows the policy to include exceptions to specific documentation requirements where the board of directors:

- Finds that the required documentation is not generally available for a particular type of loan, and
- States the reasons for those findings in the credit union's written policies.
- The collateral requirements, which include:
 - Loan-to-value (LTV) ratios;
 - Determination of value;
 - Determination of ownership;
 - Steps to be taken to secure various types of collateral; and
 - How often the credit union will re-evaluate the value and marketability of collateral.
- The interest rates and maturities of business loans.
- Loan procedures including loan monitoring, collection, servicing and follow-up.
- The identification of those individuals prohibited from receiving MBLs.
- Guidelines for the purchase and sale of member business loans and loan participations, if the credit union intends to engage in those activities.

Exhibit A to this ii Release is an MBL sample policy that Wisconsin state-chartered credit unions can consider using as a template to help them develop an MBL policy that complies with Wisconsin law. Each credit union must review this sample thoroughly and edit it as needed to match the credit union's actual practices and procedures. Language that appears in brackets and in bold should be changed as needed. Consider deleting material that is not relevant to the credit union's member business lending process.

Collateral & Security Requirements

DFI-CU §72.07

State regulations generally require MBLs to be secured by collateral unless the credit union obtains a waiver from regulators, although unsecured MBLs are allowed in certain situations.

Collateral requirements: If the credit union will have a first lien on collateral, the LTV ratio cannot exceed 80% unless the value greater than 80% is either:

- Covered by private mortgage insurance (or similar coverage) and the LTV ratio is not more than 95%; or
- Insured, guaranteed, or subject to a commitment to purchase, by a government agency, and the LTV ratio is not more than 95%.

The same limits apply if the credit union will have both a first lien and a second or lesser priority lien on the same collateral.

However, if the credit union will have only a second or lesser priority lien on collateral (without a first lien), the LTV ratio cannot exceed 80%.

Wisconsin's MBL rules for state-chartered credit unions do not include exemptions from the LTV ratio rules for loans to purchase certain consumer-type vehicles that are used for commercial purposes.

As explained later in this release, Wisconsin allows its state-chartered credit unions to seek waivers from the LTV requirements.

Separate equity requirements, explained later in this release, apply to construction and development loans.

Unsecured MBLs: Credit unions can offer credit card line of credit programs to "non-natural persons" (that is, organizations) that are limited to routine purposes normally made available under those programs.

Credit unions can only make unsecured MBLs (other than credit card lines of credit) if:

- The amount of the loan or loans to any one individual does not exceed 1% of the credit union's net worth.

- The aggregate (i.e., total) of the unsecured business loans does not exceed 10% of the credit union's net worth.
- The credit union has a net worth ratio of at least 7%.
- The credit union submits reports to the Office of Credit Unions with its NCUA call reports, providing data to demonstrate compliance with these requirements.

The Wisconsin rules do not provide for state-chartered credit unions to obtain waivers from the limit on total unsecured MBLs.

Personal guaranties: The Wisconsin rules for state-chartered credit unions do not generally require personal guaranties from the “principals” of a business. Even though the Wisconsin rules do not address personal guaranties, state-chartered credit unions should still strongly consider requiring them, to help insure payment of an MBL if the business fails. The League does not offer a personal guarantee form, but forms are available from other vendors, including TruStage.

Experience Requirements

DFI-CU §72.05 & 72.06(6)

In making MBLs, the credit union must use the services of someone with at least two years’ direct experience in the type of lending the credit union will engage in (five years’ for state-chartered credit unions if construction or development lending is involved). The regulations do not require credit unions to hire staff to meet this requirement. They can use an independent contractor, another credit union’s employee or CUSO services, but the actual decision to grant a loan must remain with the credit union.

The credit union’s MBL policy must address the qualifications and experience of the personnel involved in making and administering business loans.

Conflicts of interest

The Wisconsin rules have no conflict-of-interest provisions for state-chartered credit unions using the services of a third party to meet the experience requirements; however, Wisconsin credit unions are subject to NCUA guidance on third-party relationships, which says that credit unions should consider any conflict of interest a vendor may have.

Experience rule for construction or development lending

The Wisconsin rules for state-chartered credit unions do not allow a credit union to engage in construction or development lending unless it uses the services of someone with at least five years’ (not just two years’) direct experience in that type of lending.

Limit on Credit Union’s Total MBLs

DFI-CU §§72.14 to .16

Wisconsin rules limit the total “amount of a credit union’s member business loans” to the lesser of:

- 1.75 times the credit union’s net worth, or
- 12.25% of the credit union’s total assets.

Under DFI-CU 72.01(1), “amount” means the outstanding balances, any unfunded commitments, and any undisbursed proceeds of a loan. As explained earlier in this release, the definition of MBL has a number of exceptions. For example, loans that are fully secured by shares or deposits are not considered MBLs.

Requesting exceptions to these limits

Certain credit unions can request an exception from this MBL cap:

- If the credit union has a low-income designation or community development credit union. (See *ii Release No. 0165* for information on low-income and community development credit unions.)
- If the credit union can show that it was chartered for the purpose of making business loans. Documentary evidence that could be used for this purpose includes, for example, the credit union’s charter, bylaws, business plan, field of membership, board minutes and loan portfolio.

The exceptions are not automatic; credit unions must submit supporting documentation and request an exception. State-chartered credit unions make the request with the Director of the Office of Credit Unions, which then forwards it to the NCUA for final approval. Exceptions are not effective until approved.

The Wisconsin rules do not include a time limit for regulators to act on exception requests.

The rules also allow credit unions to ask for “waivers” from certain MBL requirements, as explained later in this release. Those waiver rules are different from these “exceptions” to the aggregate MBL limits.

Limit on MBLs to One Member or Associated Members

DFI-CU §§72.08 to .09

The Wisconsin regulations limit the aggregate (that is, total) amount of MBLs that a credit union can make to any one member or group of associated members; however, credit unions can obtain waivers from this limit, as explained later in this release.

The limit is the greater of:

- 15% of the credit union’s net worth, or
- \$100,000.

“Associated member” means a member that has a shared ownership, investment or other pecuniary interest in a business or commercial endeavor with another member.

To calculate this 15% limit, first add the amount of MBLs to the member and any associated members. (The “amount” of MBLs means the outstanding balances, any unfunded commitments, and any undisbursed loan proceeds.) Next, subtract MBLs (or any portion of an MBL) that are:

- Secured by shares in the credit union or deposits in another financial institution;
- Fully or partially insured or guaranteed by a government agency; or
- Subject to an advance commitment to purchase by a government agency.

Divide the remaining figure by the credit union’s net worth.

Limits on unsecured MBLs to one member

Earlier subsections of this release, under “Collateral & Security Requirements,” described state limits on the total amount of *unsecured* MBLs that may be made to a member or group of associated members.

Construction and Development Loans

DFI-CU §72.04

Wisconsin regulations limit a credit union’s total construction and development loans to 15% of the credit union’s net worth; however, credit unions can obtain waivers from this limit, as explained later in this release.

In calculating the limit, do not include any portion of a loan that is:

- Secured by shares or deposits in the credit union or in another financial institution; or
- Insured or guaranteed by, or subject to an advance commitment to purchase by, any agency or political subdivision of the state or federal government.

The release of funds must be subject to:

- On-site inspections.
- Written inspection reports by qualified personnel.
- A preapproved schedule for draws.

“Construction or development loan” definition

The Wisconsin regulations for state-chartered credit unions define a construction or development loan as “a financing arrangement for acquiring real property or rights to real property, including land or structures, with the intent to develop or improve it” for:

- Residential housing for sale,
- Income property,
- Commercial use,
- Industrial use, or
- Any similar uses.

Borrower equity requirements

The borrower must have at least:

- 30% equity in the project if the loan is for land development; and
- 25% equity in the project if the loan is for construction, or for a combination of development and construction.

Experience rule for construction or development lending

The Wisconsin rules do not allow a state-chartered credit union to engage in construction or development lending unless it uses the services of someone with at least five years’ (not just two years’) direct experience in that type of lending.

Waivers*DFI-CU §§72.10 & .11*

State regulations let credit unions ask for waivers from many of the limits on business lending. State-chartered credit unions make the request with the Director of the Office of Credit Unions, which then forwards it to the NCUA for final approval.

Wisconsin state-chartered credit unions can ask the Office of Credit Unions for a waiver from the following:

- Construction and development loan requirements;
- Loan to value ratio requirements;
- The maximum loan limit to a member or group of associated members; and
- Appraisal requirements under NCUA Regs. §722.3.

Credit unions requesting a waiver must also submit:

- A copy of its member business loan policy;
- The higher limit sought, if applicable;
- An explanation of the need to raise the limit, if applicable;
- Documentation supporting the credit union’s ability to manage this activity; and
- An analysis of the credit union’s prior experience making MBLs, including:
 - The history of loan losses and loan delinquency;
 - Volume, and cyclical or seasonal patterns;
 - Diversification;
 - Concentrations of credit to a member and associated members in excess of 15% of net worth;

- Underwriting standards and practices;
- Types of loans grouped by purpose and collateral; and
- The qualifications of personnel responsible for underwriting and administering member business loans.

The Office of Credit Unions has 45 calendar days to act on waiver requests, in consultation with the NCUA Regional Director. If it does not notify the credit union within that time, the request is deemed to be approved.

NCUA MBL RULES (FOR FEDERAL CREDIT UNIONS)

NCUA Regulations Part 723

This section summarizes the NCUA regulations on member business loans and commercial lending, as of January 2017. For complete details, credit unions must refer to the regulations directly (Part 723 of the NCUA regulations, available at www.ncua.gov).

Consult the NCUA Examiner's Guide

Covered credit unions should consult closely with *the NCUA Examiner's Guide* chapter "Commercial and Member Business Loans." It describes in detail the examiners' expectations for a commercial lending program. It includes examples, explanations and commentary that go well beyond the summary provided in this release.

Applicability

FCUs must comply with the NCUA's MBL rules.

The NCUA rules also generally apply to all federally insured, state-chartered credit unions; however, in 2002, the NCUA approved Wisconsin's MBL regulations. As a result, state-chartered credit unions in Wisconsin are exempt from the NCUA rules summarized in this section, and they should consult the previous section of this release for information on Wisconsin MBL rules.

Purpose and Scope

NCUA Regs. §723.1(a)

Part 723 of the NCUA regulations establishes policy and program responsibilities that a credit union must adopt and implement as part of a safe and sound commercial lending program. It also incorporates the statutory constraints in §107A of the *Federal Credit Union Act*, which limits the aggregate amount of Member Business Loans (MBLs) that a credit union has on its balance sheet to the lesser of 1.75 times the actual net worth of the credit union or 1.75 times the minimum net worth required under the Act for a credit union to be well-capitalized.

Exemption for Small Credit Unions with Limited Commercial Lending Activities

NCUA Regs. §723.1(b)(1)

Part 723 of the NCUA regulations applies to all federally insured credit unions (though Wisconsin state-chartered credit unions are exempt because they are subject to MBL regulations from the Wisconsin OCU).

However, a small credit union that holds a relatively small amount of commercial loans compared to its net worth and infrequently originates and sells commercial loans is exempt from certain sections of the NCUA rules:

- §723.3, titled "Board of directors and management responsibilities," and
- §723.4, titled "Commercial loan policy."

To qualify for the exemption, a credit union must satisfy all of the following conditions:

- Less than \$250 million in total assets.
- Aggregate amount of outstanding commercial loan balances and unfunded commitments, plus any outstanding commercial loan balances and unfunded commitments of participations sold, plus any outstanding commercial loan balances and unfunded commitments sold and serviced by the credit union total less than 15% of the credit union's net worth (which is the aggregate amount of outstanding commercial loan balances and unfunded commitments amounts includes any such balances outstanding, including those that were originated and purchased by the credit union).

This threshold is measured against all commercial loans in a credit union's portfolio, as well as whole commercial loans or commercial loan participations a credit union has sold but continues to service. For example, suppose a credit union has \$20 million commercial loans including unfunded commitments. In addition, the credit union has sold \$10 million commercial loan participations, including unfunded commitments, and \$5 million whole commercial loans, including unfunded commitments with servicing retained. In this example, the aggregate amount of commercial loans that need to be measured against the 15% of net worth threshold would be \$35 million.

- Amount of commercial loans originated and sold (which the credit union does not continue to service) total less than 15% of the credit union's net worth in a given calendar year.

All credit unions must have a board-approved loan policy covering their lending activity in general, including those credit unions that qualify for this exemption. A credit union that meets the criteria outlined above is only exempt from the specific policy and infrastructure requirements of §723.3 and §723.4. Exempt credit unions must ensure their general loan policy (required by Part 701 of the NCUA regulations) covers the types of commercial loans the institution makes, including satisfying all other applicable commercial lending requirements in the rule.

“Commercial Loan” Definition

NCUA Regs. §723.2

The NCUA commercial lending regulations apply, with some exceptions, to any “commercial loan” made by a covered credit union.

The term “commercial loan” means any loan, line of credit, or letter of credit (including any unfunded commitments) made to an individual, sole proprietorship, partnership, corporation, or other business enterprise for commercial, industrial, agricultural, or professional purposes (but not for personal expenditure purposes). This includes any interest a credit union obtains in a commercial loan made by another lender (such as a participation) as outlined in §723.2.

Excluded from the definition of “commercial loans” are loans:

- Made by a corporate credit union;
- Made by a federally insured credit union to another federally insured credit union;
- Made by a federally insured credit union to a credit union service organization;
- Secured by a 1- to 4- family residential property (whether or not it is a borrower's primary residence);
- Fully secured by shares in the credit union making the loan or deposits in other financial institutions;
- Secured by a vehicle manufactured for household use; and
- That would otherwise meet the definition of commercial loan and which, when the aggregate outstanding balances plus unfunded commitments less any portion secured by shares in the credit union to a borrower or an associated borrower, are equal to less than \$50,000.

See *NCUA Legal Opinion Letter 16-0604*, which explains: “When a single closed-end MBL is paid down below \$50,000, the loan no longer needs to be classified as an MBL, and the FICU does not need to count it toward its statutory MBL limit. ... When the member pays down the amount of the total business purpose loans owed to the credit union so that the aggregate amount falls below the \$50,000 threshold, the credit union is no longer required to report the [loan that caused the aggregate amount of business purpose loans to the member to exceed the \$50,000 threshold] as an MBL.” However this approach is specific to closed-end loans, as explained in *NCUA Legal Opinion Letter 02-0384*, which says: “We note, however, that a CU may not use outstanding balances in this context on lines of credit due to the member's ability to draw on the line and easily alter the MBL's outstanding balance.”

Commercial loans include loans made to members, as well as purchased non-member loans and participations.

Vehicle exception

The term “loan secured by a vehicle manufactured for household use” is defined to mean “a loan that, at origination, is secured wholly or substantially by a lien on a new and used passenger car and other vehicle such as a minivan, sport-

utility vehicle, pickup truck, and similar light truck or heavy-duty truck generally manufactured for personal, family or household use ...”

However, loans primarily secured by fleet vehicles or vehicles to carry fare-paying passengers are considered commercial loans. In addition, a loan to a vehicle dealership or seller to replenish inventory of vehicles for sale (a so-called “floor plan loan” or “vehicle inventory loan”) secured by those vehicles is a commercial loan.

Residential property exception

Loans secured by a 1- to 4- family residential property, whether or not it is the borrower’s primary residence (that is, owner or non-owner occupied) are not commercial loans.

The term “loan secured by a 1-4 family residential property” means any loan secured (at origination) wholly or substantially by a lien on a 1- 4 family residential property for which the lien is central to the extension of credit. A loan is wholly or substantially secured by a lien on a 1-to-4 family residential property if the estimated value of the real estate collateral at origination (after deducting any senior liens held by others) is greater than 50 % of the principal amount of the loan.

The term “residential property” means a house, condominium, cooperative unit, manufactured home, and unimproved land zoned for 1- to 4- family residential use. A boat or motor home, even if used as a primary residence, or timeshare property is not residential property. Recreational-type vehicles, such as campers, are not residential property.

Even though such loans are not “commercial loans,” the NCUA Examiner’s Guide urges caution when residential properties are used for business or investment purposes:

[T]hese loans have risk characteristics more similar to commercial real estate loans than those of owner-occupied 1- to 4- family residential loans. A credit union should have credit risk management policies and processes suitable for the risks specific to this type of lending. Underwriting standards and the complexity of risk analysis should increase as the number of properties financed for a borrower and associated borrowers increases. When a borrower finances multiple properties and the repayment of a loan depends on the successful operation of the multiple residential rental units, a comprehensive global cash-flow analysis of the borrower and principal is generally necessary to properly underwrite and administer the credit relationship. In such cases, a credit union should analyze and administer the relationship on a consolidated basis.

Whether or not a loan is a “commercial loan” under the NCUA rules, credit unions must separately determine if the loan is a consumer or “business purpose” loan for Truth in Lending / Reg. Z purposes. See the material later in this release, under the heading “Other Regulatory Compliance Issues” and the subheading “Reg. Z & Rental Properties” for a summary of how Reg. Z treats owner-occupied and non-owner-occupied rental property loans.

Commercial loans vs. MBLs

A commercial loan is any loan, line of credit, or letter of credit (including any unfunded commitments) made to an individual, sole proprietorship, partnership, corporation, or other business enterprise for commercial, industrial, agricultural, or professional purposes (but not for personal expenditure purposes). Various types of loans are excluded from this definition, as listed in the previous section. For example, loans secured by 1- to 4-family residential property (owner-occupied or not) are not considered “commercial” loans.

The NCUA regulations define MBL to mean “any commercial loan ... except” for certain categories of loan. In other words, MBLs are a subset of commercial loans (whether the credit union makes the loan directly or purchases a loan participation.) It’s important to understand the difference, in order to properly calculate the rule’s limits on MBLs. The following types of loans *are not* MBLs, so they don’t count toward the aggregate MBL limit:

- Any commercial, industrial, agricultural, or professional loan in which a federal or state agency (or its political subdivision) has committed to fully insure repayment, fully guarantee payment, or provide an advance commitment to purchase the loan in full.
- Any non-member commercial loan or non-member participation interest in a commercial loan made by another lender. (In other words, non-member loan participations do not count towards an FCU’s MBL cap.) A credit union must acquire a non-member loan or non-member participation interest in compliance with applicable laws and regulations and must not swap or trade MBLs with other credit unions to circumvent the statutory aggregate limit. A credit union that demonstrates a pattern or practice of evading the MBL cap, as with any other regulatory violation, is subject to supervisory action.

- Any loan that is secured by a lien on a 1- to 4-family dwelling.

One type of loan is *not* a commercial loan but *is* defined as an MBL for purposes of calculating the 1.75% aggregate MBL limit (which is described later in this release): Loans secured by a vehicle manufactured for household use, but which will be used for a commercial, corporate, or other business investment property or venture, or agricultural purpose, if the outstanding net member business loan balance is greater than \$50,000.

In addition, loans recognized as commercial loans must be evaluated based on the risk management principles outlined in the NCUA commercial loan rules.

In all cases, a credit union should perform appropriate risk assessment to ensure a loan is supported by a reliable and adequate repayment source.

The following chart summarizes which loans are commercial loans vs. MBLs.

“Associated Borrower” Definition

NCUA Regs. §723.2

The NCUA’s commercial lending rules define an “associated borrower” as any person or entity that has a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with a borrower. This means any person or entity named as a borrower or debtor in a loan or extension of credit. Associated borrowers also include any person or entity (such as a drawer, endorser, or guarantor) that is engaged in a common enterprise with a borrower, or that derives a direct benefit from a loan to a borrower. Exceptions are made for partnerships, joint ventures and associations, as discussed later in this section.

The NCUA Examiner’s Guide explains the importance of identifying “associated borrowers”:

Consistent with common industry practice, credit unions should make credit decisions based on a full understanding of the risks posed by commercial borrowers. Such risks include the potential impact of the influence associated individuals or entities have on a borrower. Influence stems from interdependent business actions between different borrowers, reliance on repayment from other borrowers, and borrowers that share common management and ownership. In some cases, such influence can have a material impact on a borrower’s operational activities or loan repayment ability. ...

Understanding the concept of an associated borrower is critical to ensure a lender aggregates total credit risk exposure to a borrower and avoids undue concentrations relative to the lender’s net worth.

Credit unions should require commercial borrowers to disclose associated individuals and entities in order to fully identify all influences on a borrower. A credit union should understand the overall borrowing relationship, and perform an appropriate risk assessment based on available information. Associated borrower relationships can be complex, and credit unions should have consistent and definitive criteria for identifying associated individuals and/or entities.

Determining the associated borrower relationship

An associated borrower relationship exists when:

- A borrower (person or entity) receives a “direct benefit” from the proceeds of a loan to another borrower (person or entity), or
- A borrower is engaged in a “common enterprise” with another borrower (of the credit union).

When a direct benefit or common enterprise exists amongst borrowers, loans to the borrowers must be aggregated and the total applied against the regulatory limit on loans to one borrower or group of associated borrowers as defined in NCUA Regs. §723.4(c) and discussed later in this release.

Direct benefit: A direct benefit is established when the proceeds of a loan or extension of credit to a borrower, or assets purchased with those proceeds, are transferred to another person or entity. A direct benefit is not established in the event of a bona fide arm’s length transaction, in which the proceeds of a loan are used to acquire property, goods, or services. For examples, see the *“Associated Borrower” material* in the NCUA Examiner’s Guide.

Common enterprise: There are three tests a credit union can use to determine if a borrower is engaged in a common enterprise with another borrower. A common enterprise is established if one or more of these tests are met: 1) the

common source of repayment test; 2) the common control and financial interdependence test; or 3) the majority voting rights in business acquisition test.

1. Common source of repayment test.

This test is satisfied if: a) the expected source of repayment for each loan or extension of credit is the same for each borrower, and b) no individual borrower has another source of income from which the loan (together with the borrower's other obligations) may be fully repaid.

An employer will not be treated as a source of repayment because of wages and salaries paid to an employee, unless the standards described in the second test for common control and financial interdependence described below are met.

This test focuses on the ultimate source of repayment. Credit unions should have a full understanding about the primary source of revenue that a borrower has to repay its loans. Such an understanding is the only way to establish whether different loans have a common repayment source.

In more complex business arrangements, an operating entity that delivers goods and services to the end user generates income. Such an operating entity may lease equipment, real estate, or management service from supporting entities. Because the supporting entities depend on the operating entity for revenue they need to make their loan payments, loans to the supporting entities have the same source of repayment as loans to the operating entity.

For further discussion and examples of the common source of repayment test, see the *"Associated Borrower" material* in the NCUA Examiner's Guide.

2. Common control and financial interdependence test.

A common enterprise exists when borrowers are related by "common control" (or one borrower controls the other) and there is "substantial financial interdependence" between the borrowers.

A borrower (person or entity) is deemed to have "common control" of another borrower when it:

- Owns, controls, or has the power to vote 25% or more of any class of voting securities of another person or entity; or
- Controls, in any manner, the election of a majority of the directors, trustees, or other persons exercising similar functions of another person or entity; or
- Has the power to exercise a controlling influence over the management or policies of another person or entity.

When evaluating a borrowing relationship, a credit union should first identify the owners of each related borrower and each owner's ownership interest. Owners with more than 25% or more ownership meet the first condition. A credit union should then determine if the borrowers meet the second condition for financial interdependence.

The "financial interdependence" condition focuses on intercompany transfers of funds, whether in the form of fees paid for goods or services or in the form of inter-company loans, dividends, and other distributions to owners, capital contributions, and similar payments. There is substantial financial interdependence between borrowers when 50% or more of one borrower's gross receipts or gross expenditures (on an annual basis) are derived from transactions with another borrower. Gross receipts and expenditures include gross revenues or expenses, intercompany loans, dividends, capital contributions, and similar receipts or payments.

For further discussion and examples of the common control and financial interdependence test, see the *"Associated Borrower" material* in the NCUA Examiner's Guide.

3. Majority voting rights in business acquisition test.

A common enterprise exists when separate borrowers obtain loans or extensions of credit to acquire a business enterprise in which the borrowers will own more than 50% of the voting securities or voting interests.

The third test requires aggregating the ownership interest of separate borrowers that have used loan proceeds to purchase an interest in an entity. If the aggregated ownership of those borrowers is higher than 50% or if they

control 50% of the voting rights, the borrowers are engaged in a common enterprise and are considered associated borrowers.

For further discussion and examples of the Majority voting rights in business acquisition test, see the *“Associated Borrower” material* in the NCUA Examiner’s Guide.

Partnership exclusion

There are three exceptions to the associated borrower for partnerships, joint ventures and associations. For discussion and examples of each exception, see the *“Associated Borrower” material* in the NCUA Examiner’s Guide.

- *First exception:* If the borrower is a partnership, joint venture or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is a member or partner of the borrower, and neither a direct benefit nor a common enterprise exists, such other person is not an associated borrower.

This exception excludes the associated debt of a member or partner when the borrower is a partnership, joint venture or association – except when a direct benefit or common enterprise exists between the member or partner and the borrower (partnership, joint venture or association). However, the partnership, joint venture, or association loan is an associated debt of the member or partner when the member or partner is directly liable for that debt.

In this case, a direct benefit or common enterprise only exists when loans or extensions of credit are made to the member or partner to purchase an interest in the partnership, joint venture or association.

- *Second Exception:* If the borrower is a member or partner of a partnership, joint venture, or association, and the other entity with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is the partnership, joint venture, or association and the borrower is a limited partner of that other entity, and by the terms of a partnership or membership agreement valid under applicable law, the borrower is not held generally liable for the debts or actions of that other entity, such other entity is not an associated borrower.

As the members and partners of partnerships, joint ventures, and associations are liable for the borrowing entity’s debt, the debts of the borrowing entities are included in the associated borrower calculation for each member or partner unless the partner or member is a limited partner. By law, limited partners are not liable for the partnership debt. The borrowing partnership’s debts should not be included in the calculation of the aggregate associated debt of the individual limited partners.

- *Third Exception:* If the borrower is a member or partner of a partnership, joint venture, or association, and the other person with a shared ownership, investment, or other pecuniary interest in a business or commercial endeavor with the borrower is another member or partner of the partnership, joint venture, or association, and neither a direct benefit nor a common enterprise exists, such other person is not an associated borrower.

This exception establishes that the related debt of one partner or member is not an associated debt of the other partners or members. Members or partners of a partnership, joint venture, or association are not considered associated borrowers of the other members or partners of the partnership, joint venture, or association unless there is either a direct benefit or a common enterprise.

Other NCUA Commercial Lending Definitions

NCUA Regs. §723.2

The NCUA commercial lending regulations include a number of definitions, beyond those already discussed in this release:

- *“Credit risk rating system”* means a formal process that identifies and assigns a relative credit risk score to each commercial loan in a credit union’s portfolio, using ordinal ratings to represent the degree of risk. The credit risk score is determined through an evaluation of quantitative factors based on financial performance and qualitative factors based on management, operational, market, and business environmental factors.
- *“Immediate family member”* means a spouse or other family member living in the same household, for purposes of the NCUA’s commercial lending rules.

Note that for field of membership purposes, the term may be defined differently. For example, as explained in The League’s *ii Release No. 0001 – “Membership”*:

- Membership in state-chartered credit unions is open to the immediate family of any qualified person. Wis. Stats. §186.02(2)(c). State statutes do not define who is an immediate family member, though the model bylaws for state-chartered credit unions define the term. Credit unions may amend their bylaws to delete it or to create their own definition.
- Membership in federal credit unions is open to members of an eligible person's immediate family or household. Immediate family members may include a grandparent, parent, spouse, sibling, child, grandchild, stepparent, stepchild or stepsibling. See the NCUA *Chartering and Field of Membership Manual* for interpretations. Federal credit union bylaws may include a more restrictive definition of who is an immediate family member. FCU Bylaws, Article XVIII, Sec. 2.
- “*Loan-to-value ratio (LTV)*” means, with respect to any item of collateral, the aggregate amount of all sums borrowed and secured by that collateral, including outstanding balances plus any unfunded commitment or line of credit from another lender that is senior to the credit union's lien position, divided by the current collateral value. The current collateral value must be established by prudent and accepted commercial lending practices and comply with all regulatory requirements. For a construction and development loan, the collateral value is the lesser of cost to complete or prospective market value, as determined in accordance with §723.6, described later in this release.
- “*Net worth*” means a covered credit union's net worth as defined in NCUA's Regulations, Part 702.
- “*Readily marketable collateral*” means a financial instrument or bullion that is salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations based upon actual transactions on an auction or similarly available daily bid and ask price market.

Board of Directors and Management Responsibilities

NCUA Regs. §723.3

As explained earlier in this release, a small credit union that holds a relatively small amount of commercial loans compared to its net worth and infrequently originates and sells commercial loans is exempt from certain sections of the NCUA rules, including this section on the duties of directors and management.

A credit union's board is responsible for ensuring that the institution's commercial lending program is administered in a safe and sound manner and in compliance with applicable laws and regulations. The board of directors and senior management have crucial roles in maintaining a safe and sound commercial loan program.

A key principle in the NCUA's MBL and commercial lending rules is that a credit union's board of directors is ultimately accountable for the safety and soundness of the credit union's commercial lending activities. The board must remain adequately informed about the level of risk in a credit union's commercial loan portfolio. The rule reinforces the fiduciary responsibility of a credit union's board for maintaining the safety and soundness of the institution, hiring competent staff, establishing appropriate policies and procedures, and for providing adequate oversight.

Adequate experience and expertise are essential to a safe and sound commercial lending program. Credit union personnel involved in commercial and member business lending must meet certain experience and expertise requirements. Experience requirements are delineated between the qualifications required for a credit union's senior executive officers and its staff. By having experienced and risk-management oriented senior management oversee commercial lending, credit unions are more likely to ensure that loans are granted safely, that staff possess necessary skills, and that loans are well structured to meet the needs and interests of members. Credit unions have options for how they can meet experience requirements. Credit unions may rely on internal personnel, external personnel, or a combination of the two to satisfy their staffing needs.

Board of directors

Under NCUA Regs. §723.3(a), the board of a credit union subject to the NCUA's MBL rules must:

- Approve the commercial loan policy;
- Ensure the credit union appropriately staffs its commercial lending program in compliance with §723.3(b); and
- Understand and remain informed about the nature and level of risk in the commercial loan portfolio, including its potential impact on the credit union's earnings and net worth.

The board of directors must approve a commercial loan policy that complies with §723.4. The board should periodically reassess policies, since commercial loans are subject to business and economic changes that warrant

frequent monitoring to ensure policy requirements remain effective. The policy must be reviewed at least annually and more frequently if there is material change in a credit union's portfolio performance or in economic conditions. The policy should be updated when warranted, and any policy updates must be approved by the board of directors.

To ensure effective governance, a credit union's board of directors must understand the nature and level of risk associated with the institution's commercial lending program and receive periodic updates from credit union management on the performance of the commercial loan portfolio. These updates should include, but are not limited to:

- Credit risk rating distribution and migration;
- Loan growth;
- Delinquencies;
- Charge offs;
- Workout activities;
- Concentration by loan types, geographic areas, industries, etc.;
- Policy exceptions;
- Watch list loans;
- Status of individual loan review and other risk monitoring; and
- Adherence to policy and regulations.

It is also the board of directors' responsibility to ensure that credit union management takes the necessary steps to identify, measure, monitor, and control these risks. This includes approving dollar thresholds for annual reviews, loan approvals, delegated approval authorities, exceptions, as well as exception thresholds.

The board of directors and senior management must also ensure their commercial lending program is staffed with personnel that have demonstrated appropriate expertise in managing the type of commercial lending in which the credit union is engaged. For example, if a credit union wants to engage in commercial lending activities to finance farm equipment, acquisition of farmland, or production expenses related to farming or ranching, it needs to ensure its staff has expertise in underwriting, servicing, identifying, and managing risks associated with agricultural loans.

Senior management

Under NCUA Regs. §723.3(b)(1), the senior executive officers responsible for overseeing the commercial lending function a credit union that is subject to the NCUA's MBL rules must:

- Understand the credit union's commercial lending activities;
- Have a comprehensive understanding of the role of commercial lending in the credit union's overall business model; and
- Establish risk management processes and controls necessary to conduct commercial lending activities safely.

A credit union's board of directors relies on senior management to directly oversee risk management activities and verify they are consistent with board policy. It is essential that senior executive officers have a comprehensive understanding of the credit union's commercial lending activities and the ability to adequately oversee the management of the risks associated with those activities. Senior executive officers must ensure the credit union implements appropriate risk management processes to measure, monitor and control risks. Further, any staff involved in a credit union's commercial loan program must have sufficient expertise in assessing and managing the risks associated with the type of commercial lending in which a credit union is engaged. Skills should be commensurate with each particular individual's position and level of responsibility.

Managers responsible for a credit union's commercial lending program should have demonstrated experience in:

- Overseeing commercial credit risk assessment and underwriting;
- Managing and administering a credit risk rating system;

- Managing a commercial loan portfolio and being held accountable for the risk in that portfolio; and,
- Managing commercial lenders and other risk managers.

Qualified lending personnel

Under NCUA Reg. §723.3(b)(2), a credit union subject to the NCUA's MBL rules must employ qualified lending personnel with experience in the following areas:

- Underwriting and processing for the types of commercial lending in which the credit union is engaged;
- Overseeing and evaluating the performance of a commercial loan portfolio, including rating and quantifying risk through a credit risk rating system; and,
- Conducting collection and loss mitigation activities for the types of commercial lending in which the credit union is engaged.

Maintaining appropriate staff expertise in the commercial lending area is a central pillar of a sound commercial lending program. Examiners evaluate staff expertise when determining whether a credit union's overall program is being managed in a safe and sound manner. When evaluating experience, examiners will primarily focus on the overall type and relevance of staff experience for those individuals involved in a credit union's commercial loan program, with an emphasis on experience in commercial loan risk management. This includes experience requirements for any senior executive officers who oversee a credit union's lending department and are otherwise accountable for the performance of the commercial loan portfolio.

More specifically, a credit union should have qualified lending personnel with:

1. Experience directly related to the specific types of commercial lending in which the credit union is engaged;
2. Demonstrated experience in conducting commercial credit analysis and evaluating the risk of a borrowing relationship using a credit risk rating system;
3. Demonstrated experience in underwriting, processing, and conducting workout activities for the types of commercial lending in which the credit union is engaged; and
4. Knowledge of the legal documentation necessary to protect the credit union from legal liability, and all relevant laws and regulations impacting commercial lending activities.

Meeting experience requirements

Under NCUA Regs. §723.3(b)(3), a credit union has multiple options to meet staff experience requirements. For example, it may train and develop existing staff, hire experienced professionals, or use a third party such as a CUSO or an independent contractor. It is generally not prudent for a credit union that has newly adopted a commercial loan program to initially rely solely on training and developing existing staff, unless existing staff already possess the skills, competencies, and experience required.

See the section titled "Prohibited Activities," later in this release for information on CUSOs and conflict of interest rules.

Before using a third party, a credit union must ensure the third party meets the experience requirements outlined above. It is vital that a credit union possess sufficient in-house expertise to fully evaluate the reasonableness and accuracy of risk assessments and recommendations provided by any third party, and to effectively oversee the third party relationship. Final responsibility for services provided by a third party, especially risk assessments, remains with a credit union because the risks associated with the transaction are borne by the credit union. While a credit union may use a third party for underwriting and assessing the credit risk, the credit union must ultimately make a credit decision. Before a credit union outsources key aspects of its credit risk management program to third parties, it should be satisfied it has internal staff that have a sufficient understanding of the key risks to comprehend and challenge the information they are getting from their third-party service providers. This is consistent with basic due diligence expectations and NCUA's guidance on evaluating third party relationships. (See NCUA Letter to Credit Unions 07-CU-13, *Evaluating Third Party Relationships*.)

Lastly, as required by the conflict of interest provision in §723.7(c), a credit union must ensure that there is no affiliation or contractual relationship between a third party and a borrower, or any associated borrowers, to avoid potential conflicts of interest. For example, if a third party is performing underwriting services for a credit union while also being compensated by a borrower for obtaining a loan, the conflict of interest provisions of the regulation have been violated. In addition, the risk assessment performed and provided by a third party must be based on a credit union's underwriting criteria, as reflected in its commercial loan policy.

Commercial Loan Policy

NCUA Regs. §723.4

As explained earlier in this release, a small credit union that 1) holds a relatively small amount of commercial loans compared to its net worth and 2) infrequently originates and sells commercial loans is exempt from certain sections of the NCUA rules, including this section on commercial loan policy.

A credit union that is not exempt, however, must adopt and implement a comprehensive written commercial loan policy and establish procedures for commercial lending. The policies and procedures must provide for ongoing control, measurement, and management of the credit union's commercial lending activities.

All credit unions must have a board-approved loan policy covering their lending activity in general, including those credit unions that qualify for the exemption. Exempt credit unions must ensure their general loan policy (required by Part 701 of the NCUA regulations) covers the types of commercial loans the institution makes, including satisfying all other applicable commercial lending requirements in Part 723 (the NCUA's MBL rules).

The commercial loan policy must be approved by the board of directors. While a credit union's board of directors can delegate the responsibility to its committee, the board is ultimately accountable for the safety and soundness of a credit union's commercial lending activities.

The board-approved commercial loan policy must be reviewed at least once a year and updated when warranted. The policy should be reviewed more frequently if there is a material change in the commercial lending program or related organizational structure, and in response to any material change in portfolio performance or economic conditions. (NCUA Reg. §723.3(a)(1).)

A commercial loan policy should include the pertinent requirements under Section 107(5) of the Federal Credit Union Act that contains limitations on loan maturity not to exceed 15 years and a prohibition on prepayment penalties. In certain states, there are exceptions (based on state law) to these restrictions for FISCUs.

Under the NCUA's rules, the credit union commercial loan policy must address each of the following issues, at a minimum:

Types of commercial loans permitted

A credit union should analyze its membership and ensure its commercial lending staff has the necessary expertise, gained through experience and training, to understand the needs of the membership and the types of loans offered.

Trade area

A credit union must be certain it is capable of serving its identified trade area. Trade areas are influenced by local demographics, economics, and industries. Credit unions should be familiar with the influences on the trade area and develop policies to ensure they monitor and react to changes in the trade area. Because effective risk management requires that a credit union have the ability to make periodic site visits to evaluate a borrower's operations and inspect collateral, the trade area should be reasonably accessible to a credit union. (Site visits should occur at least annually or more frequently based on the level of risk and complexity of the borrowing relationship. Regular site visits with the borrower will keep the lender informed of changes in the borrower's operation.)

Portfolio concentration limits

A credit union must set portfolio concentration limits, as a percentage of net worth, for all types of commercial loans, unsecured commercial loans and commercial loans without a personal guarantee. It should also set portfolio concentration limits by types of commercial loans, such as construction and development loans, commercial and industrial loans by industry type, income-producing or owner-occupied commercial real estate loans, agricultural loans, etc.

NCUA Letter to Credit Unions 10-CU-03, *Concentration Risk*, states the board of directors must establish a policy which addresses its philosophy on concentration risk, limits commensurate with net worth levels, and the rationale as to how the limits fit into the overall strategic plan of the credit union.

The board should use a global perspective when developing this policy, including identifying outside forces (such as economic or housing price uncertainty) which will affect the ability to manage concentration risk. The parameters set by the board should be specific to each portfolio and should include limits on loan types, share types, third party relationship exposure, etc. The risk limits should correlate to the overall growth objectives, financial targets, and net worth plan. The risk limits set forth in the concentration risk policy should be closely linked to those codified in related policies, including, but not limited to, real estate loan, member business loan, loan participation, asset/liability management (ALM), and investment policies. Concentrations that exceed 100% of net worth must be monitored carefully, and the board of directors should document an adequate rationale for undertaking that level of risk.

Single borrower limits

A credit union's commercial lending policy must specify the aggregate dollar amount of commercial loans to any one borrower or group of associated borrowers. (See the section titled "Associated Borrowers," earlier in this release.) A single-borrower limit based on a percentage of the lender's net worth is essential to prevent imprudent concentrations in any single borrower. This limit applies at the time a loan is granted.

The aggregate dollar amount of commercial loans to any one borrower or group of associated borrowers may not exceed the greater of:

- 15% of a federally insured credit union's net worth, or \$100,000, plus
- An additional 10% of a credit union's net worth, if the amount that exceeds the credit union's 15% general limit is fully secured at all times with a perfected security interest by readily marketable collateral.

To understand the single borrower limits, credit unions should understand the following:

- *Readily marketable collateral*: Consistent with banking regulations, NCUA defines readily marketable collateral as financial instruments or bullion that are salable under ordinary market conditions with reasonable promptness at a fair market value determined by quotations based upon actual transactions on an auction or similarly available daily bid and ask price market. Inherent in the definition is that readily marketable collateral is liquid, saleable, and actively bought and sold in a normally-functioning marketplace. Such collateral will generally be in the form of bullion, currency, certain financial institution accounts (savings, checking, share, and some money market accounts), and high-quality securities. Securities may either be marketable equity or marketable debt instruments.

For a security to be marketable, it must be readily saleable for cash on short notice and in large quantities. Importantly, cash convertibility with little risk of principal loss is a key characteristic for highly-liquid instruments. As such, marketable-security collateral is generally limited to the most liquid assets, and their maturities tend to be less than one year. These shorter maturities (and lower effective durations) mean they can be bought or sold in any quantity with little effect on their prices. Typical examples of marketable securities include U.S. Treasury Bills, commercial paper and other money market instruments with maturities less than one year.

The favorable liquidity and price stability of readily marketable collateral make it a strong and stable form of credit enhancement. In cases where a credit union wants to increase its single obligor exposure to one borrower (or a group of associated borrowers) above 15% and in an amount up to but not exceeding 25%, it must fully secure the amount above 15% with true readily marketable collateral that meets the quality, liquidity, and maturity distinctions that make it highly safe at all times. A credit union should not use assets that are price volatile, illiquid, or less marketable for this purpose.

- *Associated borrowers*: A key element of measuring single-borrower exposure is to determine the associated individuals and entities that comprise the borrower's business relationships. The identification of associated borrowers captures those parties who are interdependent and have operational influence with the borrower due to shared ownership and management. (See the section titled "Associated Borrower Definition," earlier in this release.)
- *Government backed lending*: Any insured or guaranteed portion of a commercial loan made through a program in which a federal or state agency (or its political subdivision) insures repayment, guarantees repayment, or provides an advance commitment to purchase the loan is excluded from the single borrower limit.

- *Previously granted waivers:* When the NCUA overhauled its commercial lending rules in 2016, it eliminated waiver provisions. Waivers that were granted for a single borrower or borrowing relationship to exceed the limits set forth in §723.8 of the previous NCUA MBL rules will remain in effect until the aggregate balance of the loans outstanding associated with the relationship is reduced and in compliance with the requirements of §723.4(c).
- *Managing within regulatory limits:* Credit unions should ensure their aggregate activities don't breach regulatory limits and plan for unforeseen contingencies. Setting an internal limit below the regulatory limit is a prudent business practice for credit union; however, it is not a supervisory expectation.
- *Risk management beyond the requirement:* Part 723 of NCUA regulations requires credit unions to adequately identify and aggregate all associated borrowers to effectively control total exposure to a borrower or a group of associated borrowers. Tracking associated borrowers is critical, as credit unions need to aggregate total credit risk per borrower and avoid undue concentrations relative to their net worth.

Qualifications & experience requirements for lending staff

A credit union should, in developing staffing requirements, consider relevant factors specific to the credit union and to the needs of its commercial borrowing members. Staffing should be determined based on loan volume, projected loan growth, trade area, complexity of the borrowing relationships, types of loans permitted, and any other unique influences on the credit union's commercial loan portfolio.

In determining staffing levels, a credit union should consider appropriate levels of management, relationship managers, and support staff as may be required to ensure member's needs are responsibly serviced in a safe and sound manner. (See the previous section, titled "Board of Directors and Management Responsibilities.")

A credit union should also consider an appropriate separation of duties to prevent potential conflicts of interest and other problems in the loan underwriting, collection, and portfolio monitoring functions. An appropriate separation of duties provides for a strong internal control to prevent fraud and error. A credit union should strive to achieve separation of duties wherever possible.

Loan approval processes

A credit union's commercial loan policy must establish lending authority for approving credit decisions. A credit union must establish a process that assigns credit approval authority to individuals or to committees that make such decisions commensurate with the individual's or committee's experience evaluating and understanding commercial loan risk.

In addition, the approval process should ensure an adequate level of review and approval by senior management before loan decisions are made for complex or large loans or credit relationships. All lending authority limits should be assigned based on a borrower's (and associated borrower's) aggregate loan relationship. The management information system should capture sufficient data to allow adequate oversight and review of the loan approval process. The data should include, but is not limited to, all loan approvals or denials tracked by the loan department and officers. It should be periodically reported to senior management.

Underwriting standards

The level and depth of credit analysis and risk assessment should be commensurate with the overall risk the borrowing relationship poses to a credit union based on its size, risk and complexity. A credit union's commercial loan policy must address the required analysis and depth of the financial review performed to support a credit decision. It should establish the approval process, including the lending authorities and the documentation of the credit decision. It should also outline the required components of a credit approval document.

The approval process and documentation should provide sufficient information to allow the approving body to make a fully informed credit decision. A commercial loan policy should also set the requirements for the financial reporting to support a credit decision. It should address the minimum criteria for historic reporting at the inception of the loan, as well as regular reporting after the loan is closed, and the required quality of financial information to establish an accurate and reliable assessment of financial trends. Risks should be monitored throughout the life of a loan based on periodic review of the financial position of the borrower and site visits to detect any operational changes.

A credit union's borrower analysis should focus on the borrower's financial condition and ability to repay. The analysis should include income and expense trends, debt service ability, balance sheet changes, and the impact of those changes on the borrower's ability to service debt. The analysis should discuss the required evaluation of related parties and the influence those parties have on a borrower's ability to repay a loan.

For detailed guidance, see the *“Financial Analysis and Credit Approval Document”* material in the NCUA Examiner’s Guide. It summarizes examiners’ expectations for effective underwriting of MBLs, including financial analysis and internal credit approval documents.

The policy must establish due diligence requirements to evaluate the other sources of income or losses that affect the guarantors or principals to determine the global financial condition and the debt service ability of a borrower and any associated borrowers.

The policy should establish requirements for financial projections, which will ensure a borrower is actually planning and managing operations to achieve future goals. Financial statement projections should be required when a borrower’s historic performance does not support the proposed debt repayment, or when a credit union anticipates structural change in the borrower’s future operations, and repayment depends on the success of the changes. A borrower or principal must prepare such a projection, because they are responsible for executing and achieving the projected plan.

A credit union’s underwriting standards must address the quality of the financial information used to make a credit decision and ensure that the degree of verification reflected in the financial information is sufficient to support the financial analysis and the risk assessment of a credit decision. A credit union can determine the quality of a financial statement using the level of assurance provided by a preparer and the required professional standards supporting the preparer’s opinion.

In many cases, borrower-signed tax returns or financial statements professionally prepared in accordance with Generally Accepted Accounting Principles (GAAP) are sufficient for less complex borrowing relationships, such as those that are limited to a single operation of the borrower and principal with relatively low debt. For more complex and larger borrowing relationships, such as those involving borrowers or principals with significant loans outstanding or multiple or interrelated operations, a credit union should require borrowers and principals to provide either:

- An auditor’s review of the financial statements prepared consistent with GAAP to obtain limited assurance (a “review quality” financial statement), or
- An independent financial statement audit under Generally Accepted Auditing Standards (GAAS) for the expression of an opinion on the financial statements prepared in accordance with GAAP (an “audit quality” financial statement).

A credit union’s underwriting standards must also include the type of collateral allowed, loan to value ratio limits, personal guarantees of the principals, and methods for valuing all types of authorized collateral. For real estate valuation, the valuation methods must comply with *Part 722* of NCUA’s regulations. The standards should set minimum collateral requirements based on the characteristics of the collateral and risk associated with the borrowing relationships. The standards should also set forth the requirements for establishing an enforceable and perfected lien position for different types of collateral. (See the section titled “Collateral and Security,” later in this release.)

Risk management processes

A covered credit union’s commercial loan policy must address “risk management processes commensurate with the size, scope and complexity of the ... credit union’s commercial lending activities and borrowing relationships.”

The risk associated with commercial lending is dynamic due to changing influences on the market, as well as a borrower’s operational and financial condition. Credit unions must establish policies and procedures to identify and manage risk at the inception of the loan and throughout the life of the loan. Specific components to be addressed by the credit union include:

- *Use of loan covenants (when warranted):* A change in risk is generally reflected in an adverse change in the financial condition of a borrower or associated borrowers. A credit union’s policy should establish requirements for financial covenants, financial reporting, and regular site visits. Early detection of adverse changes in a borrower’s operation provides a credit union with the best opportunity to assist the member and protect itself from losses.
- *Periodic review:* The credit union loan policy must set forth the requirements for periodic loan relationship review. The periodic review requirements should include frequency of site visits, periodic financial reporting, and comprehensive review of the relationship. It is a standard practice to review the commercial relationship at least annually (more frequently if there is a change in the risk).
- *Credit risk rating system:* A credit union must incorporate a credit risk rating system to quantify and manage the credit risk of each loan. For detailed guidance, see the *“Credit Risk Rating Systems”* material in the NCUA

Examiner's Guide. It summarizes examiners' expectations for credit unions to maintain a credit risk rating system that allows it to actively manage risk at both the loan and overall portfolio level.

- *Loan policy and documentation exceptions:* A credit union's commercial loan policy may allow for exceptions to the policy, when necessary, to meet the unique circumstances of a borrowing relationship and when doing so would not create undue risk to the credit union. The policy must establish the process for approval and documentation of an exception to loan policy. All exceptions to the loan policy should be tracked and periodically reported to senior management and to the board.

Collateral and Security

NCUA Regs. §723.5

The NCUA's MBL regulations address collateral, unsecured loans, and personal guarantees for commercial loans:

- Credit unions must require collateral commensurate with loan's level of risk and sufficient to ensure adequate balance protection and risk sharing with the borrower.
- For unsecured commercial loans, the credit union "must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk."
- If the credit union does not require a "full and unconditional personal guarantee from the principal(s)" of a business, it "must determine and document in the loan file that mitigating factors sufficiently offset the relevant risk."

Collateral

A fundamental principle of commercial lending is that commercial loans will be appropriately collateralized. Collateral is an essential component of a commercial loan transaction to protect the credit union from a loss in the event of a borrower default.

For detailed guidance on different types of collateral, as well as how credit unions can effectively confirm, value, manage, and control collateral, please see the "*Collateral*" material in the NCUA Examiner's Guide. In addition, it covers "prudent commercial lending practices" related to:

- Commercial real estate loans,
 - Appraisals,
 - LTV ratio limits,
- Working capital loans (asset-based lending),
 - Repayment,
- Term loans,
- Blanket lien or assignment,
- Intangible assets,
- Enterprise value (going concern value), and
- Unsecured loans.

Personal guarantees

Business owners are not automatically personally liable for the business' debts. The type of entity involved in a commercial loan determines whether a principal or business owner is responsible for the obligations of the business. The liability of an owner or principal that is not personally liable for the debts of a business can be obtained if they agree to personally guarantee the business' obligations. This guarantee would be provided through a separate personal guarantee agreement. Personal liability of the principals of a borrower for the borrower's debts relies on the following factors:

- Principals are *personally liable* when a borrower entity is a sole proprietorship or when the principal is acting as a general partner in a partnership.

- Principals are *not personally liable* when a borrower is a corporation (S or C Corporation), limited liability company (LLC), limited liability partnership (LLP), not-for profit co-op, trust, or an association unless the principal signs a separate agreement to personally guarantee the terms and conditions of the loan.

See Exhibit B to this release for information describing various common types of business entities.

The rules do not explicitly require a personal guarantee for all commercial loans, but the NCUA Examiner's Guide describes personal guarantees as an "implicit expectation" of the rules:

A personal guarantee from those with a controlling interest in the borrower is an appropriate risk mitigant for loans to privately held entities. A credit union should only waive a requirement for a personal guarantee when the credit union has a rigorous credit risk management program in place and the ability to properly mitigate the additional risk. The reliance on a personal guarantee should not be relinquished solely to meet competitive pressure.

The Guide says that "the most effective guarantee is an unlimited, joint, and several personal guarantee from principals that have a controlling interest of a borrower's operation."

For detailed guidance on personal guarantees, see the "*Personal Guarantees*" material in the NCUA Examiner's Guide.

Construction and Development Loans

NCUA Regs. §723.6

The NCUA commercial lending rules define a construction and development loan (C&D loan) as any financing arrangement that allows a borrower to acquire property or rights to property (including land or structures) with the intent to construct or renovate an income-producing property (such as residential housing for rent or sale, a commercial building, etc.) that is used for commercial, agricultural, industrial, or other similar purposes. The rules also define C&D loans to include financing arrangements for the construction, major expansion, or renovation of a property used for commercial, agricultural, industrial, or other similar purposes.

A loan that finances maintenance, repairs, or improvements to an existing income-producing property that does not change the property's use or materially impact the property is not a C&D loan.

Valuation methods

A credit union that chooses to make a construction or development loan "must ensure that its commercial loan policy includes adequate provisions by which the collateral value associated with the project is properly determined and established."

The collateral value of a construction or development loan is the lesser of the project's cost to complete or its prospective market value.

- *Cost to complete* means the cost to complete as the sum of all qualifying costs necessary to complete a construction project and documented in an approved construction budget. The "qualifying costs" would include on/off-site improvements, building construction, and other reasonable and customary costs such as general contractor's fees, bonding, and contractor insurance. Qualifying costs also include the value of the land (determined as the lesser of appraised market value or purchase price for land held less than 12 months, or the appraised market value for land held longer than 12 months). Qualifying costs also include interest, a contingency account to fund unanticipated overruns, and other development costs such as fees and related pre-development expenses. Interest expense is a qualifying costs only to the extent it is included in the construction budget and is calculated based on the projected changes in the loan balance up to the expected "as complete" date for owner-occupied non-income producing commercial real estate or the "as stabilized" date for income producing real estate. Project costs for related parties, such as developer fees, leasing expenses, brokerage commissions, and management fees, may be included only if reasonable in comparison to the cost of similar services from a third party. Qualifying costs do not include interest or preferred returns payable to equity partners or subordinated debt holders, the developer's general corporate overhead, and selling costs to be funded out of sales proceeds such as brokerage commissions and other closing costs.
- *Prospective market value* means the market value opinion determined by an independent appraiser in compliance with the Uniform Standards of Professional Appraisal Practice (Statement 4). Depending on whether the property is held for commercial use or for income producing use, one of two valuation methods may be used. The prospective market value "as-completed" reflects the property's market value as of the time that development is to be completed

and begin commercial use. The prospective market value “as-stabilized” reflects the property's market value as of the time an income producing property is projected to achieve stabilized occupancy.

To determine the duration of the financing period, under the prospective market value method of valuing a construction project, the NCUA rules distinguish between income-producing properties and commercial-purpose properties:

- “Income-producing properties” are those that generate income from the rental or sale of the units constructed; loan proceeds and the repayment of a C&D loan for an income-producing property depends on the successful completion of a project.
- Projects built for “a commercial purpose” refers to structures that do not directly generate income, but which enhance the operation of a commercial or industrial operation (such as a warehouse, manufacturing facility, and management office space).

For income producing properties, the financing period generally ends on the “as-stabilized” date. For commercial-purpose properties, the financing period generally ends on the “as-completed” date.

Policy requirements for C&D lending

A credit union that elects to make a C&D loan must assure that its commercial loan policy meets the following conditions:

- Qualified personnel representing the interests of the federally insured credit union must conduct a review and approval of any line item construction budget prior to closing the loan;
- A credit union approved requisition and loan disbursement process is established;
- Release or disbursement of loan funds occurs only after on-site inspections, documented in a written report by qualified personnel representing the interests of the credit union, certifying that the work requisitioned for payment has been satisfactorily completed, and the remaining funds available to be disbursed from the construction and development loan is sufficient to complete the project; and
- Each loan disbursement is subject to confirmation that no intervening liens have been filed.

Further C&D guidance

For credit unions that engage in C&D lending, see the *“C&D Loans” material* in the NCUA Examiner’s Guide. It provides detailed guidance on the following topics:

- Income producing and commercial purpose properties,
- Due diligence analysis,
 - Borrower creditworthiness,
 - Feasibility,
- Monitoring borrowers,
- Project valuation,
 - Cost to complete,
 - Prospective market value,
- Administration and loan disbursements,
 - Budget,
 - Disbursements process,
 - Pre-disbursement inspection and report, and
 - Intervening liens.

Prohibited Activities

NCUA Regs. §723.7

To safeguard against insider abuse and conflicts of interest, the NCUA commercial lending rules prohibit certain commercial lending activities.

The rules prohibit involvement by certain transaction parties, as well as certain compensation features. These prohibitions help avoid unsafe incentives, conflicts, and risks that can undermine the integrity of a sound and prudent commercial loan program and expose a credit union to insider abuse.

The rule prohibits a credit union from granting a commercial loan:

- To any senior management employee directly or indirectly involved in the CU's commercial loan underwriting, servicing, and collection process, and any of their immediate family members;
- To any associated borrowers of those senior staff and family identified under the previous bullet point;
- To any compensated director, unless the credit union's board approves the loan (with the compensated director recused); or
- If any additional income received by the credit union or its senior management employees is tied to the profit or sale of any business or commercial endeavor that benefits from the proceeds of the loan.

In addition, any third party that is used to satisfy the expertise requirements of the NCUA commercial loan rules (such as a CUSO) must be independent from the loan, and it cannot have a participation interest in the loan or have any interest in collateral securing a loan being evaluated by the third party. (See the section "Meeting experience requirements," earlier in this release.)

Third parties are also prohibited from receiving compensation contingent on the closing of a loan, with the following exceptions: the third party may 1) provide services related to the loan such as loan servicing; 2) purchase a participation interest in a loan it evaluates for a credit union; and 3) a CUSO need not be independent from the transaction provided the credit union has a controlling financial interest in the CUSO.

The NCUA Examiner's Guide discusses these prohibited activities:

If a credit union insider who is not ineligible under §723.7 obtains a commercial loan, a credit union needs to ensure it has the appropriate due diligence, reporting, and policy requirements to prevent the lending activity from violating the spirit and intent of NCUA's prohibitions. (That is, the credit union must ensure the credit union insider is truly independent from influencing the transaction.)

While a credit union must ensure that involving a CUSO in its commercial lending activities does not create a conflict of interest, there is some flexibility regarding CUSO involvement. For example, a credit union may engage a CUSO, subject to certain conditions, to help meet the credit union's regulatory requirements for commercial lending experience as set forth in §723.3(b)(3) [discussed earlier in this release].

The authority to hire a CUSO to meet required experience levels may be a prohibited activity because the CUSO is not always independent of the loan transaction. As set forth in §723.7(c)(3), flexibility can be granted if a federally insured credit union has a controlling financial interest in the CUSO as determined under GAAP. A credit union with a controlling interest in a CUSO can ensure that the CUSO aligns its legal and business interests with the credit union. Conversely, a less-than-controlling interest in a CUSO means there is an increasing risk these interests may diverge.

Aggregate Member Business Loan Limit

NCUA Regs. §723.8

In addition to the NCUA limit on the aggregate dollar amount of commercial loans to any one borrower or group of associated borrowers (described earlier in this release), the NCUA commercial loan rules cap the aggregate amount of member business loans that may be held by a covered credit union to the lesser of:

- 1.75 times the actual net worth of the credit union or
- 1.75 times the minimum net worth required under the Prompt Corrective Action provisions in section 1790d(c)(1)(A) of the *Federal Credit Union Act* to be well-capitalized.

The NCUA rules no longer refer to 12.25% of assets.

Difference between commercial loans and MBLs (§723.8(b))

A commercial loan is any loan, line of credit, or letter of credit (including any unfunded commitments) made to an individual, sole proprietorship, partnership, corporation, or other business enterprise for commercial, industrial, agricultural, or professional purposes (but not for personal expenditure purposes). Various types of loans are excluded from this definition, as listed previously in this Release. For example, loans secured by 1- to 4-family residential property (owner-occupied or not) are not considered “commercial” loans.

The NCUA regulations define MBL to mean “any commercial loan ... except” for certain categories of loan. In other words, MBLs are a subset of commercial loans (whether the credit union makes the loan directly or purchases a loan participation.) It’s important to understand the difference, in order to properly calculate the rule’s limits on MBLs. The following types of loans *are not* MBLs, so they don’t count toward the aggregate MBL limit:

- Any commercial, industrial, agricultural, or professional loan in which a federal or state agency (or its political subdivision) has committed to fully insure repayment, fully guarantee payment, or provide an advance commitment to purchase the loan in full.
- Any non-member commercial loan or non-member participation interest in a commercial loan made by another lender. A credit union must acquire a non-member loan or non-member participation interest in compliance with applicable laws and regulations and must not be swapping or trading MBLs with other credit unions to circumvent the statutory aggregate limit. A credit union that demonstrates a pattern or practice of evading the MBL cap, as with any other regulatory violation, is subject to commensurate supervisory action.
- Any loan that is secured by a lien on a 1- to 4-family dwelling.

Exception (§723.8(c))

One type of loan is *not* a commercial loan, but *is* defined as an MBL for purposes of calculating the 1.75% aggregate MBL limit: Loans secured by a vehicle manufactured for household use, but which will be used for a commercial, corporate, or other business investment property or venture, or agricultural purpose, if the outstanding net member business loan balance is greater than \$50,000.

Exemptions (§723.8(d))

Pursuant to the statute and the rule, the following CUs are exempt from the MBL 1.75% cap:

- Credit unions with an “low-income credit union” designation;
- Credit unions that participate in the Community Development Financial Institutions program;
- Credit unions chartered for the purpose of making commercial loans;
- Credit unions that had a history of primarily making member business loans as of the date of enactment of the Credit Union Membership Access Act of 1988.

Calculating net MBL balance (§723.8(e))

The net MBL balance is determined by calculating the outstanding loan balance, plus any unfunded commitments, and then subtracting any portion of the loan that is:

- Secured by:
 - Shares in the credit union,
 - Shares or deposits in other financial institutions,
 - A lien on a member’s primary residence,
- Insured or guaranteed by any agency of the federal government, a state, or any political subdivision of such state,
- Subject to an advance commitment to purchase by any agency of the federal government, a state, or any political subdivision of such state, or

- Sold as a participation interest without recourse and that qualifies for true sales accounting under GAAP.

Commercial Loan Administration Guidance

Credit unions should consult the *Commercial Loan Administration material* in the NCUA Examiner's Guide, which summarizes what examiners see as the "quality control steps and operational functions that support a sound loan administration process." As explained in the Guide, "Loan administration is the operational arm of a credit union's lending function. It begins when a loan is approved, and continues through a loan's final payoff. Loan administration includes many responsibilities and activities. While these vary widely from credit union to credit union, some are consistent across institutions, including risk identification, management, monitoring, and reporting duties."

The material covers:

- Quality control steps,
- Loan administration risks,
- Loan and collateral documentation,
- Internal and systems controls,
- Management information systems,
- Data quality,
- Tracking and monitoring,
- File organization and maintenance,
- Internal periodic review,
- Independent loan review,
- Policy and underwriting exceptions, and
- Loan and collateral documentation exceptions.

Commercial Loan Workouts Guidance

Credit unions should consult *the Commercial Loan Workouts material* in the NCUA Examiner's Guide. It summarizes federal regulators' guidance and expectations regarding credit unions' risk management practices for member business loan workout programs and individual member business loan workout arrangements, including prudent commercial real estate (CRE) loan workouts.

Examination Procedures Guidance

To help prepare for examinations of a commercial lending program, credit unions should consult *the Exam Procedures material* in the NCUA Examiner's Guide. It includes guidance for examiners reviewing a federally insured credit union's commercial and member business loan program in a state with its own MBL rules, like Wisconsin.

OTHER REGULATORY COMPLIANCE ISSUES

In addition to the MBL regulations, credit unions must keep in mind that other state and federal regulations may or may not apply to a business purpose loan.

Generally speaking, whether a particular law applies to a loan depends on the "purpose" of the loan. (It would ordinarily be presumed that if a loan is made to an organization, or if the loan proceeds are used to buy property or services for use by an organization, the loan is for a business purpose.) The purpose does not necessarily depend on the ownership of the collateral securing the loan. For example, if a business takes out a loan to expand its operations, securing it with property that the business owner holds personally, titled under his/her own name, the loan would still be considered a business purpose loan. However, special rules may apply when rental property secures a loan, depending on whether it is owner-occupied.

Exemptions

Commercial loans are exempt from certain consumer protection and other regulations, including the following:

- *FTC Rule on Preservation of Consumers' Claims and Defenses.* This Federal Trade Commission rule only applies to consumer credit contracts. For details, see The League's *ii Release No. B063*.
- *Real Estate Settlement Procedures Act (RESPA) & Reg. X.* An extension of credit primarily for a business, commercial, or agricultural purpose, as defined by Reg. Z § 1026.3(a)(1) is exempt from RESPA and from Reg. X. Credit unions may rely on Reg. Z in determining whether the exemption applies. In other words, if Reg. Z does not apply to this loan because it's for a business purpose, then RESPA does not apply either. For details on Reg. X, see The League's *ii Release No. B014*. (See the discussion below for more details on when/how Reg. Z may apply to certain business related loans secured by rental properties.)
- *Truth in Lending (Reg. Z).* Reg. Z generally does not apply to an extension of credit *primarily* for a business, commercial or agricultural purpose. However, the Reg. Z rules on issuance of credit cards (§ 1026.12(a)) and liability of a cardholder for unauthorized use (§ 1026.12(b)) apply to any person to whom a credit card is issued, for any purpose, including business, commercial, or agricultural use. See the discussion below for more details on when/how Reg. Z may apply to certain business related loans secured by rental properties.
- *Wisconsin Consumer Act.* Loans for a primarily business purpose are exempt from the Wisconsin Consumer Act, which only covers loans made in Wisconsin for a personal, family, or household purpose. Note that it is the loan's purpose, not collateral ownership, that determines whether the Consumer Act applies.

Agricultural transactions are exempt from the Consumer Act, except:

- Wis. Stats. § 422.210 states that the creditor may not charge, collect, or receive any finance charge or fee unless the charge or fee is clearly disclosed in writing to the customer and is agreed to by the credit union and the customer; and
- The debt collection provisions of the Consumer Act, found at Wis. Stats. Ch. 427, apply to Consumer Act transactions that are primarily for an agricultural purpose. The prohibited practices are listed in *ii Release No. 0121*.
- *Wis. Stats. § 138.052.* Wis. Stats. § 138.052 does not apply if the loan is primarily for a business or agricultural purpose. For details, see The League's *ii Release No. B047*.
- *Chapter 428.* Chapter 428 of the Wisconsin statutes applies to personal, family, household, or agricultural purpose loans secured by a first lien real estate mortgage (or equivalent security interest). It does not apply to business loans, but it does not contain a specific exemption for agricultural loans. For details, see The League's *ii Release No. B047*.
- *SAFE Act and Reg. G.* Federal SAFE Act rules (the CFPB's Reg. G) require mortgage loan originators to register before they can originate a "residential mortgage loan." That term is defined to mean "any loan primarily for personal, family, or household use that is secured by a mortgage, deed of trust, or other equivalent consensual security interest on a dwelling ..." The regulation would not apply to a loan for a business purpose. For details on the SAFE Act, see *ii Release No. B070*.

No Exemptions

Certain sets of laws, including the following, do apply to business lending:

- *Equal Credit Opportunity Act (Reg. B).* The Equal Credit Opportunity Act and Regulation B apply to all credit, commercial as well as personal. For details, see The League's *ii Release No. B041*. Reg. B includes a "small business lending rule," described later in this release, that requires certain credit unions to collect and report data on most loans to "small businesses." For details, please see The League's *ii Release No. B083*.
- *Home Mortgage Disclosure Act (Reg. C).* This regulation applies to certain credit unions, depending on their asset size, office locations, and other tests. Covered credit unions must collect certain data and report a variety of information for "covered loans." As of Jan. 1, 2018, Reg. C applies to business-purpose, closed-end loans and open-end lines of credit that are dwelling-secured and are home purchase loans, home improvement loans, or refinancings. In other words, for business-purpose transactions, Reg. C may apply depending on whether the loan is 1) dwelling-secured and 2) is for certain purposes. A covered credit union must notify applicants that it is requesting information; request that information (or collect it based on visual observation or surname in some cases); record the information

and various other data points about the loan on a Loan/Application Register (LAR); and submit the LAR annually by March 1. (In some cases, credit unions are required to submit data quarterly.) The credit union also must provide notices that its disclosure statement and modified LAR are available on the Consumer Financial Protection Bureau's website. For details, see The League's *ii Release No. B017*.

- *Truth in Lending (Reg. Z)*. As noted above, the Reg. Z rules on issuance of credit cards (§ 1026.12(a)) and liability of a cardholder for unauthorized use (§ 1026.12(b)) apply to any person to whom a credit card is issued, for any purpose, including business, commercial, or agricultural use. See the discussion below for more details on when/how Reg. Z may apply to certain business related loans.
- *Wisconsin mortgage payoff law*. Section 708.15 of the Wisconsin Statutes covers state law on mortgage payoff requests, payoff statement, and mortgage satisfactions in this state. Except for the material on affidavits of satisfaction, this law applies to all real estate mortgages recorded in Wisconsin, including commercial mortgages and consumer mortgages on residential property. However, an "affidavit of satisfaction" cannot be used for commercial loans. For details, see The League's *ii Release No. B078*.
- *Loan workouts, non-accrual, and troubled debt restructuring*. Credit unions must adopt written nonaccrual policies that specifically address the discontinuance of interest accrual on loans past due by 90 days or more, as well as the requirements for returning such loans (including member business loan workouts) to accrual status. For more information, see *ii Release No. B072*.

For information on member business lending extension, deferral, renewal, and rewrite policies, see the *Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts* (October 30, 2009) in the NCUA's *Letter to Credit Unions No. 10-CU-07*.

- *Appraisal rules*. The NCUA's appraisal rules require an appraisal performed by a state-certified or licensed appraiser for all real estate-related financial transactions, with some exceptions. For details on the appraisal rules, see The League's *ii Release No. B008*, which also explains the federal regulators' joint "Interagency Appraisal and Evaluation Guidelines" (Dec. 2010).
- *Office of Foreign Assets Control (OFAC) regulations*. OFAC maintains lists of people, groups and nations that are subject to U.S. trade sanctions. Credit unions must screen transactions for persons and entities on those lists, and this includes checking the names of parties to business loan arrangements. For details, see The League's *ii Release No. 0148*.
- *Bank Secrecy Act (BSA)*. All credit unions must comply with federal BSA anti-money laundering regulations, which require them (among other things) to report certain transactions, keep records of other transactions, report suspicious activity, verify the identities of "customers," engage in "Customer Due Diligence (CDD)" and apply enhanced due diligence to high-risk customers. The CDD rules also require credit unions to have written procedures to identify "beneficial owners" – the people who own and control "legal entity customers" – organizations opening credit union accounts. Credit unions then must verify the identities of those beneficial owners. The CDD beneficial owner rules apply whenever a business or other "legal entity customer" opens an account, which includes a credit account, such as a loan or line of credit. BSA requirements apply in business lending, just as it does in other areas of a credit union's operations. For details, see The League's *ii Release No. 0071*. In addition, *ii Release No. 0109* covers Suspicious Activity Reports, and *ii Release No. 0159* covers Customer Identification Programs & Customer Due Diligence.

Frequently Asked Questions in *ii Release No. 0159*, Exhibit I, specifically address complications relating to multiple accounts and loan renewals as they are affected by the CDD beneficial owner rules.

- *Membership eligibility*. A credit union may only lend to an organization (or individual) that is a member. The credit union must determine that the organization is within its field of membership and open at least a basic membership share account for the organization. For details, see The League's *ii Release No. 0161 – "Organization Accounts."* It explains how organizations qualify for credit union membership, how to open organization accounts, and how to handle organization account transactions.

Reg. Z & Rental Properties

As explained above, whether a particular law applies to a loan depends on the "purpose" of the loan, and not necessarily on the ownership of the collateral securing the loan. Special considerations apply, however, when a loan is taken to buy rental property.

Under Reg. Z (Truth in Lending), whether such a loan is for a business purpose (as opposed to a consumer loan) depends on whether the owners plan to live there in the coming year and if so, whether it has more than two units. The following material, from the regulator's commentary to Reg. Z §1026.3(a), explains how to determine how owner-occupied and non-owner-occupied rental property loans are treated:

Comment 3(a)-4

4. *Non-owner-occupied rental property.* Credit extended to acquire, improve, or maintain rental property (regardless of the number of housing units) that is not owner-occupied is deemed to be for business purposes. This includes, for example, the acquisition of a warehouse that will be leased or a single-family house that will be rented to another person to live in. If the owner expects to occupy the property for more than 14 days during the coming year, the property cannot be considered non-owner-occupied and this special rule will not apply. For example, a beach house that the owner will occupy for a month in the coming summer and rent out the rest of the year is owner occupied and is not governed by this special rule. (See comment 3(a)-5, however, for rules relating to owner-occupied rental property.)

5. *Owner-occupied rental property.* If credit is extended to acquire, improve, or maintain rental property that is or will be owner-occupied within the coming year, different rules apply:

- i. Credit extended to acquire the rental property is deemed to be for business purposes if it contains more than 2 housing units.
- ii. Credit extended to improve or maintain the rental property is deemed to be for business purposes if it contains more than 4 housing units. Since the amended statute defines dwelling to include 1 to 4 housing units, this rule preserves the right of rescission for credit extended for purposes other than acquisition. Neither of these rules means that an extension of credit for property containing fewer than the requisite number of units is necessarily consumer credit. In such cases, the determination of whether it is business or consumer credit should be made by considering the factors listed in comment 3(a)-3.

Reg. Z & loans to trusts

Reg. Z does not apply when the borrower is not a "natural person." For example, loans to corporations, partnerships, associations, churches, unions, and fraternal organizations are exempt. The exemption applies regardless of the purpose of the loan and regardless whether an actual person may guarantee or provide security for the credit.

However, if the loan is for a consumer purpose, it is clear that as of Aug. 1, 2015, Reg. Z does apply even if the borrower is a trust created for tax or estate planning purposes – such as the revocable living trusts that credit union members often create. The CFPB's Comment 3(a)-10 to Reg. Z explains:

Consumers sometimes place their assets in trust, with themselves or themselves and their families or other prospective heirs as beneficiaries, to obtain certain tax benefits and to facilitate the future administration of their estates. During their lifetimes, however, such consumers may continue to use the assets and/or income of such trusts as their property. A creditor extending credit to finance the acquisition of, for example, a consumer's dwelling that is held in such a trust, or to refinance existing debt secured by such a dwelling, may prepare the note, security instrument, and similar loan documents for execution by a trustee, rather than the beneficiaries of the trust. Regardless of the capacity or capacities in which the loan documents are executed, assuming the transaction is primarily for personal, family, or household purposes, the transaction is subject to the regulation because in substance (if not form) consumer credit is being extended.

Servicemembers Civil Relief Act (SCRA)

The SCRA provides a number of protections for borrowers in active military service, as explained in The League's *ii Release No. 0072*. For example, it sets a 6% limit on the interest that can be charged on loans that were taken out before entry into active military service.

The SCRA does not distinguish consumer from business purpose loans. As one national law firm has explained: "Therefore if a service member is personally liable for repayment of a business or commercial loan, regulators and courts are taking the position that the act covers these loans just as it would any other obligation or debt. This scenario typically arises either when a service member personally takes out a corporate loan from a financial institution or when a service member co-signs with a small business so both the individual and the business are jointly and severally liable on the debt."

Collecting/reporting data on small business lending

Reg. B's small business lending rule requires certain credit unions to collect and report data about loans to small businesses. It applies to credit unions of any asset size that originated at least 100 covered transactions to small businesses in each of the two preceding calendar years.

A "small business" is one that had \$5 million or less in gross annual revenue for its preceding fiscal year. A covered credit transaction is any extension of business credit, including loans, lines of credit, credit cards, merchant cash advances, and credit products used for agricultural purposes; however, certain types of transactions are excluded from coverage.

Generally, covered credit unions must report the data they collect – which includes demographic information about business owners – to the CFPB by June 1 of the next year.

Subject to certain modifications or deletions that the CFPB determines would advance a privacy interest, data submitted to the CFPB is made available to the public annually.

A covered credit union must make available to the public on its website, or otherwise upon request, a statement that its small business lending application register, as modified by the CFPB, is or will be available from the CFPB. The rule includes language that could be used for this statement.

For more information, please see The League's *ii Release No. B083*.

BUSINESS LOAN DOCUMENTATION

The documentation for a commercial loan is generally very different from that of a personal loan. Business notes are used rather than consumer notes. The credit union must obtain all of the proper signatures from the parties to the transaction. The borrower must qualify for and be admitted to membership in the credit union. Signatures must be from individuals authorized by appropriate borrowing resolutions if the business is an organization such as a corporation, partnership, LLC, or co-op.

For very basic business-purpose loans, The League offers the following limited selection of forms – if the loan is exempt from Regulation Z and other consumer protection laws:

- Business Real Estate Mortgage Note, WCUL #81096 (Rev. 11/06)
- Verification of Financial Statement, WCUL #81097 (Rev. 12/98)
- Business Real Estate Mortgage, WCUL #81098 (Rev. 12/98)
- Declaration of Business Purpose, WCUL #82022 (Rev. 12/98)

Many business loans require more advanced loan documentation. TruStage and WBA/FIPCO offer additional options. Large or complex transactions may call for customized loan agreements, riders, or addenda.

An attorney experienced in commercial loan documentation should prepare the loan agreement for large loans as appropriate covenants may not be found in preprinted forms. Credit unions willing to take the risk of making a commercial loan should be willing to pay for the expertise needed to document the loan.

Loan covenants should be included as part of a business loan note to document specific conditions of the loan. Examples of useful loan covenants may include but are not limited to:

- Frequency of providing financial reports,
- Insurance renewal periods,
- Working capital requirements,
- Limits on owner draws,
- Permission for periodic on-site business inspections, and
- Call options if the financial performance of the business deteriorates.

LIEN FILINGS UNDER UCC ARTICLE 9

Lien filings often require the use of Uniform Commercial Code (UCC) documents. Lenders should be familiar with Article 9 of the UCC, which is found in *Chapter 409 of the Wisconsin Statutes*.

Article 9 of the UCC governs transactions between a creditor and debtor where the creditor takes a security interest in certain personal property owned by the debtor. (Other rules may apply to titled collateral, such as vehicles. For information on vehicle liens in Wisconsin, see *ii Release No. B044*.)

Article 9 addresses not only how a creditor obtains a valid security interest against collateral owned by the debtor, but also how the credit union establishes its priority in relation to other creditors and how a creditor can repossess and sell the collateral.

The UCC covers most forms of collateral, like commercial deposit accounts, commercial tort claims, health-care-insurance receivables and payment intangibles. These types of collateral may be more common in business lending than consumer lending.

For an overview of Article 9, see *ii Release No. B060*. While this release cannot cover all the issues that may arise under Article 9, the following subsections summarize some of the key points relevant to business lending.

Debtor's location

It is critical that you determine where debtors are “located.” As a general rule, the location of the debtor and not the location of the collateral will determine where a financing statement should be filed. Wis. Stats. § 409.301(1). The rules are different for certain types of collateral, however. Refer to the statute and to *ii Release No. B060* for details. For example, if collateral is in Wisconsin, but the individual debtor resides in Illinois, then generally the appropriate place to file the financing statement is in Illinois.

Under Article 9 (Wis. Stats. § 409.307), the “location of the debtor” is as follows:

- For an individual – the location of the debtor's principal residence;
- For a registered organization (corporation, limited liability company, limited partnership) – the state in which it is registered;
- For non-registered organizations (sole proprietorships, general partnerships, unincorporated associations, etc.) with only one place of business – that place of business;
- For non-registered organizations that have more than one place of business – the organization's chief executive office; and
- For foreign persons or entities in a jurisdiction without a filing system, the proper filing location is Washington, D.C.

Note that if the debtor moves out of state, then the credit union must re-file in the state to which the borrower re-located.

Type of organization

A credit union must understand the type of organization it is lending to. For example, is it a general partnership (which does not register with the DFI) or a limited partnership (which does)? Even business owners themselves may be uncertain about the legalities involved and misunderstand the type of organization they have.

The League's *ii Release No. 0161* has detailed information on handling organization accounts. Exhibit B to the release summarizes the characteristics of the organizations that credit unions are most likely to encounter. This can be helpful when the credit unions needs to determine exactly what type of organization is involved in a business loan.

You may ask to see documents showing the existence of the organization, such as certified articles of incorporation or a government-issued business license. Corporations, limited liability companies, cooperatives, religious societies, fraternal societies, veterans groups, limited partnerships and limited liability partnerships are all established by filing certain documents with the Wisconsin Department of Financial Institutions (DFI).

You may determine an organization's status online via *the DFI's Corporate Registration Information System*. If you want written confirmation of a corporation's status, request a “certificate of status” from the DFI. This certificate is

sometimes referred to as a “certificate of existence” or “certificate of good standing” and is available for a nominal sum. To make the request, *visit the DFI website* and follow the links to fill out a Form SP-48. Credit card payments are accepted for this service. The same form can be used to request certified copies of articles of incorporation/organization and other documents from the DFI online.

You may obtain a copy of an entity’s annual report by submitting a letter request. (Not all organizations are required to file annual reports with DFI, however.) Check with the DFI for current service fees. Address the request to:

Department of Financial Institutions
Division of Corporate & Consumer Services
P.O. Box 7846
Madison Wisconsin 53707-7846

Identification documents, including those issued by the government, may be obtained illegally and may be fraudulent. So, credit unions are encouraged to verify an organization’s identity in other ways, even when a customer has provided original documents. For example: by contacting a member/customer at their place of business; by comparing information the organization gives you with information obtained from a consumer reporting agency, public database, or other source; by checking references with other financial institutions; and by obtaining a financial statement.

An organization does not have to be formed under Wisconsin law to operate in this state or to join a credit union here. For example, it is not uncommon to form a corporation by filing articles of incorporation in another state, such as Delaware, even if the corporation will operate exclusively in Wisconsin. A foreign corporation, non-stock corporation, limited partnership, limited liability company, cooperative association, or limited liability partnership may not transact business in Wisconsin until it has obtained a certificate of authority or registration from the DFI.

Use the correct name on UCC filings

It is important to set forth the correct legal name of the debtor in any UCC filing. Financing statements are indexed under the debtor’s name, and people wishing to find filed financing statements search for them under the debtor’s name. The UCC has rules about how this should be done for individuals, but the rules are different if the “debtor” is an entity, not a natural person. The credit union must use the organization’s name as it appears on a “public organic record” of the registered organization – in other words, a record filed with the state to form the organization and available for public inspection. Examples include a corporation’s articles of incorporation, an LLC’s articles of organization, or a limited partnership agreement.

If the debtor has more than one “public organic record,” use the information from the most recent one.

It is not enough to rely on the name as it appears on a certificate of good standing issued by a state or on a state’s publicly searchable database, like the DFI’s corporate records search page (though copies of documents, such as articles of incorporation, can be ordered via that site for a fee). Those are not “public organic records” (and they could contain misspellings). Instead, rely only on the filed document.

Do not use an organization’s trade name – a “doing business as” name. Any organization, not just a sole proprietorship, can use a trade name. For example, ABC Corporation may “do business as” Quick Lube. In such cases, use ABC Corporation’s full legal name as it appears on the company’s articles of incorporation; do not use “Quick Lube.” A financing statement that provides only the debtor’s trade name is not sufficient. For guidance on various types of organizations, see The League’s *ii Release No. 0161*.

A sole proprietorship is not an organization, even if the individual proprietor does business under a trade name. So, if the credit union takes a lien on equipment owned by John Doe, a sole proprietor who does business under the trade name “John’s Barbershop,” follow the rules for naming an individual debtor on a UCC1 Financing Statement.

Article 9 no longer requires the UCC1 Financing Statement to show the debtor’s (1) type of organization, (2) jurisdiction of organization, and (3) organizational identification number.

Use up-to-date UCC forms

Be sure you are using up-to-date UCC forms. You can find them in the *UCC area of the Wisconsin Department of Financial Institutions (DFI) website*.

WAGE LIEN PRIORITY

Commercial lenders with properly perfected security interests in a business' assets may still find themselves in second place behind unpaid workers if the business fails.

Employees and the Wisconsin Department of Workforce Development (DWD) can assert a lien on an employer's assets in Wisconsin to secure claims for unpaid wages earned by its workers. Wisconsin law gives the wage lien "super-priority," meaning that it cuts to the head of the line in front of many other kinds of liens, even if they were filed before the wage lien.

Under Wisconsin law (as of Dec. 1, 2003), workers are paid first, at least partially. Unpaid wages of up to \$3,000 per employee earned during the six-month period preceding the wage claim are given super-priority before the liens of commercial lenders, including credit unions.

The credit union's position depends on when the business granted the credit union its lien:

- If the credit union's lien: 1) originated on or *after* December 1, 2003, and 2) originated *before* the wage lien, then the credit union's lien is subordinate to the wage lien for up to \$3,000 in unpaid wages per employee earned during the six months before the date when the employee files a wage claim with the DWD or the date the employee brings his or her own action to collect the wages.
- If the credit union's lien: 1) originated *before* December 1, 2003, and 2) originated *before* the wage lien, then the credit union lien is treated as it would have been under the old law, which is to say, the credit union's lien has full priority ahead of the wage lien.
- If the credit union's lien originated *after* the wage lien, then the credit union's lien is subordinate to the entire wage lien, just as it is subordinate to any other prior lien.

Wage liens on real estate are filed with the clerk of courts for the county in which the employee worked. For personal property, wage liens are filed in the same place that financing statements would be filed under the UCC to perfect a lender's security interest in the employer's property – usually by filing with the Department of Financial Institutions. *See ii Release No. B060 for more information on UCC filing.*

No wage liens for management

Wage liens are not allowed for an officer or director of a corporation, a member or manager of a limited liability company, a partner of a partnership or joint venture, the owner of a sole proprietorship, an independent contractor, or a person employed in a managerial, executive or commissioned sales capacity or in a capacity in which the person is privy to confidential matters involving the employer-employee relationship.

ENVIRONMENTAL LIABILITY

Environmental liability concerns are heightened with commercial lending. A credit union could be vulnerable under state and federal environmental cleanup laws if it forecloses on secured property that is contaminated. However, credit unions may be protected from liability under certain exemptions built into those laws, even when foreclosure leads to actual ownership.

Given the various governmental entities involved (federal, state, and local) and the technicality of the environmental laws applying to lenders, credit unions should be cautious in their dealings with borrowers having potential and actual pollution and environmental problems. Credit unions in such situations should consult environmental counsel, especially before any foreclosure of property or other collateral.

State and federal laws contain exceptions, however, that help lenders avoid liability in some situations. For a good overview of these laws, please see the *Wisconsin Department of Natural Resources publication, "Environmental Liability Exemptions for Lenders and Representatives" (PUB-RR-508, Oct. 2013).*

NCUA requires environmental risk management program

The NCUA, in this *2008 NCUA letter to all federally insured credit unions*, says that all credit unions granting MBLs secured by real estate should implement an environmental risk management program to help minimize environmental liability.

The board of directors should review and approve the program and, if warranted, designate a senior officer knowledgeable in environmental matters to be responsible for implementing it.

The program should be commensurate with the credit union's operations. Credit unions that have a heavier concentration of loans to higher risk industries or areas of known contamination may require a more elaborate and sophisticated program than credit unions that lend more to lower-risk industries or areas. For example, loans secured by 1- to 4-family residences normally have less exposure to environmental liability than loans to finance industrial properties.

According to the NCUA letter, an environmental risk management program should include:

- Staff training,
- Policy guidelines and procedures,
- An environmental review or analysis during the application process,
- Loan documentation standards, and
- Establishment of appropriate environmental risk assessment safeguards in loan workout situations and foreclosures.

The letter provides details on what each of these program elements entails.

* * * * *

League publications are designed to provide accurate information with regard to the subject matter covered, with the understanding that the League does not render legal services. If you have general questions regarding this release, please call The League at (608) 640-4050 if local; or (800) 242-0833. For specific legal advice, please consult your credit union's attorney

Legal Affairs Department

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EXHIBITS:

Exhibit A - Member Business Loan Sample Policy

EXHIBIT A - MEMBER BUSINESS LOAN SAMPLE POLICY**MEMBER BUSINESS LOAN SAMPLE POLICY**

State-chartered credit unions can consider using this sample as a template to help them develop a member business loan policy that complies with Wisconsin law. Each credit union must review this sample thoroughly and edit it as needed to match the credit union's actual practices and procedures. Language that appears in brackets and in bold should be changed as needed. Consider deleting material that is not relevant to the credit union's member business lending process.

Member business loans	Date Board Reviewed: _____	Date Revised: _____
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Purpose

The purpose of this policy is to establish guidelines concerning [ABC Credit Union's] member business lending practices.

Policy statement

The credit union believes that a sound business lending program represents a safe means of making funds available and a productive way to serve our membership. Authorized credit union personnel are expected to develop loan and deposit relationships with businesses within the credit union's field of membership, while adhering to prudent practices.

The policies on member business lending will be reviewed at least annually, and changes will be recommended to the board as needed.

The policies and practices of this credit union are intended to comply fully with all applicable state and federal laws and regulations governing business lending and anti-discrimination practices.

Definitions

Consistent with Wisconsin DFI-CU §72.01, terms used in this policy have the following definitions:

1. "Amount" of a Member Business Loan includes all the following:
 - a. Any unfunded commitment to make the loan.
 - b. The outstanding balance of the loan.
 - c. Any undisbursed proceeds of the loan.
2. "Associated Member" means a person who is associated with another by means of a shared ownership, investment or other pecuniary interest in a business or commercial endeavor.
3. "Construction or Development Loan" means a financing arrangement for acquiring real property or rights to real property, including land or structures, with the intent to develop or improve it for any of the following:
 - a. Residential housing for sale.
 - b. Income property.
 - c. Commercial use.
 - d. Industrial use.
 - e. Any similar uses.
4. "Director" means the director of the Wisconsin Office of Credit Unions or an authorized representative of the Director.

5. "Loan to Value Ratio" or "LTV Ratio" means the amount of all loans by the credit union secured by an item of collateral added to the amount of all outstanding loans by other lenders secured by that item of collateral, that total amount then being divided by the market value of that item of collateral.
6. "Member Business Loan" or "MBL" has the meaning set forth in s. DFI-CU §72.02(1) and does not include any of the loan types that are exempt from the definition of "Member Business Loan" under DFI-CU §72.02(2).
7. "NCUA" means the National Credit Union Administration.
8. "Net Worth" means the retained earnings as defined under Generally Accepted Accounting Principles (GAAP). Retained earnings include undivided earnings, regular reserves and any other appropriations designated by management or regulatory authorities.
9. "Master Participation Agreement" means a contract that details the relationship between the seller and buyer of a loan participation.

Geographic area (trade area)

The credit union will make business loans to businesses that are members of this credit union and that are headquartered within the credit union's field of membership. Real property used to secure MBLs must be located within the credit unions field of membership, except for Loan Participations, as discussed in the "Loan participation" section of this policy.

Insider policy

The credit union will not grant an MBL to its chief executive officer (including its president, treasurer or manager), any assistant chief executive officer (including its assistant presidents, assistant treasurers, assistant managers or vice presidents), its chief financial officer (which may include its comptroller), and any Associated Member or immediate family member of any of the above.

Furthermore, the interest rates, terms and conditions of any MBL made to any credit union director, loan officer, credit committee member or internal auditor or on which loan such a person is a co-maker or guarantor, or of a loan made for the substantial benefit of any such person will not be more favorable than the rates, terms and conditions prevailing at that time for comparable loan transactions of any other member.

The credit union's board must approve any MBL to a director, who must recuse himself or herself from any consideration of that loan.

The credit union also will not grant an MBL if any additional income received by the credit union or its senior management employees is tied to the profit or sale of the business or commercial endeavor for which the loan is made.

Portfolio size and categories

The credit union will maintain a total MBL portfolio of no more than [____%] of total outstanding loans, **[including/excluding]** participation loans. The aggregate limit on the credit union's net MBL loan balances is the lesser of 1.75 times the credit union's Net Worth (defined as retained earnings including undivided earnings, regular reserves, and any other appropriations designated by management) or 12.25% of the credit union's total assets. In making business loans, management will act in a manner consistent with the credit union's overall asset/liability goals and objectives.

The total Amount of unsecured MBLs that the credit union will make will not exceed 10% of the credit union's Net Worth. The total Amount of secured MBLs that the credit union will make will not exceed [____%] of the credit union's Net Worth.

The maximum Amount by each category of MBLs, as a percentage of the credit union's Net Worth, is as follows:

<u>Type of Loan</u>	<u>Maximum Permissible</u>
Unsecured	[____%]
Secured by real estate.....	[____%]
Collateral pledged on funds on deposit	[____%]

Secured by stocks and bonds [__%]
 Secured by titled vehicles [__%]
 Secured by business equipment [__%]
 Secured by inventory [__%]
 Seasonal loans, agricultural, etc..... [__%]

Loans to one borrower

The aggregate Amount of net MBL balances to any one member or group of Associated Members must not exceed the greater of 15% of the credit union's Net Worth or \$100,000.

Unless granted a waiver by the Director, the aggregate of the unsecured outstanding MBLs to any one individual will not exceed 1% of the credit union's Net Worth, and the credit union will comply with all other requirements of DFI-CU §72.07.

Construction and development loans

The credit union will originate Construction or Development Loans consistent with the following:

1. The aggregate of all Construction or Development Loans will not exceed 15% of the credit union's Net Worth. In determining the aggregate, the credit union may exclude any portion of a loan that is any of the following:
 - a. Secured by shares or deposits in the credit union making the extension of credit or in other credit unions, or by deposits in other financial institutions.
 - b. Insured or guaranteed by any agency or subdivision of the state or the federal government.
 - c. Subject to an advance commitment to purchase by any agency of the federal government, the state, or any of their political subdivisions.
2. The borrower will have a minimum of the following:
 - a. 30% equity interest in the project being financed if the loan is for land development.
 - b. 25% equity interest in the project being financed if the loan is for construction or for a combination of development and construction.
3. The funds will be released only after on-site inspections, documented in writing, by qualified personnel and according to a preapproved draw schedule and any other conditions as set forth in the loan documentation.
4. The credit union will not make Construction or Development Loans unless it utilizes the services of an individual with at least 5 years' direct experience in such loans.

Experience requirement

The credit union will utilize the services of individuals with at least two years of direct business lending experience. If this experience requirement cannot be met using current staff, credit union management will ensure that expertise is available by using the services of a credit union service organization (CUSO), an employee of another credit union, an independent contractor, or other third party. Any third party the credit union uses may not have a participation interest in the loan or an interest in the collateral securing the loan, unless permitted by regulation.

Even if third parties assist the credit union in assessing whether the loan should be granted, the actual decision to grant a loan will reside with the credit union.

Loan approval

The credit union's board of directors will appoint a qualified **[Business Lending Committee]** at the annual board of directors' reorganization meeting. The committee will consist of **[the President/CEO, AVP of Lending and three Officers of the Board]**. The committee is expected to develop sound loans, while adhering to prudent lending practices.

The interpretation and enforcement of the credit union's MBL program policies are the responsibility of this committee, which will develop appropriate business lending procedures and practices. Those procedures will specify what types of business loans are considered undesirable for the credit union to make. This committee can delegate the approval of certain types and/or sizes of loans to business loan officers.

The **[Business Lending Committee]** will meet as necessary to review and approve or deny business loan applications. Business loan officers will present a thorough loan presentation to the **[Business Lending Committee]** to help it evaluate applications. All business loans will require majority approval of the **[Business Lending Committee]**. Loan applications that are for more than [\$_____], and that are not approved unanimously by the **[Business Lending Committee]**, must be Board-approved.

Documentation

The credit union requires that the **[Business Loan Committee]**, or its delegates, analyze and document the ability of the borrower to repay the loan consistent with appropriate underwriting and due diligence standards.

Title evidence will be obtained on loans secured by real estate to verify good and marketable title. Insurance coverage will be verified and monitored on real estate secured loans and other types of collateral requiring insurance coverage. Where there is security other than real estate, the loan file will contain documentation showing that a security interest has been created and perfected. Collateral value and marketability will be verified periodically as determined by the **[Business Loan Committee]**, with frequency based on loan maturity, collateral type, and overall degree of risk to the credit union.

Business loan files will include some or all the following documents, as deemed appropriate by the **[Business Loan Committee]**:

- Copies of business financial statements, including periodic updates;
- Signed personal financial statement;
- Copies of credit reports, if applicable;
- Copies of tax returns (business and personal);
- Documentation of borrower's financial history and experience;
- Balance sheet analyses;
- Trend and structure analyses;
- Ratio analyses of cash flow income and expenses;
- Income statements;
- Comparison with industry averages;
- Accounting agency reports;
- Direct credit checks;
- Documentation showing current and prior experience with the credit union;
- Correspondence with the member/borrower and memos to the file;
- Insurance documents;
- Notes, security agreements, loan agreements, and other legal documents;
- Personal guarantees;
- Corporate documents, such as corporate resolutions, attorney's opinions, etc.; and
- Other appropriate documents, such as environmental impact assessments.

Recordkeeping and accounting

All business loans will be accounted for under GAAP. A rating system will be used to determine proper allocations to the allowance for credit losses. The credit union will separately identify MBLs in its records and financial reports, as required by applicable law and GAAP.

LTV ratio requirements

The maximum Loan-to-Value Ratio for loans secured by collateral on which the credit union will have a first lien (includes loans where the credit union will have a first lien as well as other lesser priority liens) will not exceed 80%, unless either: The value in excess of 80% is covered by private mortgage or equivalent type insurance by an insurer acceptable to the credit union; or the loan is insured or guaranteed, or subject to advance commitment to purchase, by an agency of the federal government, state, or any of its political subdivisions. In no case will the LTV Ratio exceed 95%. The maximum Loan-to-Value Ratio for loans secured by collateral on which the credit union will have a second or lesser priority lien (but no first lien) will not exceed 80%.

Collateral requirements, within the regulatory requirements, will be established by the **[Business Loan Committee]**. The committee is to establish in writing the maximum Loan-to-Value Ratios by category of MBLs offered by the credit union, the method(s) used to determine the value of the collateral, the procedures used to confirm ownership of the collateral, the steps to secure the various types of collateral, and how often the credit union will reevaluate the value and marketability of the collateral used to secure MBLs.

The credit union will determine in its sole judgment, or in conjunction with its third-party provider, whether a personal guarantee is necessary.

Loan maturities

Amortization and maturities of business loans will vary depending on loan structure, collateral, purpose, and the financial strength of the borrower, and will be set by the **[Business Loan Committee]**. In no case, can the maturity of a business loan secured by real estate exceed years]. All other loans will be subject to a maximum maturity of years].

Interest rates

Interest rates charged to borrowers will be determined by the **[Business Loan Committee]**, based on the credit union's cost of funds, the competitive environment, the degree of risk involved, the account relationship with the borrower, and the yield requirements of participating investors. The signature of one member of the **[Business Loan Committee]** will be sufficient authorization for setting the pricing of the business loan if the pricing falls within written guidelines agreed to by the committee.

Loan monitoring, servicing, collections and periodic reviews

MBLs will be monitored to ensure they remain in current payment status. Periodic updates of financial statements, tax returns, insurance coverage, UCC filings, and other documents will be properly maintained. The documented periodic review of MBLs will include a review of collateral value, financial analysis, and summary, as well as support for the credit unions assigned risk rating. The **[Business Loan Committee]** will determine the frequency of periodic loan reviews.

Past due borrower(s) will be promptly contacted and arrangements made to bring the account up to date. Unless otherwise indicated, normal collections practices will be followed throughout the duration of the loan.

All contacts with the borrower(s) will be documented in the loan file. A report of all past-due MBLs will be compiled monthly and provided to the **[Business Loan Committee]**. Appropriate charge-off procedures will be followed, but collections efforts will continue.

Loan participations

The credit union may enter into a loan participation in accordance with applicable law. Prior to the purchase or sale of a participation loan, the credit union will enter into a written Master Participation Agreement, which will have been approved by the board and executed by an approved member of the **[Business Loan Committee]**. In addition, a written legal opinion may be obtained on all loan participation agreements prior to execution. A well-crafted loan participation agreement will help the credit union reduce the possibility of misunderstandings and disagreements between all parties involved.

The Master Participation Agreement will include provisions requiring evidence that the originating lender, if a federal credit union, will retain an interest of at least 10% of the outstanding balance of the loan throughout the life of the loan. If the originating lender is any other type of eligible organization, such as a federally insured state-chartered credit union, the retained interest must be 5% of the outstanding balance through the life of the loan, unless a higher percentage is required under applicable state law.

In addition, the Master Participation Agreement, together with the loan specific participation certificate, will address:

- The purchase price;
- Percentage of loans sold or purchased:
- First payment due date;
- Priority interest:
- Yield to buyer:
- Representations and warranties;
- Authority and accountability for regulatory compliance;
- The location and custodian for original loan documents;
- An explanation of the conditions under which parties to the agreement can gain access to financial and other performance information about a loan, the borrower, and the services, so that the parties can monitor the loan;
- An explanation of the duties and responsibilities of the originating lender, servicer, and participants with respect to all aspects of the participation, including servicing, default, foreclosure, collection, and other matters involving the ongoing administration of the loan;
- Exit or termination clause;
- Transferability and sale of participation interests' and
- Circumstances and conditions under which participants may replace the servicer.

The credit union will only originate and participate in loan participations made on a "pari passu" basis (equal risk sharing). The Master Participation Agreement will be properly executed, retained by the credit union, and include provisions for identifying the participation loan(s) prior to their sale, either directly or by incorporation by reference.

In all cases the participation certificate must establish that the credit union is purchasing and/or selling an interest in a particular loan. The credit union will not purchase a participation certificate as a percentage interest in a pool of loans. In the event a participation agreement involves multiple loans, the documentation will include an addendum or schedule for identifying each loan and the credit union's interest in that loan.

Pursuant to NCUA Rules and Regulations §701.22(b)(5)(iv), the credit union will limit the aggregate Amount of loan participations that may be purchased with respect to a single borrower, or group of associated borrowers, to a maximum of 15% of the credit union's Net Worth, unless waived by the appropriate NCUA regional director (with prior written concurrence of the Director, as needed). In addition, the purchase will comply with all regulatory requirements to the same extent as if the credit union had originated the loan, including the loan to one borrower provisions in Wisconsin Statutes §186.098 and Member Business Loan limits in DFI-CU §72.08.

The credit union will limit the aggregate Amount of loan participations that may be purchased from any one originating lender, not to exceed the greater of \$5,000,000 or 100% of the credit union's Net Worth, unless this Amount is waived by the appropriate NCUA regional director (with prior written concurrence of the Director, as needed).

As the originating lender, the credit union will:

- Originate loans only to its members;
- Retain an interest of at least 5% of the face amount of each loan;
- Retain the original or copies of all relevant loan documents; and

- Use the same underwriting standards for participation loans as it uses for loans that are not being sold, unless there is a participation agreement in place prior to the disbursement of the loan funds to the borrower. In that situation, the credit union's policies or the participation agreement must address any variances from normal standards.

When originating loans, the credit union may sell loans to any other credit union, credit union service organization, or federally insured bank. The credit union will provide the purchasing entities with sufficient information necessary to evaluate the borrower's creditworthiness including but not limited to cash flow to service debt analysis, leverage ratio, accounts receivable and payable information, Loan to Value Ratios, liquidity levels and contingent liabilities including the borrower's personal guarantees.

As a participating lender (purchaser), the credit union will:

- Participate only in loans it is authorized to grant;
- Have a participation policy in place that sets forth the loan underwriting standards prior to entering into a participation agreement;
- Participate in participation loans only if made to its own members or members of another participating credit union;
- Retain the original or a copy of the written participation loan agreement and a schedule of the loans covered by the agreement;
- Make an independent analysis of the financial condition of the borrower and ensure compliance with internal policies before recommending approval of the participation loan;
- Retain and maintain all loan documentation, financial information, and financial analyses.

Appraisal requirements

Internal procedures have been established to address risks associated with property valuation. These procedures include minimum standards for an effective real estate appraisal and evaluation program, including selecting individuals who may perform appraisals or evaluations and selection criteria to provide for the independence and competence of the individual performing the appraisal or evaluation.

When applicable, the credit union will obtain a current written appraisal from an outside, qualified, independent appraiser. The appraiser will use the Uniform Standards of Professional Appraisal Practice in determining market value and will document the results of the appraisal on the Uniform Residential Appraisal Report. The appraiser will be state-certified or licensed and have no interest in the subject property.

A documented appraisal or evaluation review will be completed. The reviewer will be independent of the loan underwriter for the applicable loan and will be capable of assessing whether the appraisal or evaluation contains sufficient information and analysis to support the credit union's decision to engage in the transaction.

Flood hazard determination

The credit union will not make, increase, or renew any loan secured by property (building) unless a current standard flood hazard determination form has been received for the property. If the property is located in a special flood hazard area and the community in which the property is located participates in the National Flood Insurance Program, flood insurance will be required for the term of the loan. The amount of insurance must be at least the lesser of the outstanding principal balance of the loan or the maximum limit of coverage available for the property under the National Flood Insurance Act. Flood insurance coverage will be limited to the overall value of the property minus the value of the land on which the property is located.

Exceptions to policy

Exceptions to this policy will be reviewed in accordance with applicable law, regulatory limits, and available waivers. All exceptions to this policy will be handled and approved by **[three members of the Business Loan Committee]**. On approval, these exceptions will be formally documented and included in the loan file.