NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Parts 701 and 714

[NCUA-2022-0185]

RIN 3133-AF49, 3133-AE96

Financial Innovation: Loan Participations, Eligible Obligations, and Notes of Liquidating Credit Unions

AGENCY: National Credit Union Administration (NCUA).

ACTION: Final Rule.

SUMMARY: The NCUA Board (Board) is amending the NCUA's regulations regarding the purchase of loan participations and the purchase, sale, and pledge of eligible obligations and other loans (including notes of liquidating credit unions). The final rule clarifies the NCUA's current regulations and provides additional flexibility for federally insured credit unions (FICUs) to make use of advanced technologies and opportunities offered by the financial technology (fintech) sector. The final rule also amends the NCUA's rule regarding loans to members and lines of credit to members by adding new provisions about indirect lending arrangements and indirect leasing arrangements. Finally, the final rule makes certain conforming changes and technical amendments to the NCUA's regulations. The Board does not view the conforming changes and technical amendments as substantive.

DATES: This final rule is effective [INSERT DATE 30 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

FOR FURTHER INFORMATION CONTACT: *For policy questions*: Naghi Khaled, Director of Credit Markets, the Office of Examination and Insurance, at (703) 518-6360; *for legal questions*: Frank Kressman, General Counsel, the Office of General Counsel, at (703) 518-

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SUPPLEMENTARY INFORMATION:

I. Background

A. Introduction

On December 30, 2022, the Board issued a proposed rule to amend §§ 701.21, 701.22, 701.23, and part 714 of the NCUA's regulations regarding the purchase of loan participations and the purchase, sale, and pledge of eligible obligations and other loans (including notes of liquidating credit unions).[1] The Board intended the proposal to provide FICUs with additional flexibility to make use of advanced technologies and opportunities offered by the fintech sector. In addition, the proposed amendments were intended to clarify ambiguities related to loan participations and eligible obligations and shift from a prescriptive to a more principles-based approach in certain areas.

The Board believes shifting to a more principles-based approach with respect to loan participations and eligible obligations is appropriate and will be beneficial to FICUs. The intent behind the final rule is to advance the NCUA's efforts to strike an appropriate balance between mitigating risk to the National Credit Union Share Insurance Fund (Share Insurance Fund), protecting credit union members, and fostering growth and stability in the credit union system by removing certain prescriptive limits and other qualifying conditions, and replacing them with risk-focused, principles-based requirements. The proposed shift to more principles-based requirements is intended to provide FICUs with additional flexibility to innovate in terms of how they manage their balance sheets while offering new or enhanced services to their members. The

[1] Note that the terms credit union, federal credit union, federally insured, state-chartered credit union, corporate credit union, and FICU are used throughout the document and are not necessarily interchangeable. Specifically, while § 701.23 applies to federal credit unions (FCUs) only, § 701.22 applies to all federally insured consumer credit unions, and § 701.21 has provisions that apply to all federally insured credit unions.

Board believes the proposed changes will increase FICUs' ability to engage in lending arrangements with other financial institutions and third parties, including fintech companies providing lending services, and expand their access to diverse loan origination channels, new markets, including the underserved, and potential new services for their members.

B. Summary of the Final Rule

The Board is now amending the NCUA's regulations regarding the purchase of loan participations and the purchase, sale, and pledge of eligible obligations and other loans (including notes of liquidating credit unions). The final rule adopts the amendments largely as proposed with a few changes, which are discussed in the section-by-section analysis of the preamble below. The final rule relocates and clarifies the NCUA's provisions regarding indirect lending and indirect leasing. The final rule also provides credit unions with additional flexibility to participate in loans acquired through indirect lending arrangements, allowing FICUs to use advanced technologies and opportunities offered by the fintech sector. In addition, the final rule removes certain prescriptive limitations and other qualifying requirements relating to eligible obligations and provides credit unions with additional flexibility to purchase eligible obligations of their members.

Removing the prescriptive limitations and other qualifying requirements is intended to allow FCUs additional flexibility to engage with the advanced technologies and other opportunities offered by the fintech sector. The greater flexibility and individual autonomy will also allow FCUs to establish their own risk tolerance limits and governance policies for these activities provided they are safe and sound given the FCU's financial and operational capabilities, while codifying due diligence, risk assessment, compliance and other management processes that are consistent with the Board's long-standing expectations for safe, sound, fair, and affordable lending practices.

As discussed in greater detail in the section-by-section analysis of the preamble, the final rule amends § 701.21 of the NCUA's regulations to add new paragraph (c)(9) regarding indirect lending and indirect leasing arrangements. The new paragraph replaces the language defining indirect lending and indirect leasing arrangements under current § 701.23(b)(4)(iv).

The final rule also amends § 701.22 of the NCUA's regulations. In particular, the final rule makes certain clarifying amendments to the introductory paragraph, and codifies NCUA Legal Opinion 15-0813, Loan Participations in Indirect Loans – Originating Lender.[2] The codification of Legal Opinion 15-0813 clarifies that a FICU engaged in an indirect lending relationship can meet the definition of "originating lender" under § 701.22 of the NCUA's regulations, provided the FICU meets certain conditions. For purposes of § 701.22, a FICU is considered the originating lender if the FICU makes the final underwriting decision regarding the loan, and the loan is assigned to the purchaser very soon after the inception of the obligation to extend credit.

In addition, the final rule amends § 701.23 of the NCUA's current regulations as follows:

- Makes clarifying and conforming amendments to the introductory paragraph.
- Removes the CAMELS ratings and well-capitalized requirements under paragraph (b)(2) for FCU purchases of certain non-member loans from FICUs.
- Narrows the application of the 5-percent limit on the purchase of eligible obligations to cover only purchases of notes of liquidating credit unions.
- Adds safety and soundness requirements to paragraph (b)(6)(i)–(vi) concerning the purchase of eligible obligations, to offset risks associated with removing the CAMELS ratings and well-capitalized requirements from paragraph (b)(2). Safety and soundness requirements would apply to all FCUs engaged in the purchase of eligible obligations and

[2] NCUA Legal Op. 15-0813 (Aug. 10, 2015) *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2015/loan-participations-indirect-loans-originating-lenders.

notes from a liquidating credit union. In particular, the final rule requires an FCU purchasing eligible obligations or notes from a liquidating credit union to comply with the following:

  - Establish written, board-approved policies, risk assessments, and risk management processes that are commensurate with the size, scope, type, complexity, and level of risk posed by the planned purchase activities. These policies would include underwriting standards for the loans, ongoing performance and risk monitoring, including compliance risk, tailored to the types of loans purchased and the sellers as applicable, and portfolio concentration limits by loan types and risk categories in relation to net worth;
  - Conduct due diligence on a seller prior to a purchase;
  - Include certain contract language and provisions in the written loan purchase agreements (similar to the standards currently established for loan participation agreements under § 701.22 of the NCUA's regulations); and
  - Address in internal written purchase policies when a legal review of agreements or contracts will be performed to ensure that the legal and business interests of the credit union are protected against undue risk.

- Revises the definition of "eligible obligation" under paragraph (a)(1) to clarify the distinction between transactions treated as loan participations and those treated as eligible obligations.
- Revises the applicability of the 5-percent limitation under current paragraph (b)(4) to cover only "notes" purchased by an FCU from a liquidating credit union.
- Revises the "grandfathered purchases" section to include eligible obligation purchases that were executed before the effective date of this final rule, provided the purchases

complied with the version of the rule that was effective at the time the transaction was executed, and subject to safety and soundness and other compliance considerations.

- Adds safety and soundness requirements to paragraph (c) concerning the sale of eligible obligations, requiring the selling FCU to do the following:
    - Obtain a review and assessment of all applicable loan sale agreements or contracts to protect the FCU's legal and business interests; and
    - Identify the specific loan(s) being sold either directly in the written loan sale agreement or through a document incorporated by reference into the loan sale agreement.

The final rule also amends § 714.9 of the NCUA's regulations to make certain non-substantive amendments related to changes to current § 701.23(b)(4)(iv).

Finally, the final rule also makes certain conforming changes and technical amendments in other sections of the NCUA's regulations. The Board does not view these additional conforming technical changes as substantive.

C. Effective Date

Under the Administrative Procedure Act, the NCUA is generally required to provide a minimum of 30 days from the date of publication in the Federal Register before a final rule becomes effective.[3] The final rule will become effective 30 days after the date of publication in the *Federal Register* so it can go into effect as quickly as possible to give credit unions prompt access to the numerous beneficial changes it makes.

II. Legal Authority

[3] 5 U.S.C. 553(d).

Section 120(a)[4] of the Federal Credit Union Act (Act) authorizes the Board to prescribe rules and regulations for the administration of the Act.[5] Similarly, section 209[6] of the Act authorizes the Board to prescribe such rules and regulations as it may deem necessary or appropriate to carry out the share insurance provisions of subchapter II of the Act. In addition, section 206 of the Act provides the Board with broad authority to take enforcement action against a FICU or an "institution-affiliated party"[7] that is engaging or has engaged, or the Board has reasonable cause to believe is about to engage, in an unsafe or unsound practice in conducting the business of such credit union.[8] Congress chose not to define "unsafe or unsound practices" in the Act, leaving determinations regarding which actions are unsafe or unsound to the Board.

Section 107(5)(E) of the Act authorizes FCUs to engage in participation lending with other credit unions, credit union organizations, or financial organizations in accordance with written policies of the credit union's board of directors.[9] Section 107(5)(E) also provides that an FCU that originates a loan for which participation arrangements are made in accordance with this subsection shall retain an interest of at least 10 per centum of the face amount of the loan.[10]

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[4] 12 U.S.C. 1766(a) (The Board may prescribe rules and regulations for the administration of 12 U.S.C. chapter 14 (including, but not by way of limitation, the merger, consolidation, and dissolution of corporations organized under the chapter). Any central credit union chartered by the Board shall be subject to such rules, regulations, and orders as the Board deems appropriate and, except as otherwise specifically provided in such rules, regulations, or orders, shall be vested with or subject to the same rights, privileges, duties, restrictions, penalties, liabilities, conditions, and limitations that would apply to all Federal credit unions under the chapter.).

[5] Sections 1751–1795k.

[6] Section 1789(11) (providing in relevant part as follows: "In carrying out the purposes of this subchapter, the Board may—[. . .] prescribe such rules and regulations as it may deem necessary or appropriate to carry out the provisions of [12 U.S.C. 1781–1790e].").

[7] *See* section 1786(r) (providing that for purposes of the FCU Act, the term "institution-affiliated party" means—(1) any committee member, director, officer, or employee of, or agent for, an insured credit union; (2) any consultant, joint venture partner, and any other person as determined by the Board (by regulation or on a case-by-case basis) who participates in the conduct of the affairs of an insured credit union; and (3) any independent contractor (including any attorney, appraiser, or accountant) who knowingly or recklessly participates in—(A) any violation of any law or regulation; (B) any breach of fiduciary duty; or (C) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured credit union.).

[8] Section 1786.

[9] Section 1757(5)(e).

[10] *Id*.

Section 107(13) of the Act authorizes FCUs, in accordance with rules and regulations prescribed by the Board, to purchase, sell, pledge, or discount or otherwise receive or dispose of, in whole or in part, any eligible obligation (as defined by the Board) of its members.[11] In addition, section 107(13) authorizes FCUs, in accordance with rules and regulations prescribed by the Board, to purchase from any liquidating credit union notes made by individual members of the liquidating credit union at such prices as may be agreed upon by the board of directors of the liquidating credit union and the board of directors of the purchasing credit union, but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union.[12]

Section 107(14) of the Act authorizes FCUs, subject to regulations of the Board, to sell all or a part of their assets to another credit union, to purchase all or part of the assets of another credit union, and to assume the liabilities of the selling credit union and those of its members.[13]

III. Section-by-Section Analysis of the Final Rule and Comments on the Proposal

The NCUA received 42 unique comment letters on the proposed rule. In general, the overwhelming majority of commenters strongly supported the proposed rule and agreed with the NCUA regarding the need for and the rationale supporting the proposed changes. The commenters also agreed with the proposal's shift toward more principles-based regulations and suggested the proposed changes would allow credit unions to be nimble in the future. Accordingly, the Board is now issuing this final rule to adopt the amendments proposed with certain changes that are discussed in more detail in the parts of the preamble below corresponding with the amended sections.

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[11] Section 1757(13).
[12] *Id*.
[13] Section 1757(14).

The NCUA has summarized the comments received that were within the scope of this rulemaking under the parts of the preamble below corresponding with the amended sections and subsections. The NCUA received many comments that were outside the scope of this rulemaking. The NCUA has read and is considering the comments beyond the scope of this rule for future rulemakings. Most of the comments received that go beyond the scope of the proposal, even if summarized, are not specifically responded to by the NCUA in the preamble to this final rule.

A. Part 701 Organization and Operation of Federal Credit Unions

As discussed in more detail below, this final rule makes several changes to sections in part 701 of the NCUA's regulations. These changes clarify numerous provisions regarding loans to members and lines of credit to members under § 701.21; loan participations under § 701.22; and the purchase, sale, and pledge of eligible obligations under § 701.23. In addition, the final rule amends the NCUA's current regulatory requirements under §§ 701.22 and 701.23. The amended requirements would provide FICUs expanded authority and autonomy to innovate and transact business with fintech companies and other institutions that provide services associated with the origination and sale of loans made to members of FICUs.

Public Comments

Several commenters noted that the proposed changes would clarify credit unions' loan participation and eligible obligation authorities, benefiting not only credit unions but also NCUA examiners and various other stakeholders. In addition, many commenters expressly offered support for the proposal's general shift toward a more principles-based approach with respect to the NCUA's loan participation and eligible obligation regulations. One commenter suggested that prescriptive regulations, with fixed limits and rules, prevent credit unions from evolving with shifting market forces (e.g., the rise of fintechs). The commenter explained further that a principles-based approach to risk tolerance and appetite will provide the opportunity for credit

union service organizations (CUSOs) to create comprehensive underwriting guidelines acceptable to all participating credit unions, which will allow credit unions to collectively compete against banks and other financial institutions and be more attractive to lending platform providers, original automotive equipment manufacturers, and point of sale retailers. Another commenter specifically asked that the Board not adopt new prescriptive definitions and regulations. The commenter requested further that all safety and soundness standards imposed in the final rule should be sufficiently flexible to permit credit unions to adopt internal written purchase policy provisions commensurate with the size, scope, type, complexity, and level of risk posed by their individual activities. Several commenters requested, generally, that the NCUA do more to clarify the rules, expand credit unions' authority in this area, or both.

Discussion

Consistent with the strong support received from commenters, the Board is adopting the rule largely as proposed, for the reasons set forth in the notice of proposed rulemaking, with certain changes discussed in the section-by-section analysis below. In addition, several commenters requested additional clarification on certain aspects of the proposal. The NCUA has provided further clarifying guidance to credit unions where appropriate.

Section 701.21 Loans to Members and Lines of Credit to Members

Section 701.21(c) General Rules

As discussed in more detail below, this final rule, as a conforming amendment, adds new provisions to § 701.21 regarding indirect lending arrangements and indirect leasing arrangements. The new provisions take the place of a provision in current § 701.23, which will be removed as part of this final rule.

Public Comments

Most commenters offered support for the proposed changes to the NCUA's regulations regarding indirect lending and indirect leasing arrangements, agreed the proposed changes would

provide additional clarification to affected parties, and supported moving the provisions to § 701.21. Moreover, three commenters agreed with the NCUA's assessment that the proposed changes to the definitions of "indirect lending arrangements" and "indirect leasing arrangements" are unlikely to have a material impact on credit unions' existing and future indirect lending or indirect leasing arrangements. Another commenter agreed that the proposed definitions use language that, while generally similar to the language in current § 701.23(b)(4)(iv), provides much needed, common-sense clarification to both terms.

Discussion

Consistent with the support received from commenters on the proposal, the Board is adopting new paragraph (c)(9) to § 701.21 regarding the indirect loans and indirect leasing arrangements as proposed for the reasons set forth in the notice of proposed rulemaking. Although not raised by commenters, the final rule also adds language and a cross citation to § 714.2(b) to direct readers to new § 701.21(c)(9) and alert them to the relationship between paragraph (c)(9) and part 714 of the NCUA's regulations regarding leasing. No substantive change to the NCUA's regulations is intended by this addition. This addition is discussed in more detail in the part of the preamble associated with part 714 of the final rule.

New § 701.21(c)(9) Indirect Lending and Indirect Leasing Agreements

For reasons discussed in the preamble discussion on current § 701.23(b)(4), the NCUA is deleting current paragraph (b)(4)(iv) regarding indirect lending. Current § 701.23(b)(4)(iv) excludes certain loans acquired through indirect lending arrangements and indirect leasing arrangements from the 5-percent limit on the aggregate of the unpaid balance of certain loans purchased under § 701.23. While the language excluding loans and leases acquired through indirect lending and indirect leasing arrangements is no longer needed in § 701.23(b)(4), the definition of such arrangements is still relevant for purposes of other provisions in the NCUA's

regulations. Under current paragraph (b)(4), and NCUA's long-standing interpretation,[14] loans acquired by an FCU pursuant to an indirect lending arrangement are considered loans made by the FCU under § 701.21, rather than loans purchased under § 701.23. Accordingly, the Board is adding new paragraph (c)(9) regarding indirect lending and indirect leasing arrangements to § 701.21. The paragraph replaces the language defining indirect lending and indirect leasing arrangements under current § 701.23(b)(4)(iv).

New § 701.21(c)(9)(i) Definitions

New § 701.21(c)(9)(i) would define the terms "indirect leasing arrangement" and "indirect lending arrangement" for purposes of the NCUA's regulations. Current § 701.23(b)(4)(iv) provides that an indirect lending or indirect leasing arrangement that is classified as a loan and not the purchase of an eligible obligation because the FCU makes the final underwriting decision, and the sales or lease contract is assigned to the FCU very soon after it is signed by the member and the dealer or leasing company, is excluded in calculating the 5-percent limit. The NCUA believes splitting the provision in paragraph (b)(4)(iv) into two definitions will help clarify the existing requirements. Accordingly, new § 701.21(c)(9)(i) provides that the term *indirect leasing arrangement* means a written agreement to purchase leases from the leasing company where the purchaser makes the final underwriting decision, and the lease agreement is assigned to the purchaser very soon after it is signed by the member and the leasing company. New paragraph (c)(9)(i) would provide further that the term *indirect lending arrangement* means a written agreement to purchase loans from the loan originator where the purchaser makes the final underwriting decision regarding making the loan, and the loan is assigned to the purchaser very soon after the inception of the obligation to extend credit.

[14] *See, e.g.,* NCUA Legal Op. 97-0546 (Aug. 6, 1997), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/1997/indirect-lending.

Both new definitions would use language that is generally similar, but not identical, to the language in current § 701.23(b)(4)(iv). The NCUA is revising the language used in current paragraph (b)(4)(iv) to clarify the different requirements that apply to indirect leasing arrangements and indirect lending arrangements. The amendments are not intended to change the current meaning of both terms. The Board specifically requested comment on whether proposed paragraph (c)(9) would have a material impact on credit unions' existing and future indirect lending arrangements, indirect leasing arrangements, or both.

Public Comments

One commenter recommended clarifying the meaning of the phrase "inception of the obligation to extend credit." The commenter asked, as an example of its confusion about the meaning of the phrase, does this mean when the credit union verifies underwriting criteria, when the borrower has a sufficient credit score according to the credit union, or some other step in the process of extending credit?

Discussion

The Board believes the phrase "inception of the obligation to extend credit" is clear and unambiguous. Merriam-Webster's Online Dictionary defines the term "inception" as "an act, process, or instance of beginning: COMMENCEMENT."[15] The inception of the obligation to extend credit, then, is the point in time when the indirect lender becomes obligated to extend credit to the borrower. As with all its rules, however, the Board will monitor implementation and provide additional clarifying guidance as it deems necessary.

Should the Board further clarify the term "final underwriting decision"? The Board invited comments in the proposal on what it means for the credit union to make the final underwriting decision regarding making the loan in an indirect lending arrangement. For example, should the

[15] *Available at* https://www.merriam-webster.com/dictionary/inception.

rule specify that a credit union in an indirect lending arrangement must be involved or consulted at the time of the extension of credit? In the alternative, should the rule specify that a credit union can simply provide its underwriting standards to the other party in the indirect lending arrangement and clarify in the indirect lending agreement that only those loans meeting the credit union's underwriting standards will be accepted for funding? Would a credit union still be making the final underwriting decision if a third party includes significantly more underwriting criteria that are more restrictive, for example, than the credit union requires?

Public Comments

In response to NCUA's question in the proposed rule preamble, two commenters responded that the NCUA should not define the phrase "final underwriting decision." One of those commenters explained that the implementation of additional requirements through a definition could stifle innovation as new products are created and/or create unintended regulatory burden that may be unnecessary due to the specifics of the underwriting situation. Another commenter responded that, if the credit union has provided its guidelines or other underwriting criteria and has the ability to not approve or not fund a loan that does not meet its criteria, there is no need to make the definition more specific. A third commenter suggested that the current safety and soundness requirements are sufficient to enable a credit union to identify, isolate, and resolve any issues the credit union may later discover.

On the other hand, two commenters asked that the NCUA define the phrase "final underwriting decision." One of those commenters recommended the phrase be defined to avoid ambiguity or potential conflict with existing laws and regulations that require the loan originator to make the final underwriting decision, and situations involving prearranged underwriting and processing agreements between third-party originators and the purchasing credit unions. The commenter recommended further that the definition allow the seller (loan originator) to use the purchasing credit union's underwriting guidelines. Another commenter recommended defining

the phrase to clarify that the purchasing FCU is considered to have made the "final underwriting decision" so long as the loan conforms to the FCU's pre-approved underwriting criteria, even when a fintech company or other indirect lending partner adds additional, more restrictive underwriting criteria than the FCU requires. In the commenter's opinion, the indirect lending partner is acting as a facilitator on behalf of the credit union in such cases to provide credit enhancements and is not overriding the credit union's underwriting criteria. The commenter also suggested that indirect lending partners weeding out bad loans in this fashion promotes safety and soundness by reducing credit risk to FCUs, whether the indirect lender uses an algorithm, natural persons' judgment, or both to provide such credit enhancements. To clarify this point, the commenter recommended the definition of "final underwriting decision" in § 701.21(c)(9)(i) provide as follows:

> The FCU makes the "final underwriting decision" so long as:
>
> (1) The FCU establishes by contract that the indirect lending partner must adhere to the underwriting standards set forth in the indirect lending agreement; these underwriting standards are typically included as an appendix or exhibit to the master agreement for the indirect lending relationship; and
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> (2) The indirect lending partner can apply additional, more restrictive underwriting criteria that go above-and-beyond the FCU's underwriting requirements, whether those additional underwriting criteria are part of an automated loan underwriting system and/or are performed by a natural person individual who is not involved in the disbursement of loan funds.

Several commenters did not expressly recommend defining the phrase "final underwriting decision," but did offer recommendations about how the term should be interpreted. Three commenters asked that credit unions be allowed to charge third-party partners with prescribed standards that must be met and manage the risk of the engagement through due diligence and oversight. One of those commenters asked further that credit unions then be allowed to choose to review loans before or after funding, depending on their comfort and experience with the third-party partner; the expectation being that the credit unions be familiar with the third party's underwriting standards and where those standards might be different (in more or less conservative ways) than their own. Finally, the commenter suggested that the adequacy of a credit union's due diligence and oversight of its third-party partners is a safety and soundness issue best left to examiners in the field. Another one of those commenters suggested that, if the NCUA needed to strengthen this part of the rule to justify making this change, it could consider also adding the following express requirements: (1) the underwriting standards must be within the credit union's approved underwriting and credit policies; (2) the underwriting standards must be clearly referenced in the representations and warranties of the agreement between the fintech/flow partner and the credit union and, if not met, require repurchase of the loans by the fintech/flow partner; and (3) the credit union must, as part of best practices and safety and soundness considerations, review and analyze the indirect loan pools prior to settlement or as soon as practical (for example, in the early part of the month subsequent to the month in which the loans were purchased) to ensure they are compliant with NCUA rules (for example, maturity limits, the statutory maximum interest rate, etc.) and meet the credit "stips"/guidelines set forth in the agreement between the parties.

Several commenters also recommend that, if the phrase "final underwriting decision" is defined, the NCUA not require that credit unions engaged in indirect lending be actively involved or consulted at the time a facilitating partner extends credit to borrowers on the credit

union's behalf or limit the number of permissible facilitating partners. The commenters suggested such a requirement would be logistically challenging and could result in fewer loans being made through indirect lending arrangements.

Discussion

The Board appreciates the detailed comments that were submitted regarding defining the phrase "final underwriting decision." While the comments received in this area go beyond the scope of this rulemaking, the comments will be retained for consideration by the NCUA during future rulemakings relating to indirect lending.

The NCUA has long used the act of underwriting a loan as a feature to distinguish between transactions where a FICU makes a loan and transactions where a FICU purchases a loan.[16] In particular, in a 1997 legal opinion the NCUA explained:

> FCUs may participate in indirect lending arrangements under the authority to make loans to members, 12 U.S.C. §107(5); 12 C.F.R. §701.21, rather than the authority to purchase eligible obligations, 12 U.S.C. §107(13); 12 C.F.R. §701.23, as long as two conditions are met. First, the FCU must make the final underwriting decision. That is, before the retailer and the member complete the loan or sales contract, the FCU must review the application and determine that the transaction conforms to its lending policies. This is because an FCU may not delegate its lending authority to a third party.[17]

By requiring the purchasing credit union to make the final underwriting decision in an indirect lending transaction, the NCUA ensures that the purchasing credit union is not relying on the due

[16] *See, e.g.,* NCUA Legal Op. 92-1203 (Jan. 5, 1993); NCUA Legal Op. 92-1203 (May 11, 1993); NCUA Legal Op. 97-0546 (Aug. 6, 1997), *available at* https://ncua.gov/regulation-supervision/legal-opinions; *and* § 701.23(b)(4)(iv).
[17] NCUA Legal Op. 97-0546.

diligence of the loan seller who might otherwise have had a decreased interest in properly underwriting the loan knowing it would later be sold.

The NCUA explained further in the same 1997 legal opinion that an eligible organization may use an automated credit scoring system to make its final underwriting decision so long as the "score" obtained from the automated system is the sole determinant for granting credit. When an eligible organization establishes the qualifying criteria for the automated scoring system, it is effectively making an advance decision on a particular application.[18] So long as the party entering the borrower's application information does not exercise any judgment regarding that information, the score will be deemed to reflect the FCU's lending policies.[19]

Nothing in current § 701.23(b)(4)(iv) or § 701.21(c)(9)(i) of this the final rule, however, prohibits an indirect lending partner from having its own separate underwriting criteria, which it may use to screen borrowers *before* the credit union makes its final underwriting decision. An indirect lending partner may screen applicants for a loan using underwriting criteria from multiple lending partners; for example, criteria such as credit score, debt-to-income or debt service coverage ratios, collateral loan-to-value ratios, loan terms, and interest rates. In such cases, the determining factor is not what initial underwriting criteria the indirect lending partner may have used, but whether the credit union made the *final* underwriting decision. Thus, the indirect lending partner's initial underwriting criteria may differ from the credit union's underwriting criteria but the credit union must make the final underwriting decision to ensure the loan meets the credit union's underwriting criteria. The Board believes that what constitutes making a final underwriting decision may continue to evolve as credit unions implement

[18] *See id.*; *see also* 63 FR 70997, 70997 (Dec. 23, 1998) (agreeing with commenters that credit or electronic scoring by a third-party vendor using the credit union's criteria is consistent with the FCU making the final underwriting decision).
[19] *See id*.

artificial intelligence and machine learning based underwriting systems, as well as engage with fintech companies.

In indirect lending situations not involving automated credit scoring systems, a credit union may not wait until after the inception of the obligation to extend credit to review the loan application and determine whether the transaction conforms to its lending policies because the credit union then would not have made the final underwriting decision. A credit union should retain approval authority to engage in indirect lending (that is, employees or independent contractors working for the indirect lending partner cannot make the final underwriting decision on the credit union's behalf).[20] For large loans, complex loans, or both, a credit union may grant preliminary approval of the loan based on the indirect lending partner's representations to the credit union's loan officer that the loan conforms to the credit union's underwriting policies. The credit union must then review the loan application and determine that the loan, the application, and the transaction conform to its lending policies before the credit union grants its final approval and before the loan proceeds are sent to the indirect lending partner.

In all indirect lending transactions, credit unions should also retain the right to deny a loan should it discover the loan does not comply with the credit union's policies or standards upon receipt of the final paperwork. A credit union should document this "right" in the indirect lending agreement.

Should the Board define the phrase "very soon after"? The Board asked in the proposal whether additional clarification was needed such as adding certain parameters around the meaning of "very soon after" for the assignment of the loan or contract to the credit union. Examples given were within 7 days of the borrower executing the loan or contract or assignment prior to the first loan payment.

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[20] NCUA Legal Op. 97-0546.

Public Comments

Three commenters recommend not defining the phrase "very soon after." One commenter suggested that using the language "very soon after" is appropriate and should not cause significant issues and that setting a specific period is not necessary. Another commenter acknowledged that timely assignment of a loan or sales contract should be a factor in ensuring a FICU or other eligible organization is prudently engaged in an indirect lending arrangement, but suggested the FICU or other eligible organization's adherence to relevant safety and soundness standards is far more determinative of any relevant risks that may accrue to the institution or the Share Insurance Fund. The commenter suggested further that a prescriptive loan or sales contract transfer timeline could undermine indirect lending partnerships the NCUA intends to promote. One commenter suggested that specifying a prescriptive period could be disruptive to the marketplace and put additional operational burdens on credit unions. The commenter also observed that each program between a fintech/flow partner and a credit union for a given loan category will have a cadence that is different (given purchase timing preferences and operational logistics) and that, if the timeframe set by regulation is too short, it could disrupt the credit union's pre-purchase settlement analysis and review process of the loan pool.

Six commenters recommend defining the phrase "very soon after" to avoid confusion. Four of the commenters recommended providing a specific number of days following the borrower's execution of the loan or contract. One commenter suggested the specific number be 5 or 7 business days but not a window that is excessive, such as 10 days. Another commenter suggested the number be 7 days. One commenter suggested the number be no more than 7 or 10 days. And one commenter suggested the number be 30 days or less.

Two commenters recommend defining "very soon after" more generally to mean prior to the due date of the member's first loan payment (other than any down payment). Two commenters also recommended clarifying that the assignment can involve more than one party,

such as if a fintech indirect lending partner uses one or more agents or subsidiaries to facilitate its operations prior to the loan being delivered to the credit union. One of those commenters suggested the changes discussed in this paragraph could be made to the rule by adding a new paragraph to proposed § 701.21(c)(9)(i) that would provide as follows:

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

Finally, one commenter suggested that if "very soon after" is defined, the definition should ensure that appropriate flexibility is given to address the various timeframes required to appropriately assign loans backed by different collateral types and to ensure a more forward-looking regulation that can help ensure future evolution as loan and lease products continue to change.

Discussion

The Board appreciates the detailed comments that were submitted regarding defining the phrase "very soon after." Defining the phrase in this final rule, however, would go beyond the scope of the proposal. Accordingly, the comments received on this issue have been shared with the Board, reviewed, and will be retained for consideration by the NCUA in future rulemakings relating to indirect lending.

Several commenters expressed confusion regarding the NCUA's use of the term "very soon after" in the regulation. The term very soon after has been used but not defined in the

NCUA's indirect lending regulation since 1998.[21] The period that satisfies the "very soon after"[22] element depends on the nature of the loan and the practical realities of assigning certain kinds of loans in the current marketplace and in accordance with prevailing industry standards.[23] "Very soon after" is determined on a case-by-case basis by loan type and in accordance with commercial reasonableness.[24] The NCUA's longstanding position is that the sooner the assignment is made the more likely the point-of-sale retailer will be viewed as an indirect lender and not the originating lender.[25] Historically, NCUA examination staff have generally used 7 days as a baseline for gauging whether a transaction meets the "very soon after" timeframe, but this has not been codified as a requirement. The longer the time between formation of the contract and assignment, the more likely the arrangement will be viewed as the purchase of a third-party loan rather than the making of a loan through indirect channels.[26] The NCUA also notes that the technology used in many indirect lending relationships today allows for an almost instantaneous assignment of loans.

In addition, two commenters recommended defining "very soon after" in a way that clarifies that the requirement for a loan to be assigned to the purchaser very soon after the inception of the obligation to extend credit may be satisfied regardless of whether the assignment process undergoes multiple functional steps, with multiple entities, so long as the other requirements of 701.21(c)(9) are met and those steps occur before the loan is assigned. The

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[21] 63 FR 70997 (Dec. 23, 1998).
[22] The preamble to the 1998 proposal to amend the eligible obligations rule requested public comment on whether NCUA should specify a certain number of days as constituting "very soon." 63 FR 41976, 41977 (Aug. 6, 1998). After considering the comments, however, the NCUA Board determined not to specifically define it because the Board wanted to provide FCUs with flexibility under various circumstances. The NCUA Board also clarified that assignment of the loan means acceptance of the loan and not necessarily the physical receipt of the loan documentation, recognizing that acceptance and payment are often done electronically. However, physical receipt of the loan documents by the FCU should occur within a reasonable time following acceptance of the loan. 63 FR 70997, 70998 (Dec. 23, 1998).
[23] NCUA Legal Op. 15-0813 (Aug. 10, 2015).
[24] *Id*.
[25] *Id*.
[26] 63 FR 41976, 41977 (Aug. 6, 1998).

Board appreciates this recommendation, but believes this clarification is unnecessary because the plain language of both current § 701.23(b)(4)(iv) and § 701.21(c)(9)(i) of the final rule are clear. Neither paragraph imposes a limitation on the number of functional steps or entities that are involved in the assignment process, provided the loan is assigned very soon after the inception of the obligation to extend credit and all other applicable requirements are met.

Should the Board propose a separate indirect lending rule? The Board asked in the proposal whether the NCUA should establish an indirect lending rule. And if so, the Board asked what it should consider in any future indirect lending rulemaking. The Board also asked if a credit union should be considered the originating lender in cases where an intermediary is added to a loan transaction between the initial party extending credit and a credit union, including a third party facilitating the loan transaction. The NCUA received several inquiries from the credit union system related to CUSOs that work with other lenders to extend credit. The CUSOs in those cases then either receive an immediate assignment of the loans and/or act as a facilitator in immediately assigning loans further to credit unions, where the loans meet the credit unions' underwriting criteria.

Public Comments

Two commenters responded in the negative to the NCUA's question about whether the agency should establish a separate indirect lending rule. One of those commenters recommended maintaining a principles-based approach in this area and suggested such an approach requires no separate rule. The other commenter suggested there are numerous situations where a credit union would use a third party to assist in the origination of loans and a separate indirect lending rule would not change the overall impact of being considered the originating lender. One commenter recommended not undertaking a separate indirect lending rulemaking until the agency is able to evaluate and understand how credit unions and other credit union industry stakeholders react to any final rule the NCUA adopts related to this proposal. Finally, three

commenters recommended a separate indirect lending rulemaking to provide greater clarity and encourage greater participation in this area. One of those commenters suggested further that a new indirect lending rulemaking could amplify participation and provide credit unions, financial service providers, and CUSOs greater opportunity to collaborate and impact member retention and growth.

Discussion

The Board appreciates the detailed comments that were submitted regarding proposing a separate indirect lending rule. While the comments received in this area go beyond the scope of this rulemaking, the comments will be retained for consideration by the NCUA during future rulemakings relating to indirect lending.

New § 701.21(c)(9)(ii) Indirect Lending

New § 701.21(c)(9)(ii), consistent with current § 701.23(b)(4)(iv), clarifies the difference between loans made pursuant to indirect lending arrangements under § 701.21 and loans purchased under § 701.23. Current § 701.23(b)(4)(iv) excludes loans acquired pursuant to certain indirect lending arrangements from the 5-percent limit under current paragraph (b)(4). Paragraph (b)(4)(iv) provides that an *indirect lending* or indirect leasing arrangement that *is classified as a loan and not the purchase* of an eligible obligation *because* the FCU makes the final underwriting decision, and the sales or lease contract is assigned to the FCU very soon after it is signed by the member and the dealer or leasing company, is excluded from calculating the 5-percent limit.[27] As previously mentioned, current § 701.23(b)(4)(iv) is removed by this final

[27] (emphasis added); *see also, e.g.,* NCUA Legal Op. 97-0546 (Aug. 6, 1997) (providing in relevant part as follows: "FCUs may participate in indirect lending arrangements under the authority to make loans to members, 12 U.S.C. §107(5); 12 C.F.R. §701.21, rather than the authority to purchase eligible obligations, 12 U.S.C. §107(13); 12 C.F.R. §701.23, as long as two conditions are met. First, the FCU must make the final underwriting decision. That is, before the retailer and the member complete the loan or sales contract, the FCU must review the application and determine that the transaction conforms to its lending policies. This is because an FCU may not delegate its lending authority to a third party. Second, the retailer must assign the loan or sales contract to the FCU very soon after it is completed. Assignment close in time to the making of the loan allows the retailer to function as the facilitator of the loan while the FCU remains the true lender. As the time between completion and assignment of the loan lengthens, the FCU's payment to the retailer becomes the purchase of the loan rather than part of the processing of the loan.").

rule. Accordingly, new § 701.21(c)(9)(ii) provides that a loan acquired pursuant to an indirect lending arrangement, and that meets the requirements of § 701.21, is classified as a loan and not the purchase of a loan for purposes of the NCUA's regulations, which are codified in chapter VII of title 12 of the Code of Federal Regulations.

Public Comments

One commenter suggested clarifying in proposed § 701.21(c)(9)(ii) that for a loan to be classified as an "indirect loan," it must meet the requirements of § 701.21 *and the FCU Act*.[28]

Discussion

The Board believes the clarification requested above is unnecessary. The requirement that FICUs also comply with the Act is already clear under the NCUA's regulations given the authority for most of the provisions in the NCUA's regulations are derived directly from the Act itself. Moreover, adding such a statement in one provision within the NCUA's regulations, but not everywhere, could give the false impression that FICUs do not have to comply with the Act's requirements in places where the NCUA's regulations do not specifically require it. Accordingly, the final rule adopts the language proposed without change for the reasons set forth in the notice of proposed rulemaking.

New § 701.21(c)(9)(iii) Indirect Leasing

New § 701.21(c)(9)(iii), consistent with current §§ 701.23(b)(4)(iv) and 714.9, clarifies the difference between leases made pursuant to indirect leasing arrangements under § 714.2(b)[29] and leases purchased under § 701.23. Current § 701.23(b)(4)(iv) excludes leases acquired pursuant to certain indirect leasing arrangements from the 5-percent limit under current paragraph (b)(4). Paragraph (b)(4)(iv) provides that an indirect lending or *indirect leasing*

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[28] (emphasis added).

[29] § 714.2(b) (Providing: "[An FCU] may engage in indirect leasing. In indirect leasing, a third party leases property to [the FCU's] member and [the FCU] then purchases that lease from the third party for the purpose of leasing the property to [the FCU's] member. [The FCU does] not have to purchase the leased property if [it complies] with the requirements of § 714.3.").

arrangement that *is classified as a loan and not the purchase* of an eligible obligation *because* the FCU makes the final underwriting decision, and the sales or lease contract is assigned to the FCU very soon after it is signed by the member and the dealer or leasing company, is excluded in calculating the 5-percent limitation.[30] Similarly, current § 714.9 provides that an FCU's indirect leasing arrangements are not subject to the eligible obligation limit if they satisfy the provisions of § 701.23(b)(3)(iv) that require that an FCU make the final underwriting decision and that the lease contract is assigned to the FCU very soon after it is signed by the member and the dealer or leasing company. Accordingly, new § 701.21(c)(9)(iii) provides that a lease acquired pursuant to an indirect leasing arrangement, and that meets the requirements of part 714 of the NCUA's regulations, is classified as a lease and not the purchase of a lease for purposes of the NCUA's regulations, which are codified in chapter VII of title 12 of the Code of Federal Regulations.

Section 701.22 Loan Participations.

As discussed in more detail below, the final rule makes clarifying amendments to § 701.22. These changes are primarily intended to clarify FCUs' authority to purchase loan participations and the requirements applicable to the purchase of loan participations by federally insured, state-chartered credit unions (FISCUs).

Public Comments

Two commenters asked the NCUA to do more to reduce confusion regarding whether §§ 701.22 or 701.23 applies to a particular transaction. One of those commenters recommended

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[30] *Id.* (emphasis added); *see also* 12 CFR 714.2(b) & 714.9; *and* NCUA Legal Op. 00-0811 (Nov. 2000) (providing in part as follows: "NCUA's leasing regulation recognizes that FCUs may engage in the leasing of personal property and does not distinguish between consumer and business leasing. 12 C.F.R. Part 714. The authority of FCUs to engage in secured lending is the basis for their authority to engage in leasing. Therefore, FCU leasing generally must comply with the statutory and regulatory requirements applicable to secured lending, including the member business loan rule. 12 C.F.R. Part 723. Our leasing regulation, however, notes exceptions from certain provisions of the lending rules that are not pertinent to leasing; for example, the interest rate ceilings. 12 C.F.R. §§714.10, 701.21(c)(7). In a lease, the lessee's payments are periodic rental payments, not the repayment of principal and interest as in a loan.").

that the NCUA clarify in the loan participation and eligible obligation rules that purchasing FICUs have discretion to classify a partial interest in a loan under either Section 701.22 or 701.23 when the terms and conditions of the purchase meet the requirements of both rules.

Discussion

The specific clarifications requested above would expand the authorities proposed beyond the scope of the proposed rule. As outlined in the notice of proposed rulemaking, one purpose of the amendments was to clarify ambiguities related to distinguishing between loan participations and eligible obligations. To facilitate this, the proposed definition of eligible obligation was revised to provide that an eligible obligation is a whole loan or part of a loan (other than a note held by a liquidating credit union) that does not meet the definition of a loan participation under § 701.22(a). The Board believes the rule clarifies FICUs' authority to purchase partial loans under § 701.23 given that the amended definition of "eligible obligation" expressly excludes the purchase of partial loans that meet the definition of a "loan participation," as that term is defined under § 701.22(a). An FCU is authorized under §§ 701.22 and 701.23 to purchase a loan or part of a loan only if it meets the definition of *one* of the following: (1) a "loan participation," (2) an "eligible obligation," or (3) a "note of a liquidating credit union."[31] For FCUs, a loan or partial loan purchased cannot meet the definitions of both an eligible obligation and a loan participation. Amending the final rule to provide otherwise would go beyond the scope of this rulemaking. For FISCUs, partial loan purchases that meet the definition of a "loan participation" must comply with the requirements of § 741.225 and the applicable requirements of § 701.22. Other types of loans purchased by FISCUs must meet the requirements of both state law and part 741 of the NCUA's regulations. Accordingly, the Board

[31] Note, § 741.8 requires prior approval for the purchase of certain types of loans and partial loans authorized under § 701.23(b).

adopts the language originally proposed in § 701.22 without change for the reasons set forth in the notice of proposed rulemaking.

The purchase of part of a loan under § 701.23 and the purchase of a loan participation under § 701.22 are treated as separate and distinct transactions under the final rule. The purchase of part of a loan by an FCU, provided it meets the definition of an eligible obligation, is subject to the requirements and conditions of § 701.23. The purchase of a loan participation, as defined under § 701.22, by a FICU is subject to the requirements and conditions under the NCUA's loan participation rule. Credit unions must properly identify each transaction as either the purchase of an eligible obligation or the purchase of a loan participation at the time of purchase.

701.22 Introductory Paragraph

The introductory paragraph to current § 701.22 sets forth the scope and limitations of the section. The NCUA Board added the introductory paragraph to § 701.22 as part of a final rule it approved in 2013 (2013 Final Rule).[32] The introductory paragraph was intended to clarify several issues related to the scope and applicability of § 701.22. In particular, the 2013 Final Rule is explained as follows in the remainder of this paragraph. The introductory text clarified the scope of the rule and helped distinguish a loan participation under § 701.22 from an eligible obligation under § 701.23. Further, it clarified that the rule applies to a consumer FICU's purchase of a loan participation where the borrower is not a member of that credit union. The introductory text goes on to state that generally, an FCU's purchase, in whole or in part, of its member's loan is covered by NCUA's eligible obligations rule at § 701.23. Additionally, by a cross-reference to Part 741 of NCUA's regulations, the rule also was made applicable to consumer FISCUs. The Board noted that corporate credit unions are subject to the loan

[32] 78 FR 37946 (June 25, 2013).

participation requirements set forth in Part 704 and, therefore, are not subject to § 701.22 of NCUA's regulations.[33]

The introductory paragraph to current § 701.22 has seven separate substantive provisions. First, the paragraph provides that this section applies only to loan participations as defined in the section. Second, it provides that the section does not apply to the purchase of an investment interest in a pool of loans. Third, it provides that the section establishes the requirements a FICU must satisfy to purchase a loan participation. Fourth, it provides that the section applies to a FICU's purchase of a loan participation only where the borrower is not a member of the purchasing FICU and where a continuing contractual obligation between the seller and purchaser is contemplated. Fifth, it provides that § 701.23 generally applies to an FCU's purchase of all or part of a loan made to one of its members. Sixth, it provides that § 741.225 requires FISCUs to comply with the requirements of § 701.22. Section 741.225 also provides that FISCUs are exempt from the borrower membership requirement in current § 701.22(b)(4). Seventh, the paragraph provides that the section does not apply to corporate credit unions as defined in part 704.

In the 2013 Final Rule, the Board added a similar introductory paragraph to § 701.23 regarding the purchase, sale, and pledge of eligible obligations to clarify the scope of that section and distinguish loan participations from eligible obligations. The provisions included in that introductory paragraph are discussed in detail later in the part of the preamble about the introductory paragraph to § 701.23.

Since adopting the prefatory language in both sections, the NCUA has received inquiries from NCUA examiners, FICUs, fintech companies, and other parties who have expressed confusion about how to interpret many of these provisions. This confusion has led to

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[33] *Id*. at 37948.

inconsistent reporting of loan interests by FICUs and uncertainty about which of the two sections, § 701.22 or § 701.23, to apply to certain transactions, particularly innovative programs that have been designed by FICUs after 2013. In addition, the Board is concerned that continued confusion about lines of authority in this area could discourage FICUs from entering into certain safe, sound, and compliant loan participation, purchase, or sale agreements that are within their statutory authority.

One significant issue with the introductory paragraph to current § 701.22 that parties have raised is when a FICU's partial loan purchase is subject to that section. Parties have cited the continuing contractual obligation qualifier as a source of confusion. The fourth sentence in the introductory paragraph provides that the section applies only to a FICU's purchase of a loan participation where the borrower is not a member of that credit union *and where a continuing contractual obligation between the seller and purchaser is contemplated*.[34] The fifth sentence in the paragraph provides further that, generally, an FCU's purchase of all or part of a loan made to one of its own members, subject to a limited exception for certain well-capitalized FCUs in § 701.23(b)(2), *where no continuing contractual obligation between the seller and purchaser is contemplated*, is governed by § 701.23 of this part.[35] Similarly, the introductory paragraph to § 701.23 provides that § 701.23 governs an FCU's purchase, sale, or pledge of all or part of a loan to one of its own members, subject to a limited exception for certain well-capitalized FCUs, *where no continuing contractual obligation between the seller and purchaser is contemplated*.[36]

In practice, however, purchase agreements, regardless of whether the transactions involve the purchase of an eligible obligation or a loan participation, frequently contain some form of continuing contractual obligation between the buyer and the seller, including representations and warranties regarding the loans and loan repurchase agreements, servicing agreements, and other

[34] Emphasis added.
[35] Emphasis added.
[36] Emphasis added.

similar types of ongoing obligations set forth under the agreements. The Board believes the continuing contractual obligation clauses in the fourth and fifth sentences in the introductory paragraphs to current § 701.22 are unnecessary when determining whether a loan purchase agreement qualifies as either a loan participation or an eligible obligation.

In addition to the concerns explained above, the clause *where the borrower is not a member of that credit union* in the first part of the fourth sentence of the introductory paragraph conflicts with another provision in § 701.22. This language could be misinterpreted to suggest that § 701.22 does not apply to a partial loan purchase where the borrower is a member of the purchasing credit union, even when the transaction otherwise meets the definition of a loan participation under § 701.22. This clause directly conflicts with the more specific requirement in § 701.22(b)(4), which provides that the borrower must become a member of one of the participating credit unions before the purchasing FICU purchases a participation interest in the loan. The NCUA has long interpreted the more specific language in paragraph (b)(4) as controlling and has applied the requirements of § 701.22 to partial loan purchases where the purchase meets the definition of a loan participation and the borrower is a member of the purchasing FICU.

Accordingly, the NCUA believes the removal of this clause will serve to clarify and reduce confusion when § 701.22 applies to certain transactions. As part of the 2022 proposed rule, the Board requested comment on whether deleting the fourth and fifth sentences in the introductory paragraph to current § 701.22 would clarify when the section applies to certain transactions.

The NCUA recognizes that whether the purchase of a partial loan is a loan participation under § 701.22 or a loan purchase under § 701.23 may still be uncertain in some instances even if these sentences are removed. The NCUA believes, however, that other provisions in § 701.22,

such as the definition of loan participation and the conditions outlined in paragraph (b), make clear which transactions are subject to the requirements of § 701.22.

As discussed in more detail in the part of the preamble below regarding § 701.23, the Board is also deleting the continuing contractual obligations sentence in current § 701.23. The Board intends the deletion to work in conjunction with the changes to the introductory paragraph to current § 701.22.

The Board proposed no other changes to the introductory paragraph to current § 701.22. Another provision in the introductory paragraph that is often misread, however, is the sentence providing that § 701.22 does not apply to the *purchase of an investment interest in* a pool of loans. That sentence is intended to clarify that the purchase of such investment interests, to the extent they are permitted, are governed by part 703 of the NCUA's regulations for FCUs (and under part 741 of the NCUA's regulations and as authorized under state law for FISCUs) and not § 701.22. This continues to be the case under this proposal. The NCUA notes further that this qualification to the section makes clear that § 701.22 neither applies to nor authorizes FICU investments in either asset-backed securities or the purchase of other similar investment interests in pools of loans.[37] The requirements of § 701.22 apply to each individual loan in which a FICU purchases a loan participation interest.[38]

The final rule amends the introductory text of § 701.22 to provide the following: First, § 701.22 applies only to loan participations as defined in paragraph (a). Second, § 701.22 does not apply to the purchase of an investment interest in a pool of loans. Third, § 701.22 establishes the requirements a FICU must satisfy to purchase a participation in a loan. Fourth, FISCUs are required by § 741.225 to comply with the loan participation requirements of the section. Fifth, § 701.22 does not apply to corporate credit unions, as that term is defined in § 704.2.

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[37] Emphasis added.
[38] *See, e.g.,* NCUA Legal Op. 18-0133 (March 2018), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2018/loan-participations.

Public Comments

Four commenters stated generally that they supported the proposed changes to the introductory paragraph because the changes will reduce confusion and better enable credit unions to evaluate new loan participation opportunities without reducing credit unions' loan participation authorities or increasing risks to individual credit unions or the Share Insurance Fund. Four commenters stated that they supported deleting the "continuing contractual obligation" clauses in the introductory paragraph. In addition, one commenter recommended removing the sentence in the introductory paragraph regarding the restriction of corporate credit unions purchasing loan participations from eligible organizations. The commenter explained that this issue is covered in section 704 appendix B, which requires part IV authority be granted by the NCUA for corporates to purchase participations. The commenter recommended further that corporate credit unions be allowed to purchase loan participations from FICUs by removing this sentence and eliminating the Part IV authority requiring separate application and approval for any purchase authority. The commenter suggested that corporate credit unions act as a liquidity provider for credit unions and being allowed to purchase loan participations with fewer restrictions would provide much needed liquidity and improve the overall safety and soundness for the credit union system.

Discussion

Commenters generally supported the proposed changes to the introductory paragraph to § 701.22, with one commenter suggesting additional changes that go beyond the scope of the proposed rule. While the Board appreciates that comment, the NCUA did not propose allowing corporate credit unions to purchase loan participations from FICUs by removing the last sentence of the current introductory paragraph and eliminating the Part IV authority requiring separate application and approval for any purchase authority. The NCUA will retain the comment, however, for consideration as part of future rulemakings related to loan participations or

corporate credit union purchase authorities. Given the NCUA received no comments in opposition to the proposed changes, the Board is adopting the changes in this final rule as proposed for the reasons set forth in the notice of proposed rulemaking.

Defining the term "investment interest in a pool of loans"? The Board asked in the proposal whether it should define the term "an investment in a pool of loans" in a future rulemaking. And, if so, the Board asked how the term should be defined and why.

Public Comments

Three commenters responded in the affirmative to the NCUA's question. One commenter recommended clarifying that the restrictions in § 701.22 (containing the memberization requirement for FCUs) do not apply to an investment in a pool of loans. Another commenter suggested the phrase is confusing as currently used and does not provide information regarding what options credit unions may have to invest in these types of transactions. The commenter asked, as an example, would this include the ability to invest in a "pool" or "fund" of subordinated debt loans made to credit unions? In the commenter's opinion, credit unions should be allowed to purchase a percentage of a pool of loans that credit unions are allowed to originate.

Discussion

The Board appreciates the comments received and will retain them for consideration as part of future rulemaking efforts related to this area of the NCUA's regulations.

Section 701.22(a)

The final rule adds a second sentence to the current definition of "originating lender" in § 701.22(a) to codify and further clarify a 2015 NCUA legal opinion (2015 Opinion) regarding loan participations in indirect loans.[39] The NCUA's 2013 Final Rule amended the loan

[39] NCUA Legal Op. 15-0813 (Aug. 10, 2015) *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2015/loan-participations-indirect-loans-originating-lenders.

participation regulation to, among other things, clarify that the originating lender must participate in the loan throughout the life of the loan.[40] In the 2013 Final Rule, the NCUA explained that this requirement derives from sections 107(5) and (5)(E)[41] of the Act.[42] Section 107(5) provides in relevant part that an FCU shall have the *power to participate with* other credit unions, credit union organizations, or financial organizations in making loans to credit union members.[43] Section 107(5)(E) requires further that participation loans *with* other credit unions, credit union organizations, or financial organizations shall be in accordance with written policies of the FCU's board of directors, provided that an FCU that *originates* a loan for which participation arrangements are made in accordance with this subsection *shall retain an interest* of at least 10 per centum of the face amount of the loan.[44] While the statutory requirements of section 107(5)(E) primarily pertain to FCUs involved in loan participations, the Board chose, for safety and soundness reasons, to extend most of the requirements in § 701.22 to cover all FICUs as part of the 2013 Final Rule.[45]

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[40] 78 FR 37946, 37949 (June 25, 2013) (providing verbatim that, "[t]he proposed rule revised the definitions of 'originating lender' and 'loan participation' to clarify that the originating lender must participate in the loan throughout the life of the loan."); s*ee also* § 701.22(a) (providing in relevant part that, *loan participation* means a loan where one or more eligible organizations participate pursuant to a written agreement *with the originating lender*, and the written agreement requires the originating lender's continuing participation throughout the life of the loan. (emphasis added)).

[41] § 1757(5) and (5)(E).

[42] *See* 76 FR 79548, 79549 (Dec. 22, 2011); *and* 78 FR 37946, 37949 (June 25, 2013) (providing that the requirement that credit unions only participate with the originating lender derives from the FCU Act's requirement for originating FCUs to retain at least a 10 percent interest in the face amount of all loans they participate out. Moreover, the Board interprets the authority in the FCU Act for credit unions to participate in loans "with" other lenders to contemplate a shared, continuing lending arrangement. Simply put, the rule requires an originating lender to remain part of the participation arrangement and to retain a continuing interest in the loan in order to be a true participant. Otherwise, the transaction is not a loan participation but more akin to the sale of an eligible obligation.).

[43] 12 U.S.C. 1757(5) (emphasis added).

[44] Section 1757(5)(E) (emphasis added).

[45] *See* 76 FR 79548, 79548 (Dec. 22, 2011) (Explaining in part that loan participations [. . .] create more systemic risk to the share insurance fund (NCUSIF) due to the resulting interconnection between participants. For example, large volumes of participated loans in the system tied to a single originator, borrower, or industry or serviced by a single entity have the potential to impact multiple credit unions if a problem arises. Additionally, as both federal credit unions (FCUs) and federally insured, state-chartered credit unions (FISCUs) actively engage in loan participations, it is important to the safety and soundness of the NCUSIF that all federally insured credit unions (FICUs) adhere to the same minimum standards for engaging in loan participations. The Board believes such standards are necessary to ensure the NCUSIF consistently recognizes and accounts for the risks associated with the purchase of loan participations. Finally, during examinations and other FICU contacts, the agency has encountered confusion concerning the application of the current loan participation rule regarding the entities and transactions subject to the rule.); *and* 78 FR 37946, 37947 & 37955 (June 25, 2013); *and* § 741.225.

In the 2013 Final Rule, the Board noted two specific safety and soundness concerns as reasons for adopting the current definition of "originating lender," explaining in relevant part as follows:

> The 2013 Final Rule requires an originating lender to remain part of the participation arrangement and to retain a continuing interest in the loan in order to be a true participant. Otherwise, the transaction is not a loan participation but more akin to the sale of an eligible obligation. As the Board noted in 1991, permitting the sale of participation interests in eligible obligations will *blur the distinction* between loan participations and loan purchases and sales, arguably circumventing the purpose of the loan participation and eligible obligations rules. Additionally, the Board believes the continued participation of the lender that initially originated the loan is integral to a safe and sound participation arrangement. In 1991, the Board expressed its concern that a lender may have a *decreased interest in properly underwriting a loan* if they know they can later reduce their risk by selling participation interests in it. The requirement for the originating lender's continued participation in a loan participation arrangement is intended to address this safety and soundness concern.[46]

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[46] 78 FR 37946, 37948 & 37949 (emphasis added) (providing also that in granting [loan participation authority to FCUs], Congress expressed its intent to enhance the ability of FCUs to serve their members' loan demands. Congress also expressed, however, that originating FCUs must maintain discipline in the origination process. [. . . T]he loan participation authority must not be so broad that loan participations may be originated from any source. [. . .]); 56 FR 15034, 15034–15035 (April 15, 1991) (providing that NCUA has interpreted the term "participation loan" to mean arrangements made prior to disbursements of the loan proceeds. In the preamble to the proposed rule, the Board stated that this interpretation may be too restrictive and proposed deleting it. [. . .] One commenter noted that this change will blur the distinction between loan participations and loan purchases and sales. [. . .] There are two basic safety and soundness concerns with the proposed change. FCUs may have a decreased interest in properly underwriting a loan if they know they can later reduce their risk by selling participation interests in it. Alternatively, FCUs interested in obtaining a participation after the loan is made may not properly investigate the loan and may instead rely on the original participants to have properly underwritten the loan. FCUs may jump in without a proper due diligence review. [. . .] Accordingly, the NCUA Board declines to adopt the proposed change and will continue

As explained in more detail below, these concerns are fully accounted for under the 2015 Opinion and this rulemaking by limiting the interpretation to indirect loans and requiring that such loans meet the same general requirements applicable to indirect loans made by FCUs under current § 701.23(b)(4)(iv).

The 2013 Final Rule responded to concerns raised by commenters regarding the proposed definition of "originating lender" and its application in situations where a CUSO underwrites and processes a loan, but the FICU funds the loan. In response to this feedback the Board provided the following explanation:

> These commenters observed that a CUSO often serves as an originator in name only and, thus, is not the most appropriate party to regard as the originating lender for the purposes of the rule. For example, loans may be *underwritten* and processed by a CUSO, but funded by its owner credit union. The Board acknowledged that this CUSO model is not uncommon within the industry and permissible under § 712.5. For purposes of this final rule, it was the Board's intent that the originating lender is the entity with which the borrower initially or originally contracts for the loan.[47]

As noted, the Board's responses to commenters in the 2013 Final Rule regarding the definition of originating lender were limited to situations in which a FICU purchased a loan from a CUSO that had underwritten the loan. The Board did not discuss the application of the definition of originating lender to CUSOs or other entities in the context of indirect lending arrangements in which a purchasing FICU underwrites the loan and makes the final underwriting

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to require a written commitment to participate in a loan precede final disbursement.); *see also* 68 FR 39866, 39867 (July 3, 2003); 68 FR 75110 (Dec. 30, 2003); *and* H.R. Rep. No. 95–23, at 12 (1977), *reprinted in* 1977 U.S.C.C.A.N. 115.

[47] 78 FR 37949-37950 (emphasis added).

decision. Accordingly, the application of the definition of originating lender to CUSOs or other entities in the context of indirect lending arrangements was left unaddressed in the 2013 Final Rule and open to later interpretation by the NCUA, which is what it did 2 years later in the 2015 Opinion discussed in more detail in the following paragraphs.

The NCUA has long used the act of underwriting a loan as a feature to distinguish between transactions where a FICU makes a loan and transactions where a FICU purchases a loan.[48] In particular, in a 1997 legal opinion the NCUA explained as follows:

> FCUs may participate in indirect lending arrangements under the authority to *make loans to members*, 12 U.S.C. §107(5); 12 C.F.R. §701.21, rather than the authority to purchase eligible obligations, 12 U.S.C. §107(13); 12 C.F.R. §701.23, as long as two conditions are met. *First, the FCU must make the final underwriting decision*. That is, before the retailer and the member complete the loan or sales contract, the FCU must review the application and determine that the transaction conforms to its lending policies. This is because an FCU may not delegate its lending authority to a third party. Second, the retailer must assign the loan or sales contract to the FCU very soon after it is completed. Assignment close in time to the making of the loan allows the retailer to function as the facilitator of the loan while the FCU remains the true lender. As the time between completion and assignment of the loan lengthens, the FCU's payment to the retailer becomes the purchase of the loan rather than part of the processing of the loan.[49]

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[48] *See, e.g.,* NCUA Legal Op. 92-1203 (Jan. 5, 1993); NCUA Legal Op. 92-1203 (May 11, 1993); NCUA Legal Op. 97-0546 (Aug. 6, 1997), *available at* https://ncua.gov/regulation-supervision/legal-opinions; *and* § 701.23(b)(4)(iv).
[49] NCUA Legal Op. 97-0546 (emphasis added).

By requiring the purchasing credit union to make the final underwriting decision in an indirect lending transaction, the NCUA ensured that the purchasing credit union was not relying on the due diligence of the loan seller who might otherwise have had a decreased interest in properly underwriting the loan knowing that it would later be sold. Moreover, under the NCUA's loan participation regulation, the originating lender is required to retain at least a 5-percent interest in any participation for the life of the loan.[50] Accordingly, where an eligible organization makes a loan through an indirect lending arrangement there is no greater risk of incentives for lax or improper underwriting for purposes of § 701.22 than if the eligible organization had processed and funded the loan itself.

Furthermore, as discussed in the 1997 legal opinion quoted above, the NCUA has long distinguished between indirect loans, made under section 107(5)[51] of the FCU Act and § 701.21 of the NCUA's regulations, and eligible obligations purchased under section 107(13)[52] of the FCU Act and § 701.23 of the NCUA's regulations.[53] For over 25 years the NCUA has treated indirect loans—as defined under current § 701.23(b)(4)(iv)—made by a credit union to be separate and distinct from eligible obligations. Accordingly, while permitting the sale of participation interests in eligible obligations might blur the distinction between loan participations and loan purchases and sales and circumvent the purpose of the loan participation and eligible obligation rules, allowing the sale of participation interests in indirect loans presents no such risk.

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[50] § 701.22(d)(4)(ii) ("The interest that the originating lender will retain in the loan to be participated. If the originating lender is a federal credit union, the retained interest must be at least 10 percent of the outstanding balance of the loan through the life of the loan. If the originating lender is any other type of eligible organization, the retained interest must be at least 5 percent of the outstanding balance of the loan through the life of the loan, unless a higher percentage is required under state law.").
[51] § 1757(5).
[52] § 1757(13).
[53] NCUA Legal Op. 97-0546.

Working within the regulatory and interpretative history discussed above, the NCUA determined in the 2015 Opinion that an "eligible organization"[54] may be considered the "originating lender" for purposes of § 701.22 where the eligible organization generated the loan through an "*indirect lending arrangement*"[55] with a retailer such as an auto dealer.[56] Current § 701.22(a) defines the term "originating lender" as "the participant with which the borrower initially or originally contracts for a loan and who, thereafter or concurrently with the funding of the loan, sells participations to other lenders."[57] The 2015 Opinion explained that, in indirect lending arrangements with a retailer such as an auto dealer, the retailer is acting as an agent of the eligible organization and is simply performing as an administrative functionary processing a loan for the eligible organization, and the retailer's activities are part and parcel of, and an extension of, the eligible organization's lending operations. In this context, the 2015 Opinion concluded that the retailer is not acting as a separate lender generating loans for itself and then selling those loans to an eligible organization. Rather, the retailer is a facilitator that is part of the eligible organization's loan processing mechanism, and the eligible organization is the *de facto* originating lender and, therefore, the originating lender for purposes of the NCUA's loan participation rule.

The 2015 Opinion explained further that a loan purchased by an eligible organization must satisfy two conditions to be classified as an "indirect loan" and not the purchase of a loan.[58]

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[54] *Id*. (providing in relevant part as follows: "*Eligible organization* means a credit union, credit union organization, or financial organization.").
[55] *See* § 701.23(b)(4)(iv) ("An *indirect lending* or indirect leasing *arrangement* that is classified as a loan and not the purchase of an eligible obligation because the Federal credit union makes the final underwriting decision and the sales or lease contract is assigned to the Federal credit union very soon after it is signed by the member and the dealer or leasing company.") (emphasis added).
[56] NCUA Legal Op. 15-0813.
[57] *Id*. (providing in relevant part, "*[o]riginating lender* means the participant with which the borrower initially or originally contracts for a loan and who, thereafter or concurrently with the funding of the loan, sells participations to other lenders.").
[58] *See* § 701.22(b)(4)(iv); *see also* NCUA Legal Op. 15-0813; *and* 78 FR 37946, 37949 (explaining that "a lender 'may have a decreased interest in *properly underwriting a loan* if they know they can later reduce their risk by selling participation interests in it.'").

First, the eligible organization must make the final underwriting decision regarding the loan. In other words, a loan must be underwritten by the purchasing eligible organization before completion of the loan or sales contract.[59] An eligible organization may use an automated credit scoring system to make its final underwriting decision as long as the "score" obtained from the automated system is the sole determinant for granting credit.[60] When an eligible organization establishes the qualifying criteria for the automated scoring system, it is effectively making an advance decision on a particular application.[61] So long as the party entering the borrower's application information does not exercise any judgment regarding that information, the score will be deemed to reflect the FCU's lending policies.[62]

Second, the sales contract must be assigned to the eligible organization *very soon after* it is signed by the borrower and the dealer.[63] As explained in a separate NCUA legal opinion, assignment close in time to the making of the loan allows the retailer to function as the facilitator of the loan while the eligible organization remains the true lender.[64] The length of time that satisfies "very soon after" depends on the nature of the loan and the practical realities of assigning certain kinds of loans in the current marketplace and in accordance with prevailing industry standards.[65] While "very soon after" is generally determined on a case-by-case basis by loan type and in accordance with commercial reasonableness, the longer the time between the

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[59] *See id.*
[60] *See* NCUA Legal Op. 97-0546.
[61] *See id*.
[62] *See id*.
[63] Emphasis added.
[64] *See* NCUA Legal Op. 97-0546.
[65] The preamble to the 1998 proposal to amend the eligible obligations rule requested public comment on whether the NCUA should specify a certain number of days as constituting "very soon." 63 FR 41976, 41977 (Aug. 6, 1998). After considering the comments, however, the NCUA Board determined not to specifically define it because it wanted to provide FCUs with flexibility under various circumstances. The NCUA Board also clarified that assignment of the loan means acceptance of the loan and not necessarily the physical receipt of the loan documentation, recognizing that acceptance and payment are often done electronically. However, physical receipt of the loan documents by the FCU should occur within a reasonable time following acceptance of the loan. 63 FR 70997, 70998 (Dec. 23, 1998); *see also* NCUA Legal Op. 97-0546 (Aug. 6, 1997) (Concluding that an indirect lending arrangement where the retailer made a loan and assigned it to the purchasing credit union within one business day met the "very soon after" timing requirement.).

formation of the contract and its assignment, the more likely the program will be viewed as involving the purchase of an eligible obligation rather than the making of a loan.[66]

The Board believes that codifying the 2015 Opinion will clarify the loan participations rule and facilitate further growth in credit unions' purchase and sale of indirect loan participations. Industry data shows significant growth in credit unions engaging in indirect lending programs, which have become an important channel for credit unions to extend services to their members and provide a viable source of income to support their growth.

Since 2015, FICUs have experienced large growth in indirect lending programs as reflected in Table 1. The $336.8 billion outstanding balance of indirect loans as of 2022 more than doubled the 2015 year-end loan balance.[67]

During the past 7 years, FICUs' indirect lending activities had double-digit increases (ranging from 14 percent to 21 percent) year over year between 2016 and 2018, and a low single-digit increase in 2019 and 2020.[68] The speed of growth went back to double digits in 2021 and 2022, with FICUs reporting an aggregate 30.93 percent increase during 2022.[69] The share of indirect loans outstanding in FICUs' total loan portfolio increased from 17.35 percent in 2015 to 21.22 percent in 2018, and reached 22.36 percent as of 2022.[70]

Furthermore, between 2015 and 2022, the delinquency rate on the indirect lending program was relatively stable, ranging from 0.77 percent to 0.47 percent, while the net charge-off rate ranged between 0.70 percent and 0.24 percent.[71]

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[66] 63 FR 41976, 41977 (Aug. 6, 1998).
[67] NCUA Call Report data for all FICUs from the 4th quarter of 2015 through the 2nd quarter of 2022.
[68] NCUA Call Report data for all FICUs from the 4th quarter of 2015 through the 4th quarter of 2021.
[69] NCUA Call Report data for all FICUs from the 4th quarter of 2015 through the 4th quarter of 2022.
[70] *Id*.
[71] *Id*.

Table 1: FICU Indirect Lending Activities[72]

(in $ million)	2015	2016	2017	2018	2019	2020	2021	2022
Total Outstanding Indirect Loans	136,583	165,171	194,016	221,477	228,559	233,161	257,271	336,845
% Year over Year Growth	20.29	20.93	17.46	14.15	3.20	2.01	10.34	30.93
% Indirect Loans Outstanding /Total Loans	17.35	19.00	20.27	21.22	20.63	20.05	20.50	22.36
Total Del. Indirect Loans (>= 60 Days)	988	1,264	1,391	1,494	1,513	1,291	1,198	2,479
% Loans Delinquent >= 60 Days / Total Indirect Loans	0.72	0.77	0.72	0.67	0.66	0.55	0.47	0.74
Net Indirect Loan Charge-Offs	782	997	1,264	1,318	1,354	1,129	594	903
% Net Charge-Offs / Avg Indirect Loans	0.63	0.66	0.70	0.63	0.60	0.49	0.24	0.30

For the reasons discussed previously, and consistent with sections 107(5) and 107(5)(E) of the Act and the 2015 Opinion, the Board is codifying into the NCUA's regulations its interpretation that an eligible organization may be considered an "originating lender" for purposes of § 701.22 where the eligible organization generates a loan through an indirect lending arrangement. Moreover, the Board is clarifying in the regulation that any "eligible organization"—as the term is defined under § 701.22(a)—that acquires a loan through an indirect lending arrangement acts as the originating lender for purposes of § 701.22, provided the eligible organization made the final underwriting decision regarding making the loan and was assigned the loan or sales contract very soon after the inception of the obligation to extend credit. In such cases, the Board considers the third party processing the loan to be an agent of the eligible organization that performs as an administrative functionary processing the loan for the eligible

[72] *Id*.

organization, and the third party's activities are part and parcel, and an extension, of the eligible organization's lending operations.

Where an indirect loan is underwritten by the purchasing eligible organization before the loan is made and the loan is transferred to the eligible organization very soon after the inception of the obligation to extend credit, the Board believes there is little risk the loan will not be underwritten to the eligible organization's standards. Accordingly, the final rule amends current § 701.22(a) by adding to the end of the definition of "originating lender" a second clarifying sentence providing that the originating lender includes a participant that acquires a loan through an indirect lending arrangement as defined under § 701.21(c)(9). Proposed paragraph (c)(9) provides in relevant part that *indirect lending arrangement* means a written agreement to purchase loans from the loan originator where the purchaser makes the final underwriting decision regarding making the loan, and the loan is assigned to the purchaser very soon after the inception of the obligation to extend credit.

The Board requested comment in the proposal on whether there are certain types of transactions that should be excluded from the interpretation above. In particular, the Board asked whether there are transactions in which eligible organizations acquire loans through indirect lending arrangements, but the third parties making the loans do *not* act as administrative functionaries processing the loan on behalf of the eligible organizations, and the third parties' activities are *not* part and parcel, and an extension, of the eligible organizations' lending operations. If there are transactions of this type, commenters were asked to explain why they should be excluded and provide information about the transactions and the specific activities undertaken by the parties.

Public Comments

All comments received on this issue supported revising the definition of "originating lender" to codify the 2015 Opinion. One commenter recommended the NCUA amend the

definition of "originating lender" further to recognize and separate the functions of the originator, initial lender and subsequent owner/purchaser. The commenter also recommended amending the definition to recognize the different point in time of the legal ownership of the loan even though such lending decisions are made in compliance with the underwriting stipulations of the credit union that buys the loan after the initial funding of the loan by the fintech/flow partner. The commenter suggested these additional changes are important because they would (a) follow the legal ownership of the loan, (b) place the responsibility on the originator to comply with the requisite regulations—for example, Consumer Financial Protection Bureau (CFPB) reporting—and (c) if future regulatory requirements are placed on the originator, there would be no confusion about which party is responsible for complying with such requirements. In the commenter's opinion, the fintech originator should have responsibility for complying with regulations and the credit union's due diligence should include an extensive review of the originator's policies and procedures to ensure compliance with all regulations.

Another commenter asked that the NCUA clarify further in the definition whether both the indirect loan source (e.g., dealer) and the purchasing credit union are "originators," because the current language could cause interpretive confusion and raise questions as to Call Report instructions and other areas regarding what the scope of origination is versus other types of indirect lending, such as correspondent mortgage lending. The commenter explained that the language "from the loan originator" in the definition suggests that when a broker closes a loan in the credit union's name it is not an indirect loan, while prior interpretations have suggested that it might be. The commenter recommended, in particular, that the NCUA not use the word "originator" in the definition as it relates to sources of indirect loans because it introduces confusion about the meanings of terms under the 2015 Opinion and prior doctrine.

Discussion

The comments received regarding the changes to the definition of "originating lender" all generally supported the proposed change. The NCUA did, however, receive comments requesting additional changes to the proposed definition of "originating lender" and the associated definition of "indirect lending arrangement" in § 701.21(c)(9)(i). Those additional changes go beyond the scope of the proposed rule and will be retained for consideration by the NCUA during future rulemakings relating to indirect lending. Accordingly, the final rule adopts the changes to the definition of "originating lender" in § 701.22(a) as proposed for the reasons set forth in the notice of proposed rulemaking.

Some commenters requested additional clarification regarding the relationship between the originating lender and indirect lender. The term "originating lender" is defined in the final rule as the participant with which the borrower initially or originally contracts for a loan and who, thereafter, concurrently with the funding of the loan, sells participations to other lenders. Originating lender includes a participant that acquires a loan through an indirect lending arrangement as defined under § 701.21(c)(9). The term "loan participation" is defined as a loan where one or more *eligible organizations* participate pursuant to a written agreement with the originating lender, and the written agreement requires the originating lender's continuing participation throughout the life of the loan. For purposes of the NCUA's regulations, a FICU acquiring a loan through an indirect lending arrangement is the originating lender. The acquiring FICU, however, may not be considered the originator under other applicable state laws, federal laws, or both. In such cases, the acquiring FICU is generally required to comply with all applicable laws.

Under § 701.22(b), a FICU may purchase a participation interest in a loan from an eligible organization only if the loan is one the purchasing credit union is empowered to grant and certain additional conditions are satisfied. Both the current rule and this final rule limit purchases of loan participations to purchases from eligible organizations. An "eligible

organization" is defined in the current and final rule as a credit union, credit union organization, or financial organization. The term "financial organization" is defined under the current and final rule as any federally chartered or federally insured financial institution and any state or federal government agency and its subdivisions. This final rule makes no changes to either definition. The term "financial organization" includes participants outside the credit union industry, including federally chartered and federally insured financial institutions, such as banks, and state and federal government agencies and their subdivisions.[73] In addition, the current and final rule's definition of "eligible organization" includes non-federally insured or non-federally chartered credit unions through the definition's use of the term "credit union."[74]

Additional concerns? The Board requested comment in the proposal on whether there are other factors, changes, safety and soundness, or compliance implications the NCUA should consider related to the proposed amendments to the definition of "originating lender." The Board asked further whether there are structural, safety and soundness, or compliance concerns that would warrant considering that the addition of intermediaries in loan origination transactions, including CUSOs, precludes a credit union assignee from being considered the originating lender under the revised definition in the proposed rule. Finally, the Board asked whether there are any additional safety and soundness or compliance implications concerning the proposed definition of "originating lender" that the Board should consider.

Public Comments

One commenter responded that, in many instances, CUSOs assist credit unions with various aspects of the loan origination process. The commenter explained that CUSOs may provide specific expertise (such as in member business loans) or other services to assist in credit unions making appropriate decisions; however, the credit union is still funding the loan

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[73] 78 FR 37946, 37948 (June 25, 2013).
[74] *Id. at* 37949.

according to its own guidelines (or as agreed upon through a CUSO) and should be considered the originating lender.

Discussion

The Board appreciates the comment above and notes that the final rule does not affect the ability of CUSOs to provide loan support services to FICUs under part 712 of the NCUA's regulations and that simply providing loan support services does not necessarily change what entity is the originating lender.

Section 701.22(e) Temporary Regulatory Relief in Response to COVID-19

From April 21, 2020, to December 31, 2022, § 701.22(e) of the NCUA's regulations provided that, notwithstanding paragraph (b)(5)(ii) of § 701.22, during the period commencing on April 21, 2020, and *concluding on December 31, 2022*, the aggregate amount of loan participations that may be purchased from any one originating lender shall not exceed the greater of $5,000,000 or 200 percent of the FICU's net worth.[75] The Board approved § 701.22(e) to help ensure that FICUs remained operational and had sufficient liquidity during the COVID-19 pandemic.[76] The Board concluded, at the time, that the amendments would provide FICUs with the necessary flexibility in a manner consistent with the NCUA's responsibility to maintain the safety and soundness of the credit union system.[77] As provided in paragraph (e), the temporary regulatory relief provided under the paragraph expired on December 31, 2022. Because the temporary regulatory relief has expired, the Office of the Federal Register removed paragraph (e) shortly after December 31, 2022, as part of its regular review and editing process.

Public Comments

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[75] Emphasis added.
[76] *See* 85 FR 22010 (April 21, 2020); 85 FR 83405 (Dec. 22, 2020) (extending paragraph (e) through Dec. 31, 2021); *and* 86 FR 72517 (Dec. 22, 2021) (extending paragraph (e) through Dec. 31, 2022).
[77] 85 FR 22010, 22010 (April 21, 2020).

Three commenters recommended the NCUA extend or permanently adopt expired section 701.22(e)'s higher loan participation purchasing threshold. One of the commenters suggested that loan participation agreements generally have high fixed costs and comparatively modest variable costs so a $10 million loan participation agreement does not require significantly more due diligence or post-closing resources, from either a loan originator or potential loan participation interest purchasers, than a $2 million loan participation agreement. Consequently, individual loan participation interests generally represent larger rather than smaller capital commitments. Another commenter suggested that the United States is currently entering a period of declining liquidity access, raising concerns among FICUs about their ability to access liquidity. The commenter suggested the relief provided in § 701.22(e) would be more useful now than it was during the pandemic as the liquidity tightness the credit unions see now is due to the business cycle. The commenter suggested further that a permanent variation of this rule would not harm the safety and soundness of the credit union system, and as such, it asked the NCUA to reconsider removing this rule. One of the commenters suggested raising the aggregate amount of loan participations that may be purchased may decrease overall risks because it allows individual credit unions to develop relationships and trust with each other with ongoing transactions that reduce costs and risks for both.

Five commenters recommended the NCUA eliminate the limit on the aggregate amount of loan participations that may be purchased from any one originating lender altogether.

Discussion

The Board appreciates the comments that were submitted regarding expiration of the temporary regulatory relief under § 701.22(e). The temporary regulatory relief provided under paragraph (e) expired on December 31, 2022. The Board may consider approving temporary regulatory relief again in the future if circumstances warrant.

Benefits of the temporary regulatory relief. The Board requested comments on the impact, if any, that was experienced due to the flexibilities provided in the temporary rule; whether the temporary rule had any effect on the participation markets; and whether there are safety and soundness or compliance implications related to the expiration of the flexibilities.

Public Comments

One commenter responded to the NCUA's questions by stating that the change did not have a material effect on credit unions because it was temporary in nature but noted that the change did allow some credit unions to manage their balance sheets in a more effective manner during the relief period. The commenter suggested further that credit unions that benefited from the temporary regulatory relief may now be unable to work with those sellers/buyers again even though they have established strong relationships due to expiration of the temporary regulatory relief.

Discussion

The Board appreciates the comment that was submitted regarding the benefits of the temporary regulatory relief under § 701.22(e). The Board may consider approving temporary regulatory relief again in the future if circumstances warrant.

Other comments on the loan participation rule. The Board also invited other recommendations it should consider in the loan participation rule. For example, the Board asked whether it should consider replacing prescriptive limits with principles-based requirements, consider removing the limit on the amount of loan participations that could be purchased from any one originating lender under current § 701.22(b)(5)(ii), or both.

Public Comments

One commenter responded to the NCUA's questions by stating that eliminating the prescriptive limits and replacing them with principles-based requirements allows credit unions the most flexibility in managing their balance sheets. The commenter suggested that credit

unions have proven the ability to manage their risk levels with many other prescriptive limits being removed.

Discussion

The Board appreciates the comment above and will consider replacing prescriptive limits with more principles-based requirements where appropriate in future rulemakings.

Section 701.23 Purchase, Sale, and Pledge of Loans

As discussed in more detail in this portion of the preamble, this final rule makes several changes to current § 701.23 of the NCUA's regulations. These changes are intended to clarify numerous provisions regarding the purchase, sale, and pledge of eligible obligations. The changes also provide FCUs expanded authority and autonomy to innovate and transact business with fintech companies and other institutions that provide services associated with the origination and sale of loans made to members of FCUs.

In addition, the final rule adds new headings to a number of subparagraphs under § 701.23. The addition of these headings is a non-substantive change to both the current regulation and proposed § 701.23, which is intended to add consistency to the section as well as make the section more reader friendly. In addition to the other changes discussed in this part of the preamble, the final rule adds the following new headings to § 701.23. Paragraph (b)(1) is amended to add the heading *purchase of obligations from any source*. Paragraph (b)(1)(i) is amended to add the heading *eligible obligations*. Paragraph (b)(1)(ii) is amended to add the heading *notes of a liquidating credit union's individual members*. Paragraph (b)(1)(iii) is amended to add the heading *student loans*. Paragraph (b)(1)(iv) is amended to add the heading *real estate-secured loans*. Paragraph (b)(3) is amended to add the heading *other requirements*. Paragraph (b)(4) is amended to add the heading *five-percent limitation*. Paragraph (b)(5) retains the heading *grandfathered purchases* from the current rule. Paragraph (b)(6) is amended to add

the heading *written purchase policies*. Paragraph (h)(1) is amended to add the heading *expanded purchase authority*.

Public Comments

Several commenters specifically offered strong support for the proposed edits to § 701.23. One commenter agreed that removing some of the limits in the current regulation will greatly improve credit union activity with eligible obligations and allow members to be served within the industry without incremental risk being placed on the Share Insurance Fund. Another commenter suggested that the clarifying language on eligible obligations and removal of the prescriptive limitations will eliminate ambiguity on the interpretation regarding permissible activities. Another commenter supported the proposed changes but thought more should be done to reduce confusion regarding whether §§ 701.22 or 701.23 applies to a particular transaction. One commenter stated that FISCUs should also benefit from this rule pursuant to state credit union act parity statutes. The commenter recommended finalizing the amendments to § 701.23 as proposed. The commenter, however, also recommended that the NCUA clarify in the loan participation and eligible obligation rules that a purchasing FICU has discretion to classify a partial interest in a loan under either Section 701.22 or 701.23 when the terms and conditions of the purchase meet the requirements of both rules. As an alternative, the commenter requested that, even if credit unions are obligated to designate a transaction as a loan participation or eligible obligation at or near the time of the sale/purchase (for example on a subsequent Call Report), credit unions be given discretion to change that designation at a later time if they choose so long as the terms and conditions of the purchase meet the requirements of both rules. The commenter suggested this change could be made by adding new paragraphs to §§ 701.22 and .23 providing as follows:

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

Discussion

Consistent with the strong support received from commenters, the Board is adopting the changes to § 701.23 largely as proposed, for the reasons set forth in the notice of proposed rulemaking, with certain changes that are discussed in the section-by-section analysis below. The changes and clarifications requested in the comments above would expand the authorities proposed beyond the scope of the proposed rule. Thus, the comments will be retained for consideration in future rulemakings relating to loan purchases.

Section 701.23 Introductory Paragraph

The Board added the introductory paragraph to § 701.23 as part of the 2013 Final Rule.[78] The introductory paragraph was added to clarify several issues related to the scope and applicability of § 701.23. In particular, the 2013 Final Rule explained that the rule added introductory text to § 701.23 to clarify the scope of § 701.23 and to distinguish transactions under § 701.23 from transactions covered by § 701.22. The 2013 Final Rule explained further that RegFlex provides a limited exception to the general requirement that an FCU's purchase, sale, or pledge of all or part of a loan must be to one of its own members.[79] Specifically, the 2013 final rule explained that the exception permits FCUs that meet the well-capitalized standard to buy loans from other FICUs without regard to whether the loans are eligible obligations of the

[78] 78 FR 37946 (June 25, 2013).
[79] 12 CFR 701.23(b)(2).

purchasing FCU's members or the members of a liquidating credit union. The 2013 Final Rule also explained that it made a parallel conforming amendment to the introductory text to § 701.22 in this regard.[80]

The introductory paragraph to current § 701.23 includes three sentences. The first sentence provides that the section governs an FCU's purchase, sale, or pledge of all or part of a loan to one of its own members where no continuing contractual obligation is contemplated between the seller and the purchaser. The first sentence also notes that there is a limited exception to the membership requirement for certain well-capitalized FCUs. The second sentence elaborates on the membership requirement by providing that the borrower must be a member of the purchasing FCU *before* the purchase is made, except as provided in current §701.23(b)(2). The third sentence provides broadly that an FCU may not purchase a non-member loan to hold in its portfolio.

Since amending § 701.23 as part of the 2013 Final Rule, the NCUA has received numerous inquiries from NCUA examiners, FCUs, fintech companies, and other parties who have expressed confusion about how to interpret these provisions. This confusion has led to inconsistent reporting of loan interests by FCUs and uncertainty regarding which of the two sections, § 701.22 or § 701.23, applies to certain transactions, particularly innovative programs that have been designed by FICUs after 2013. In addition, the Board is concerned that continued confusion about when a borrower is required to be a member under § 701.23 could discourage FCUs from entering into certain safe and sound loan purchase, sale, and pledge agreements that are within their statutory authority.

The clause in the first sentence of the introductory paragraph to current § 701.23, which provides "where no continuing contractual obligation between the seller and purchaser is

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[80] 78 FR 37954–37955.

contemplated," continues to be a source of confusion for examiners and the credit union system. As previously mentioned, loan purchase agreements, regardless of whether the transactions involve the purchase of an eligible obligation or a loan participation, frequently contain some form of continuing contractual obligation between the buyer and the seller, including representations and warranties regarding the loans and loan repurchase agreements, servicing agreements, and other similar types of ongoing obligations. Accordingly, the final rule deletes the continuing contractual obligations clause in current § 701.23. The Board intends this deletion to work in conjunction with the proposed changes to the introductory paragraph to current § 701.22.

The final rule also removes the clause in the first sentence of the introductory paragraph to current § 701.23 referring to the limited exception for well-capitalized FCUs. As discussed in more detail subsequently in the part of the preamble on § 701.23(b)(2), the final rule removes the well-capitalized requirements for FCU purchases of certain non-member loans from FICUs. Accordingly, deleting the clause in the introductory paragraph referring to the limited exception for well-capitalized FCUs is a necessary conforming amendment.

The second sentence in the introductory paragraph to current § 701.23 provides that for purchases of eligible obligations, except as described in paragraph (b)(2) of the section, the borrower must be a member of the purchasing FCU before the purchase is made. As discussed previously, there are express exceptions to the membership requirement under paragraph (b)(1) as well as under paragraph (b)(2). For example, paragraphs (b)(1)(iii) and (iv) authorize FCUs to buy non-member loans to complete a pool of loans for resale. Accordingly, the final rule amends the second sentence in the introductory paragraph to current § 701.23 to provide that for purchases of eligible obligations, except as described under paragraph (b) of the section, the borrower must be a member of the purchasing FCU before the purchase is made.

The third sentence in the introductory paragraph to current § 701.23 provides that an FCU may not purchase a non-member loan to hold in its portfolio. This prohibition appears to have originally been intended to address FCU purchases of non-member loans to complete pools of loans for resale, as authorized for real estate-secured loans and federally guaranteed student loans under current § 701.23(b)(1)(iii) and (iv). The prohibition on retaining the non-member loans in portfolio goes together with the authority in paragraphs (b)(1)(iii) and (iv) because those provisions allow an FCU to buy such non-member loans solely to complete a pool of loans for resale. The second sentence in current § 701.23(b)(1)(iv) further confirms this relationship by providing that a pool must include a substantial portion of the credit union's members' loans *and must be sold promptly*.[81] For other purchases of non-member loans under current § 701.23, the authority is not tied to a plan or requirement to resell the loans being purchased. Prohibiting the FCU from retaining the loans in portfolio, as the current wording in the undesignated introductory paragraph implies, unnecessarily restricts FCUs' authority to purchase and hold non-member loans from FICUs under current § 701.23(b)(1)(ii)[82] and (b)(2). Accordingly, the final rule deletes the third sentence in the introductory paragraph to § 701.23, providing that an FCU may not purchase a non-member loan to hold in its portfolio.

For the reasons outlined in the preceding paragraphs, the final rule amends the introductory text of § 701.23 to provide that the section governs an FCU's purchase, sale, or pledge of all or part of a loan to one of its own members, subject to certain exceptions. The introductory paragraph provides further that for purchases of eligible obligations, except as otherwise described under paragraph (b) of § 701.23, the borrower must be a member of the purchasing FCU before the purchase is made.

Public Comments

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[81] Emphasis added.
[82] Authorizing FCUs to purchase eligible obligations of a liquidating credit union's individual members, from the liquidating credit union.

Three commenters specifically expressed their support for the clarifying amendments to the introductory paragraph to § 701.23. Another commenter offered support for removing the following sentence: "A federal credit union may not purchase a non-member loan to hold in its portfolio." And one commenter recommended amending the second sentence of the introductory paragraph to clarify that an FCU may purchase certain eligible obligations prior to the borrower becoming a member of the purchasing FCU under §§ 701.23(b)(1) and 701.23(b)(2).

Discussion

The comments received on the changes to the introductory paragraph to 701.23 were strongly supportive. The comment requesting that the Board allow purchases of certain eligible obligations prior to the borrower becoming a member goes beyond the scope of the proposal. Accordingly, the Board is adopting the changes to the introductory paragraph as proposed for the reasons set forth in the notice of proposed rulemaking.

Section 701.23(a) Definitions

The final rule, in addition to other changes discussed below, amends current § 701.23(a) to add the heading "*Definitions*" to the paragraph and remove the numbering from the individual definitions under paragraph (a). These changes are intended to avoid errors and confusion when definitions in paragraph (a), which may be cross referenced elsewhere in the NCUA's regulations, are added or removed. Accordingly, the individual definitions included under § 701.23(a) are listed in alphabetical order but not numbered individually.

Eligible obligation.

The final rule amends the definition of eligible obligation under § 701.23(a) to clearly distinguish between an eligible obligation and a note held by a liquidating credit union. Current § 701.23(a) defines the term "eligible obligation" broadly to mean a loan or group of loans,

which includes the notes of a liquidating credit union.[83] As explained in the part of the preamble on § 701.23(b)(4), the statutory 5-percent limitation on the aggregate of the unpaid balance of notes purchased under § 701.23 applies only to notes of liquidating credit unions and not to eligible obligations as that term is generally used under section 107(13)[84] of the Act. Accordingly, the final rule amends the definition of eligible obligation to clarify that the term does not include a note held by a liquidating credit union.[85]

The final rule also amends the definition of eligible obligation to clarify that the term includes a whole loan or part of a loan. The NCUA has long held the position that the term "eligible obligation" includes loans, in whole or in part, provided the loan does not meet the definition of a loan participation under § 701.22(a).[86] The Board believes that the amended definition of an eligible obligation will provide clarity and reduce confusion in the credit union system concerning when a transaction involving a loan purchased in part (a partial loan) meets the regulatory definition of an eligible obligation. Many credit union officials find the current eligible obligations rule unclear, specifically when attempting to determine which rule applies to a loan purchased in part. The amended definition will help FCU officials to differentiate between transactions involving partial loan purchases that meet the definition of an eligible

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[83] *See, e.g.,* §§ 701.23(b)(1)(ii), (b)(2)(ii), and (b)(4).

[84] Section 1757(13) (authorizing FCUs, in accordance with rules and regulations prescribed by the Board, to purchase, sell, pledge, or discount or otherwise receive or dispose of, in whole or in part, any eligible obligations (as defined by the Board) of its members and to purchase from any liquidating credit union notes made by individual members of the liquidating credit union at such prices as may be agreed upon by the board of directors of the liquidating credit union and the board of directors of the purchasing credit union, but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union[.]).

[85] The new definition of eligible obligation excludes notes held by a liquidating credit union.

[86] *See* 78 FR 37946, 37948 (June 25, 2013) (providing in part as follows: "[The introductory paragraph to § 701.22] clarifies that the [section] applies to a [consumer] FICU's purchase of a loan participation where the borrower is not a member of that credit union. Generally, an FCU's purchase, in whole or in part, of its member's loan is covered by NCUA's eligible obligations rule at § 701.23." The 2013 Final Rule also notes in FN 2 that there is "a limited exception for certain well-capitalized federal credit unions to purchase, subject to certain conditions, non-member eligible obligations from a FICU. 12 CFR 701.23(b)(2)."); *see also*, 12 U.S.C. 1757(13) (providing in part that an FCU shall have power, "in accordance with rules and regulations prescribed by the Board, to purchase, sell, pledge, or discount or otherwise receive or dispose of, *in whole or in part*, any eligible obligations (as defined by the Board) of its members." (emphasis added)).

obligation under § 701.23 and transactions involving partial loan purchases that meet the definition of a loan participation under § 701.22.

Current § 701.22(a) provides that loan participation means a loan where one or more eligible organizations participate pursuant to a written agreement with the originating lender, and the written agreement requires the originating lender's continuing participation throughout the life of the loan. For example, if an FCU purchases a partial loan that does not meet the definition of loan participation under amended § 701.22(a), then the transaction may still be permissible provided it meets the definition of an "eligible obligation" under amended § 701.23(a) and meets the requirements under that section.

The final rule also amends the definition of "eligible obligation" to remove the words "group of loans." The words are redundant because the term "eligible obligation" is used in its plural form, eligible obligations, throughout proposed and current § 701.23 to indicate where the section authorizes or applies to the purchase of one or more loans. The Board believes removing the phrase "group of loans," in conjunction with the other changes discussed in this proposal, will clarify the definition of eligible obligation. Accordingly, for all the reasons discussed above, proposed § 701.23(a) would provide that *eligible obligation* means a whole loan or part of a loan (other than a note held by a liquidating credit union) that does not meet the definition of a loan participation under § 701.22(a).

Public Comments

Four commenters specifically expressed support for the revised definition of eligible obligation as proposed. Two commenters recommended further clarifying the definition of eligible obligation. One of those commenters explained that further defining the term would allow credit unions the ability to understand the accounting and loss reserve ramifications on how the loan is sold. The commenter also asked the following two clarifying questions: (1) If a

credit union sells a tranche in a portfolio of loans would this constitute an eligible obligation? And (2) what if a credit union sold just the interest portion of a loan?

Discussion

The comments received on the revised definition of eligible obligation were generally supportive. Two commenters did request further clarifying the definition; however one commenter did not specify what aspects of the proposed definition were confusing or how the definition could be clarified. The other commenter asked questions, which are addressed below. Given the lack of objections to the proposed definition, other than general requests for further clarification, the Board is adopting the definition of eligible obligation as proposed for the reasons set forth in the notice of proposed rulemaking.

Regarding the commenter's questions about selling a tranche in a portfolio of loans or only selling the interest receivable of a loan, the transaction must qualify for derecognition under generally accepted accounting principles (GAAP). Additionally, when a loan is sold in part under either §§ 701.22 or 701.23 of the NCUA's regulations, the transaction must meet the definition of a participation interest under GAAP.[87] This definition is applied at a loan level and not at the portfolio level. If an interest in a loan is sold and does not meet the definition of a participation interest under GAAP, in general, the transaction must be recorded as a secured borrowing. To meet the definition of a participation interest under GAAP, the transferor generally must sell a pro-rata share of principal and interest, except for market-based servicing fees. While the commenter did not provide sufficient details in their questions for the Board to provide definitive answers, the transactions would likely not qualify as the sale of a participation interest under GAAP and, therefore, generally are not covered by either §§ 701.22 or 701.23 of

[87] Note that the definition of a participation interest under GAAP (*see* ASC 860-10-40-6A) is not the same as the definition of a loan participation under § 701.22 of the NCUA's regulations.

the NCUA's regulations. In general, the purchaser must record the asset regardless of whether the seller qualifies for derecognition under GAAP.

Liquidating credit union.

The final rule adds a definition of liquidating credit union to § 701.23(a) to identify the point in time when a credit union becomes a liquidating credit union for purposes of applying the 5-percent limitation in § 701.23(b)(4). The term "liquidating credit union" is used but not defined in current § 701.23 because the section does not distinguish between eligible obligations and notes of liquidating credit unions for purposes of calculating the 5-percent limitation on the aggregate of the unpaid balance of loans purchased under current § 701.23(b)(1) and (b)(2)(ii). As explained in more detail later in the part of the preamble about proposed § 701.23(b)(4), under this final rule, the 5-percent limitation applies only to notes purchased from liquidating credit unions, making it necessary for the NCUA to specify the point in time when a credit union meets the definition of a liquidating credit union. Consistent with Congress' use of the broad term "credit union" in section 107(13) of the FCU Act, the definition of liquidating credit union would include both liquidating FICUs and liquidating credit unions not insured by the NCUA.[88]

Accordingly, the final rule provides that *liquidating credit union* means, (1) in the case of a voluntary liquidation, a credit union is a liquidating credit union as of the date the members vote to approve liquidation; and (2) in the case of an involuntary liquidation, a credit union is a liquidating credit union as of the date the board of directors is served an order of liquidation issued by either the NCUA or the state supervisory authority.

Public Comments

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[88] *See* Section 1757(13) (providing authority "to purchase from any *liquidating credit union* notes made by individual members of the liquidating *credit union* at such prices as may be agreed upon by the board of directors of the liquidating *credit union* and the board of directors of the purchasing credit union, but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union;" (emphasis added).).

Four commenters expressed general support for adding the proposed definition of liquidating credit union.

Discussion

Given the support received from commenters, and the lack of objections, the Board is adopting the definition of liquidating credit union as proposed.

Should other terms be defined? The Board requested comment on whether there are additional terms used in § 701.23, such as "empowered to grant," that it should consider defining or further clarifying in future rulemakings.

Public Comments

Two commenters responded that the NCUA should not define the term "empowered to grant." One of the commenters explained that the term should remain undefined so it can be sufficiently flexible to fully incorporate credit unions' currently recognized lending authorities and all those the NCUA recognizes in the future. On the other hand, one commenter responded that the term "empowered to grant" should be defined. The commenter explained that the term has a particular bearing on credit union activity under § 701.22 and § 701.23 and has been addressed in several NCUA legal opinion letters over the years. The commenter recommended that the NCUA solicit specific feedback on what should and should not fall within the scope of "empowered to grant."

One commenter asked that the NCUA define the term "notes" to avoid any future confusion regarding the purchase of notes of liquidating credit unions. Another commenter specifically recommended the term "notes" not be defined or clarified further.

Discussion

The Board appreciates the detailed comments submitted regarding defining additional terms in § 701.23. While the comments received in this area go beyond the scope of this rulemaking, the comments will be retained for consideration by the NCUA during future

rulemakings relating to the purchase, sale, and pledge of eligible obligations and notes of liquidating credit unions.

In October 2004, the NCUA issued a legal opinion letter explaining that "the phrase 'empowered to grant' as used in [the] NCUA's regulations refers to the authority of an FCU to make the type of loans permitted by the [FCU Act], NCUA regulations, FCU Bylaws, and its own internal policies."[89] The letter goes on to explain that the phrase "empowered to grant" does not include a membership requirement.[90]

Section 701.23(b) Purchase of Loans

Current § 701.23(b) would be amended, as discussed in more detail later in this preamble, to make certain substantive changes and to implement clarifying and conforming changes consistent with amendments to other subsections. The final rule amends the heading to current § 701.23(b) to clarify which transactions are covered under the paragraph. The Board believes that this would result in only a minor technical change to current § 701.23(b). The heading for current paragraph (b) is "*Purchase*." The final rule adds the words "of loans" after the word "purchase" to better clarify the type of transactions this section would apply to, that being the purchase of loans. Accordingly, the paragraph heading for proposed § 701.23(b) would be revised to read "*Purchase of loans*."

Section 701.23(b)(1)

Section 701.23(b)(1)(ii)

Current § 701.23(b)(1)(ii) authorizes FCUs to purchase certain eligible obligations of a liquidating credit union's individual members from the liquidating credit union. As explained previously in the part of the preamble on § 701.23(a) regarding the definition of eligible

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[89] OGC Op. 04-0713 (Oct. 25, 2004); *see also* OGC Op. 02-0824 (Nov. 5, 2002) (noting that an FCU is not empowered to grant a loan with a prepayment penalty); *and* OGC Op. 01-1023 (Nov. 28, 2001) (noting that if an FICU meets all other requirements of the NCUA's regulations, the fact that the credit union has not itself granted the type of loan in question does not mean it is not empowered to grant such a loan.).
[90] *Id*.

obligation, notes of liquidating credit unions would no longer be included within the definition of eligible obligations. Consistent with that change, this final rule amends current § 701.23(b)(1)(ii) to remove the references to eligible obligations and authorize FCUs to purchase notes of a liquidating credit union's individual members from the liquidating credit union. Accordingly, § 701.233(b)(1)(ii) is amended to provide that an FCU may, subject to the requirements in § 701.23, purchase notes of a liquidating credit union's individual members, from the liquidating credit union.

Public Comments

One commenter suggested that it understands keeping the 5-percent limitation on the purchase of these types of notes but believed the limitation could be eliminated because of (a) the relative rarity of liquidations, and (b) the NCUA's role in approval of purchase and assumption transactions to select those who can manage safety and soundness concerns.

Discussion

Section 107(13) of the FCU Act, which authorizes the purchases of notes of a liquidating credit union's members, provides that no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union. Accordingly, the Board is adopting the changes to § 701.23(b)(4) and retaining the 5-percent limitation as proposed for the reasons set forth in the notice of proposed rulemaking.

Section 701.23(b)(1)(iv)

The word "mortgage" is misspelled in the first sentence of current § 701.23(b)(1)(iv). The final rule amends § 701.23(b)(1)(iv) to correct that misspelling. No substantive changes are made to current paragraph (b)(1)(iv).

Section 701.23(b)(2) Purchase of Obligations from a FICU

The final rule amends current § 701.23(b)(2) to remove the CAMELS rating requirement and the capital classification requirements in the introductory paragraph. Current § 701.23(b)(2) provides that an FCU that received a composite CAMELS rating of "1" or "2" for the last two (2) full examinations and maintained a capital classification of "well capitalized" under part 702 of the chapter for the six (6) immediately preceding quarters may purchase and hold certain obligations, provided that it would be empowered to grant them. The final rule provides FCUs additional authority to purchase loans by removing the CAMELS rating and capital classification requirements.

The CAMELS rating and capital classification requirements were added to the NCUA's regulations as part of a 2001 final rule regarding the NCUA's RegFlex program.[91] The 2001 final rule explained, in response to commenters suggestions that the requirements be removed, as follows:

> The Board continues to believe that CAMEL ratings and net worth ratios are the best measures of how well a credit union is managed and how much risk it presents to the NCUSIF and the credit union system. That is, consistent with safety and soundness concerns, credit unions with advanced levels of net worth and consistently strong supervisory examination ratings have earned exemptions from certain NCUA Regulations.[92]

FCUs have generally managed their loan purchase, sale, and pledge activity well since the addition of the CAMELS and capital requirements and continue to do so. Approximately 12 percent of FCUs were engaged in the purchase, sale, or pledge of loans during 2022.[93]

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[91] 66 FR 58656 (Nov. 23, 2001).
[92] 66 FR 58656.
[93] NCUA Call Report data for all FCUs as of the 2nd quarter of 2022.

Additionally, the Board notes that this purchase authority is limited to purchases from a FICU. Therefore, the loans able to be purchased under this authority are already in the federally insured credit union system. Moving the obligation from one FICU to another FICU generally is not expected to result in a significant increase to the Share Insurance Fund's risk exposure.

Further, the current CAMELS and net worth restrictions are only applicable to a small segment of the credit union system given that the vast majority of FCUs have a CAMELS composite rating of 1 or 2 and are well-capitalized. [94] Expansion of this authority would allow slightly more FCUs to purchase obligations from a FICU, potentially creating additional revenue and capital for the purchaser and providing an additional outlet for selling FICUs, creating additional liquidity channels in the credit union system.

The NCUA believes any increased risk associated with removing the CAMELS rating and capital classification requirements in current § 701.23 would also be minimized by the addition of the proposed principles-based due diligence, risk assessment, and risk management requirements. Accordingly, the final rule amends the introductory paragraph to § 701.23(b)(2) to provide that an FCU may purchase and hold certain obligations if it would be empowered to grant them.

Public Comments

Twenty-six commenters offered their support for eliminating the CAMELS rating and capital classification requirements for the reasons provided in the proposal. One commenter suggested the change would allow a greater flow of funds between FCUs and FISCUs. The commenter suggested further that credit unions with CAMELS ratings of three and lower are negatively impacted by their current inability to access this market and allowing purchases of these obligations will help move them into a higher CAMELS rating. Another commenter

[94] As of June 30, 2023, over 97 percent of FCUs were well-capitalized. Additionally, 78.5 percent of FCUs were rated a CAMELS composite 1 or 2 and these credit unions represented 95 percent of total FCU assets.

suggested the proposed change will allow more FCUs to purchase obligations from a FICU, potentially creating additional revenue and capital for the purchaser and providing an additional outlet for selling FICUs, creating additional liquidity channels in the credit union system. Several commenters suggested that the proposed change will make sure smaller credit unions can also gain access to these loans and obtain some much-needed additional return on assets. The commenters also suggested the proposed change will allow larger credit unions to manage balance sheet risk by selling some of these loans to other credit unions without jeopardizing their relationships with non-credit union originators.

Discussion

Given the strong support expressed by commenters, and the lack of objections, the Board is adopting the changes to § 701.23(b)(2) as proposed for the reasons set forth in the notice of proposed rulemaking.

Section 701.23(b)(2)(ii) Notes of a Liquidating Credit Union

Current § 701.23(b)(2)(ii) authorizes FCUs to purchase certain eligible obligations of a liquidating credit union without regard to whether they are obligations of the liquidating credit union's individual members. As explained earlier in the part of the preamble on § 701.23(a) regarding the definition of eligible obligation, under this final rule notes of liquidating credit unions would no longer be included within the definition of eligible obligation. Consistent with that change, this final rule amends current § 701.23(b)(2)(ii) to remove the words "eligible obligations" and "obligations" and authorize FCUs to purchase notes of a liquidating credit union without regard to whether they are notes of the liquidating credit union's individual members.

Section 701.23(b)(3)

Section 701.23(b)(3)(ii)

The final rule amends the requirement in current § 701.23(b)(3)(ii) that written agreements and schedules of loans be retained by the purchaser. Current § 701.23(b)(3)(ii) provides that a written agreement and a schedule of the eligible obligations covered by the agreement are retained in the purchaser's office. Under the final rule, the purchasing FCU must still retain the written loan purchase agreement and a schedule of the eligible obligations covered by the agreement but is no longer required to retain the documents in the purchaser's office.

The Board acknowledges the requirement for the FCU to retain the written loan purchase agreement and schedule of the eligible obligations in the purchaser's office could imply that the written loan purchase agreement and schedule be retained in a hard-copy format, which is outdated given the current digital environment. An FCU might choose to store its records in electronic format, in the cloud, or housed in off-site servers or databases. An FCU must still make the loan purchase agreement and schedule of the eligible obligations covered by the agreement available upon request by the NCUA.[95] Credit unions that have some or all of their records maintained by an off-site data processor are considered to be in compliance for the storage of those records if the service agreement specifies the data processor safeguards against the simultaneous destruction of production and back-up information.[96] Accordingly, § 701.23(b)(3)(ii) of the final rule provides that a written agreement and a schedule of the eligible obligations covered by the agreement are retained by the purchaser.

This change will align this requirement with the NCUA's regulations and guidelines for FICUs on records preservation programs. Under part 749, the NCUA does not require or recommend a particular format for record retention. If the credit union stores records on microfilm, microfiche, or in an electronic format, the stored records must be accurate, reproducible, and accessible to an NCUA examiner.[97] If records are stored on the credit union

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[95] *See* § 749.2.
[96] *See* appendix A to part 749.
[97] *See* 12 CFR 749.5.

premises, they should be immediately accessible upon the examiner's request; if records are stored by a third party or off site, then they should be made available to the examiner within a reasonable time after the examiner's request.[98] The credit union must maintain the necessary equipment or software to permit an examiner to review and reproduce stored records upon request. The credit union should also ensure that the reproduction is acceptable for submission as evidence in a legal proceeding.[99]

Public Comments

Two commenters specifically offered support for aligning the requirements in §§ 701.23(b)(3)(ii), (c)(2), and (d)(1)(iii) with the electronic record availability and preservation standards outlined in part 749 of the NCUA's regulations.

Discussion

Given the strong support expressed by commenters, and the lack of objections, the Board is adopting the changes to § 701.23(b)(3)(ii), (c)(2), and (d)(1)(iii) as proposed for the reasons set forth in the notice of proposed rulemaking. Note also that current § 749.5 provides that, where NCUA regulations require credit unions to retain certain writings, records or information, credit unions may use any format that accurately reflects the information in the record, is accessible to all persons entitled to access by statute, regulation or rule of law, and is capable of being reproduced by transmission, printing, or otherwise. Section 749.5 provides further that the credit union must maintain the necessary equipment or software to permit an examiner to access the records during the examination process.

Section 701.23(b)(4)

The final rule amends current § 701.23(b)(4), which limits the aggregate unpaid balance of certain eligible obligations purchased by an FCU to a maximum of 5 percent of the FCU's

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[98] 12 C.F.R. part 749, app. A.
[99] *See generally* part 749; *and* NCUA Legal Op. 07-0812 (Jan. 2008), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2008/electronic-retention-records.

unimpaired capital and surplus. Under the final rule, the 5-percent limitation applies solely to notes of a liquidating credit union purchased by an FCU from the liquidating credit union. As discussed in the following paragraphs, the Board has determined this change would remove a regulatory limit to the purchase of eligible obligations that the FCU Act does not require. The Board believes adequate safety and soundness of eligible obligations purchases can be accomplished through principles-based regulation rather than a one-size-fits-all limitation.

Section 701.23 provides both the regulatory authority for purchases of eligible obligations by an FCU and the limitations. Under the current rule, the 5-percent limitation applies to eligible obligations purchased by an FCU under § 701.23(b)(1) and (b)(2)(ii). In general, current paragraph (b)(1) authorizes an FCU to purchase (1) eligible obligations of its members; (2) eligible obligations of a liquidating credit union's members from the liquidating credit union; and (3) student loans and real estate-secured loans from any source to facilitate the purchasing FCU's packaging of a pool of such loans to be sold or pledged on the secondary market. Current paragraph (b)(2)(ii), which is on purchases from FICUs, authorizes an FCU to purchase the "eligible obligations of a liquidating credit union without regard to whether they are obligations of the liquidating credit union's members."

The statutory source of the 5-percent limitation is section 107(13) of the Act.[100] Section 107 generally enumerates the powers of FCUs, and paragraph (13) authorizes an FCU to make certain loan purchases. Specifically, paragraph (13) provides the following authority, verbatim: in accordance with rules and regulations prescribed by the Board, to purchase, sell, pledge, or discount or otherwise receive or dispose of, in whole or in part, any eligible obligations (as defined by the Board) of its members and to purchase from any liquidating credit union *notes* made by individual members of the liquidating credit union at such prices as may be agreed upon

[100] 12 U.S.C. 1757(13).

by the board of directors of the liquidating credit union and the board of directors of the purchasing credit union, but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of *notes* purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union.[101]

Section 107(13) applies to the purchase of two mutually exclusive categories of loans—"eligible obligations" (as that term may be defined by the Board) of the purchasing FCU's members and the "notes" of a liquidating credit union made to the liquidating credit union's members. The 5-percent limitation, however, applies solely to the second category of loans; that is, the notes of a liquidating credit union to its members. The statutory language specifies that "no purchase may be made … if, upon the making of that purchase, the aggregate of the unpaid balances of *notes* purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union."[102] The 5-percent limitation is specific to the "aggregate unpaid balances of *notes*"[103] purchased "under authority of this paragraph" (that is, paragraph (13) of section 107). As italicized in the preceding quotes, the only notes authorized to be purchased pursuant to section 107(13) are those of a liquidating credit union to its members. Notwithstanding the ambiguity introduced by the reference to the entire "paragraph" (13) in the context of the 5-percent limitation, the following term "notes" narrows the required scope of its application to purchases from a liquidating credit union.

Despite the statutory wording, current § 701.23 does not distinguish between eligible obligations and notes. Section 107(13) of the FCU Act empowers the NCUA to define the term "eligible obligation." The NCUA has exercised this discretion by opting to jointly treat notes and other eligible obligations as the same type of instrument under its regulations. Both are

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[101] *Id.* (emphasis added).
[102] Emphasis added.
[103] Emphasis added.

encompassed in the regulatory definition of the term "eligible obligation," which is defined to be "a loan or group of loans."[104] Under the final rule, the 5-percent limitation applies solely to an FCU's purchase of the notes of a liquidating credit union. The limitation will not apply to other loans purchased by an FCU under the authority of section 107(13).

The final rule also amends the definition of eligible obligations to reflect the revised scope of the 5-percent limitation. As discussed previously, the final rule revises the definition of eligible obligation to mean "a whole loan or part of a loan (other than a note held by a liquidating credit union) that does not meet the definition of a loan participation under § 701.22(a)."[105]

The Board acknowledges that the current scope of the 5-percent limitation reflects or implies an alternate legal reading of the statutory language, which the Board recognizes as a plausible reading. The alternate reading hinges on the language providing that "no purchase may be made *under authority of this paragraph*." The term "this paragraph" encompasses paragraph (13) of section 107 in its entirety. This reading applies the 5-percent limitation to all instruments (eligible obligations and notes) purchased pursuant to paragraph (13). The current regulation reflects such an interpretation, and the Board has made past statements in support of this reading.[106] This rulemaking constitutes a reconsideration of the NCUA's prior position. As noted, the NCUA has determined that the regulatory change made by this final rule is more consistent with the language of the FCU Act and is more aligned with the different safety and soundness considerations with respect to eligible obligations in general and notes purchased from a liquidating credit union.

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[104] 12 CFR 701.23(a).

[105] Under the current definition of eligible obligation, there may be instances where the notes of the liquidating credit union members are also eligible obligations of the members of the purchasing FCU. The 5-percent limitation will apply to these loans as they fall within the more specific category of eligible obligations purchased from a liquidating credit union.

[106] For example, the preamble to the 1979 final rule implementing the NCUA's eligible obligations authority contained the following statement: "The Administration feels that the language of Section 107(13) is clear, and that the best interpretation is that adopted in the proposed rule" (that is, the currently codified regulatory text). 44 FR 27068, 27070 (May 9, 1979).

This new reading is better supported by accepted canons of statutory construction. The statutory construction canon of "consistent usage" logically presumes that different words denote different ideas.[107] Accordingly, the use of the terms "eligible obligations" and "notes" is intended to distinguish between two mutually exclusive categories of loans. Further, the canon holds that "a word or phrase is presumed to bear the same meaning throughout a text."[108] The use of the word "notes" in paragraph 107(13) is appropriately interpreted consistently and exclusively to reference only notes made by a liquidating credit union to its members.

This reading also aligns with the "surplusage" canon of statutory interpretation. Under this canon, "every word and every provision is to be given effect if possible."[109] "No word should be ignored. None should needlessly be given an interpretation that causes it to duplicate another provision or have no consequence."[110] This interpretation accounts for language subsequent to "under authority of this paragraph" that modifies the clause's scope. This subsequent language specifies that the prohibition applies only "if, upon the making of that purchase, the aggregate of the unpaid balances of *notes* purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union." Thus, the limit's application is required only with respect to the purchase of "notes," which, as stated previously, is appropriately narrowed to solely cover loans made by liquidating credit unions to their members. Reading the statute to require application of the 5-percent limitation to "eligible obligations" conflates the terms "notes" and "eligible obligations," despite the different terminology Congress enacted. The effect of treating the terms as duplicative is to effectively ignore the use of the term "notes," which should be separately considered under the surplusage canon.

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[107] Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts,* 148 (2012).
[108] *Id.*
[109] *Id.* at 145.
[110] *Id.*

It also bears noting that the stated rationale for original enactment of the 5-percent limitation does not apply to the purchase of eligible obligations. The 5-percent limitation language in section 107(13) of the Act was added by Congress in 1968 and referred solely to notes of liquidating credit unions at that time because that statute did not refer to purchases of eligible obligations.[111] That language is identical to the current version of the statutory text and continues to refer solely to "notes" of liquidating credit unions. Prior to the amendment, FCUs lacked express statutory authority to purchase the loans of liquidating credit unions. As a result, liquidating credit unions were hampered in their efforts to dispose of their assets to repay their members. The Senate report accompanying the legislation explained that the change would "greatly increase the market for the notes of liquidating credit unions and will prevent liquidating credit unions from having to go outside the credit union movement to liquidate their assets."[112] However, Congress was also mindful of the risks that might be posed in purchasing the loans of credit unions compelled to liquidate due to poor management decisions.[113] As a result, it opted to limit the ability of an FCU to purchase notes of liquidating credit unions to 5 percent of its unimpaired capital and surplus.[114]

The express authority to purchase eligible obligations was later added to the text of section 107(13) in 1977.[115] The legislative history from that time shows the amendment was intended to provide FCUs with flexibility to use secondary market facilities to enhance liquidity,

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[111] Pub. L. 90–375 (approved July 5, 1968) (Providing authority, in accordance with rules and regulations prescribed by the Director, to purchase from any liquidating credit union notes made by individual members of the liquidating credit union at such prices as may be agreed upon by the board of directors of the liquidating credit union and the board of directors of the purchasing credit union, *but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union*. (emphasis added)).
[112] S. Rep. No. 1265, 90th Cong., 2d Sess., at 2 (June 18, 1968).
[113] *Statement of J. Deane Gannon, Director, Bureau of Federal Credit Unions, Social Security Administration, Department of Health, Education and Welfare*, FCU Act Amendments, Subcommittee on Financial Institutions of the Comm. on Banking and Currency, at 11–12 (May 24, 1968).
[114] H.R. Rep. No. 1372 (May 9, 1968).
[115] Public Law 95-22 (approved Apr. 19, 1977).

especially in relation to real estate loans.[116] The purchase by an FCU of loans made to its own members is not analogous to, and does not pose the same inherent risk that, purchasing the notes of a liquidating credit union does. Accordingly, it is reasonable that Congress would elect not to mandate a limit on the ability of an FCU to make such purchases. This supposition is supported by Congress' decision to use the new term "eligible obligations" (and in granting the NCUA broad authority to define this term), rather than simply revising the existing scope of the term "notes" to include member loans. Further, the legislative history accompanying enactment of the 1977 amendments does not make any mention of the 5-percent limitation being applicable to eligible obligations.

The 1977 legislative history in several instances also refers to the amendment granting FCUs the ability to purchase the "notes" of its members. One could infer from this that the term "eligible obligations" was intended to be read synonymously with "notes."[117] This reading appears at least plausible because the broad category of "notes" could be seen to encompass various debt instruments, including notes or written documents evidencing a member's eligible obligations. Such a reading, however, is not required and is inferior to the interpretation the Board is proposing in this rule for two reasons. First, Congress ultimately opted to use the term "eligible obligations" in the statutory amendment that was enacted. The codified text supersedes non-binding statements in the legislative record.[118] Second, and as discussed earlier, accepted canons of statutory construction favor an interpretation that provides individual terms with their own individual meaning.

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[116] H.R. Rep. No. 95-23, at 16 (Feb. 22, 1977).
[117] *See,* for example, 123 Cong. Rec. H 1521-32, at H-1524 (Daily ed. March 1, 1977) (Describing the amendment as providing for the "Purchase and sale of notes of members."); H.R. Rep. No. 95-23, at 16 (Feb. 22, 1977) (also describing amendment as pertaining to the "Purchase and sale of notes"); and *Statement of C. Austin Montgomery, Administrator, National Credit Union Administration Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance Committee on Banking, Finance, and Urban Affairs, House of Representatives,* 95th Cong. 27 (1977) ("Temporary liquidity problems experienced by credit unions might be resolved by selling or pledging notes").
[118] Scalia & Garner, *supra* note 7 at 64 ("[T]he purpose must be derived from the text, not from extrinsic sources such as legislative history or an assumption about the legal drafter's desires").

For the preceding reasons, the NCUA has determined that the regulatory change made by this final rule is more consistent with the language of the FCU Act. The NCUA also has determined that the amendment will not pose a safety and soundness risk due to the addition of principles-based risk management requirements. By amending the current rule to narrow the application of the 5-percent limitation to the aggregate of the unpaid balances of loans purchased from any source to instead apply to only the "notes" of a liquidating credit union, the Board intends to allow FCUs greater capacity, flexibility, and individual autonomy to establish their own risk tolerance limits for the amount of the loans of its members that can be purchased from any source other than a liquidating credit union. This includes other financial institutions, fintech companies, third-party loan acquisition channels such as CUSOs, and other loan-originating retailers.

While the narrower interpretation of section 107(13) of the Act will remove the existing limit on the amount of eligible obligations that an FCU could purchase, establishing risk management expectations will reduce potential risk to the Share Insurance Fund while allowing FCUs more flexibility in how they manage their eligible obligation purchase activities. New § 701.23(b)(6), which is discussed in detail later in the part of the preamble on paragraph (b)(6), would outline minimum risk management standards that must be included in the written loan purchase policy for any FCU that plans to purchase eligible obligations. The Board believes these risk management standards should be part of the normal business practices at well-run FCUs that engage in the purchase of eligible obligations and, as such, should not represent an additional burden. It is the Board's view that the proposed changes would allow well-run FCUs more autonomy and flexibility in how they conduct their business. Provided the FCU can demonstrate and document that its loan purchase activity does not present a material risk to the viability or solvency of the FCU through the standards established in § 701.23(b)(6), the FCU

should be able to establish its own internal standards to meet its business needs and the needs of its members.

The final rule amends current § 701.23(b)(4) to remove the exclusions provided in paragraphs (b)(4)(i) through (iv) and revises the current language to apply the 5-percent limit only to notes purchased from liquidating credit unions. While the narrower interpretation of section 107(13) of the FCU Act will remove the existing restriction on the amount of eligible obligations an FCU could purchase, the new risk management requirements will minimize the potential increase in risk to the Share Insurance Fund, while allowing FCUs more flexibility in how they manage their loan purchase activities. Accordingly, § 701.23(b)(4) is revised to provide that the aggregate of the unpaid balance of notes purchased under paragraphs (b)(1)(ii) and (b)(2)(ii) of § 701.23 shall not exceed 5 percent of the unimpaired capital and surplus of the purchaser.

The Board invited comments concerning the proposed narrowing the application of the 5-percent limitation to only apply to the aggregate amount of "notes" that can be purchased by an FCU from a liquidating credit union.

Public Comments

Twenty-seven commenters specifically offered support for narrowing the 5-percent limitation to cover only notes of liquidating credit unions for the reasons provided in the proposal. Three commenters suggested the proposed change will allow credit unions, possibly through CUSOs and other collaborations, to build strong relationships with fintech companies, giving FICUs more tools to allow them to be a part of the lending system as it has evolved with the use of technology.

Discussion

Given the strong support expressed by commenters, and the lack of objections, the Board is adopting the changes to § 701.23(b)(4) as proposed for the reasons discussed earlier and in the notice of proposed rulemaking.

Section 701.23(b)(5) Grandfathered Purchases

The final rule amends current § 701.23(b)(5) to broaden the grandfathering provision in paragraph (b)(5). Current § 701.23(b)(5) provides that, subject to safety and soundness considerations, an FCU may hold any of the loans described in paragraph (b)(2) of this section provided it was authorized to purchase the loan and purchased the loan before July 2, 2012. The Board believes the revisions made by this final rule will avoid placing undue burden on FCUs that were operating in compliance with the existing rule and avoid disrupting the existing eligible obligations market by forcing widespread divestments of the eligible obligations currently held in FCU loan portfolios. While the grandfathering provision will allow FCUs to continue to hold eligible obligations that were purchased prior to the effective date of this rule, it does not exempt FCUs from conducting and updating risk assessments, establishing concentration limits, or monitoring the ongoing condition of an FCU's eligible obligation loan portfolio.

Accordingly, the final rule amends § 701.23(b)(5) to provide that, subject to safety and soundness considerations, an FCU may hold any of the loans described in paragraph (b) of this section that were acquired before the effective date of the final rule approved by the Board; provided the transaction complied with § 701.23 at the time the transaction was executed.

Public Comments

One commenter specifically offered support for the proposed revisions to § 701.23(b)(5). The commenter stated that FCUs that have operated in compliance with the recently expired § 701.23(i) and the NCUA's other regulatory requirements should not be forced to divest from their prudently purchased eligible obligations.

Discussion

Given the support expressed above, and the lack of objections, the Board is adopting the changes to § 701.23(b)(5) as proposed for the reasons set forth in the notice of proposed rulemaking.

New § 701.23(b)(6)

The final rule adds new paragraph (b)(6) to § 701.23, which sets forth basic due diligence, risk assessment, and risk management requirements that must be addressed in an FCU's internal written purchase policies.[119] An FCU's board of directors is responsible for planning, directing, and controlling the FCU's activities. To fulfill these duties, the board of directors must establish adequate policies to ensure the credit union operates safely and soundly and in compliance with applicable laws and regulations. The introductory paragraph to new § 701.23(b)(6) provides that the purchases of eligible obligations and notes of liquidating credit unions must comply with the purchasing FCU's internal written purchase policies, which must contain certain provisions.

The specific policy requirements, which are discussed in detail below, are part of the basic fiduciary responsibilities and duties required of boards of directors.[120] The requirements in the final rule address the basic elements necessary to administer a safe and sound loan purchase program.

As discussed previously, the Board is adding new requirements under § 701.23(b)(6) to mitigate the risk of removing certain regulatory limits on the purchase of loans by FCUs. The requirements are crafted to promote safe and sound loan purchase programs, which are intended to protect credit unions and the Share Insurance Fund. These requirements continue the Board's long-standing expectations for FCUs that purchase loans to appropriately identify and mitigate undue risk, while also providing FCUs greater flexibility to establish their own risk tolerance

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[119] A credit union's written loan purchase policies may be incorporated into the written lending policies required under § 741.3(b)(2).
[120] *See* §§ 701.4(b)(4), 701.21(c)(2), and 741.3(b)(2).

limits. These requirements are intended to mitigate unintended consequences related to the removal of the prescriptive requirements in current § 701.23(b)(2). The prescriptive requirements in current paragraph (b)(2), in some cases, resulted in FCUs managing their lending practices and balance sheets to regulatory restrictions instead of broader considerations for safe and sound lending practices.

The new requirements added by this final rule provide credit unions with expanded flexibility to develop loan purchase policies that are commensurate with the size, scope, type, complexity, and level of risk posed by the planned loan purchase activities. The new requirements are intended to provide principles-based requirements that are useful for credit unions of any size or complexity to implement the appropriate level of due diligence, risk assessment, and management.

When determining whether to start a loan purchase program and developing related written policies, credit unions should consider whether the loan purchase activities being contemplated are consistent with the FCU's overall business strategy and risk tolerances and financial and operational capabilities. Loan purchase, sale, or pledge activities that are inconsistent with the FCU's risk tolerance levels, represent undue risk in relation to the credit union's financial capacity, or beyond management's ability to manage can pose material risks to an FCU's financial or operational condition.

The risk management expectations outlined in this final rule reflect key components of long-standing supervisory expectations as communicated to credit unions through NCUA Letters to Credit Unions (LCU), Supervisory Letters, and the Examiner's Guide.

The Board requested comment on the following: (1) The new written purchase policy requirements in paragraph (b)(6) of the rule; (2) the principles-based due diligence, risk assessment, and risk management requirements and whether they are sufficient to offset the risk associated with removing the CAMELS rating and "well capitalized" requirements for a credit

union to purchase and hold eligible obligations from a FICU; and (3) whether there are other principles-based safety and soundness or compliance criteria the Board should consider that would mitigate the risk of removing certain prescriptive requirements from the rule.

Public Comments

Several commenters offered general support for the proposed due diligence requirements. One commenter suggested that most, if not all, of these requirements are already done as a matter of course. Another commenter believed the proposed requirements will help limit prudential risks associated with FCUs' investments in eligible obligations in a safe and sound manner. In response to a question in the proposed rule preamble for commenters, one commenter stated that additional safety and soundness criteria (beyond those included in the proposed rule) would not be helpful or mitigate risk further. The commenter recommended, however, that the limits imposed under § 701.23 should be comparable to those imposed on loan participation transactions; for example, instituting a limit in line with the loan participation limit of an amount of net worth to one seller. The commenter suggested that this change would simplify any confusion for both buyers and sellers of eligible obligations and allow examiners to compare to a benchmark when reviewing credit unions who purchase eligible obligations. One commenter recommended that each safety and soundness standard adopted in the final rule be sufficiently flexible to permit credit unions to adopt internal written purchase policy provisions that are commensurate with the size, scope, type, complexity, and level of risk posed by their individual eligible obligation activities.

Several commenters provided thoughts and recommendations regarding specific proposed due diligence requirements. One commenter suggested that requiring written purchase policies and established portfolio concentration limits seems prudent and valuable to ensure appropriate consideration by credit unions engaging in eligible obligation activity.

One commenter suggested that requiring a legal review of agreements seems unnecessary, as most credit unions already use legal counsel for the drafting or review of agreements, and those that do not perhaps have adequate internal expertise or expect to engage in a certain activity in such a modest way that it poses no material risk. The commenter suggested further that the requirement for legal review seems overly intrusive to a credit union's responsibility to understand and manage its risks. Another commenter recommended the NCUA further clarify the differences in what is required in the legal agreements for loan participations and eligible obligation purchases. The commenter noted that some of the requirements in the respective provisions (§ 701.22(d) for loan participation agreements and proposed new § 701.23(b)(6)(iv) for eligible obligation agreements) are similar and yet worded differently. The commenter provided as an example that the requirements in §§ 701.22(d)(4)(i) and 701.23(b)(6)(iv)(A) to identify the specific loans being purchased, and the requirement in the loan participation rule at § 701.22(d)(1) that the agreement be properly executed under applicable law, do not appear at all in the proposed eligible obligation rule's new language, although proposed § 701.23 does require a legal review of the eligible obligations purchase. To address these types of differences, the commenter recommended the following additions: (1) clarifying which of the loan participation agreement requirements also apply to eligible obligations (depending on whether servicing is retained or released) and (2) specifying whether there are additional (or fewer) obligations that apply to loan participations versus eligible obligations, including specifically what those differences are. To effectuate this change, the commenter recommended adding language to § 701.23(b)(6)(iv) as follows:

> Require that the written purchase agreement include, in the case of a servicing released transaction:
>
> The following requirements referenced in the loan participation rule (§ 701.22): [_____].

The following additional requirements not referenced in the loan participation rule (§ 701.22): [_____].

Require that the written purchase agreement include, in the case of a servicing retained transaction:

The following requirements referenced in the loan participation rule (§ 701.22): [_____].

The following additional requirements not referenced in the loan participation rule (§ 701.22): [_____].

One commenter suggested that partnering with responsible third parties is often what is most suitable for the credit union and their members. The commenter encouraged the NCUA to refresh its view on conflicts-of-interest and shift to something more like "credit unions relying on third party underwriting performed by the seller or an agent of the seller could be operating in an unsafe and unsound manner and should establish and demonstrate clear risk management and oversight protocols."

Discussion

In recognition of the general support from commenters for this proposed change, the Board is adopting the revisions as proposed for the reasons set forth in the notice of proposed rulemaking. The Board does not believe that performing a legal review of the written purchase or sales agreements is burdensome because, as noted by one commenter, most credit unions already carry out such reviews. Additionally, while legal reviews may need to be conducted to ensure that the legal and business interests of the credit union are protected against undue risk, the final rule does not specify when legal reviews are required, only that the credit union's internal written purchase policies must address when a legal review of agreements or contracts will be performed to ensure that the legal and business interests of the credit union are protected

against undue risk. This requirement should be based on the results of the due diligence and risk assessment processes completed for the planned activity. The determination as to when such a legal review would be required should be commensurate with the size, scope, type, complexity, and level of risk posed by the planned activity covered by the written agreement and contract.

When it is decided that a legal review by counsel is required, the credit union's attorneys should review the written agreement or contract to ensure that its legal and business interests are protected. The review should include the terms, recourse and risk-sharing arrangements, loan administration and controls. The credit union's attorneys should also make sure the board of directors and management clearly understand the rights and responsibilities of each party. For example, the review should indicate which party bears the costs of collateral disposition, and whether there are recourse arrangements, or a commitment for the purchasing credit union to make additional loan purchases and describe the interest being purchased. The legal review should also ensure that the requirements for a written loan purchase agreement under section §701.23 are adequately addressed and that the agreement complies with all state and federal laws. The legal review should address loan and collateral documentation and information that the seller is required to share with the purchasing credit union, status reports on payments and interest accrual, exit strategies or termination clauses, procedures for modifying loan terms, notification of adverse loan events, collection procedures if servicing rights are retained by the seller, turnover in key staff of the seller or servicer, and other provisions necessary to effectively manage credit risk.

The credit union's board of directors and senior management should exercise their right to negotiate the terms of any agreements or contracts to make them mutually fair and equitable. Further, a credit union should understand what actions it may take if the contract is breached, or the seller, any sub-servicers, or sub-contractors are not performing as expected. The written loan

purchase agreement is a critical component of any third-party transaction or relationship, and thus, a legal review is a key element in the overall risk mitigation and management process.

New § 701.23(b)(6)(i)

New § 701.23(b)(6)(i) requires FCUs to perform due diligence on the seller, and any applicable counterparties, before purchasing an eligible obligation. Conducting due diligence on third parties is a long-standing expectation for credit unions engaging in third-party relationships and when introducing new loan programs and products, as noted in NCUA LCU 01-CU-20 (November 2001), NCUA LCU 08-CU-26 (November 2008), and NCUA LCU 10-CU-03 (March 2010).[121]

On several occasions, third-party relationships with credit unions have resulted in financial stress due to unexpected costs, legal disputes, and asset losses. Due diligence reviews are important because they assist credit unions in risk identification and mitigation when engaging with outside parties in a new loan program and when enhancing services to members. Failure to complete adequate due diligence can result in the acquisition of loan volumes that exceed the board's risk appetite or credit union's financial capacity, loan types that go beyond management's ability to manage, or loan types or volume that exceed the capabilities of current loan processing and management information systems. The use of third parties can add complexity and additional risk to a credit union's activities and may also expose the credit union to consumer compliance and other legal risks. For example, failure to conduct adequate due diligence could lead to an FCU entering into agreements with a third party that does not have the ability to fulfill its contractual obligations. This could lead to disruptions in member service, uncollected payments on loans, and potential losses if the third party fails to remit funds that are due to the purchasing FCU.

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[121] *Available at* https://ncua.gov/regulation-supervision/letters-credit-unions-other-guidance.

The responsibility to perform appropriate due diligence remains with the FCU's board of directors and management and cannot be outsourced. Overreliance on the due diligence information provided by a third party without independent review by the FCU's board and management could result in unsafe and unsound practices.

The final rule allows FCUs the flexibility to determine the level and depth of due diligence reviews that are necessary based on the level of risk posed by the loans being purchased and the third-party relationships. Several factors may be considered when determining the appropriate nature of due diligence for third-party loan purchases and programs, including the following:

- the transaction's complexity;
- the purchasing FCU's internal lending policies and procedures;
- the transaction's size relative to the FCU's existing loan portfolio, concentrations, and net worth level; and
- the purchasing FCU's management and staff expertise regarding the types of loans being purchased.

Additionally, FCUs can take a tiered approach when establishing their due diligence processes in their loan purchase policies. For example, when conducting background checks the FCU can determine how best to assess a third party's business reputation, potential conflicts of interest, experience, and compliance with federal and state laws, rules, and regulations based on the type of relationship with the third party and its risk exposure.

Accordingly, new § 701.23(b)(6)(i) provides that the purchasing FCU's written purchase policy must require that the purchasing FCU conduct due diligence on the seller of the loans and other counterparties to the transaction prior to the purchase.

New § 701.23(b)(6)(ii)

New § 701.23(b)(6)(ii) requires FCUs to establish risk assessment and risk management processes for purchase activities. Conducting risk assessments and implementing risk management processes reflect the NCUA's long-standing expectation that credit unions incorporate these activities in relationships with third parties as outlined in NCUA LCU 07-CU-13 (April 2008), Evaluating Third-Party Relationships; NCUA LCU 22-CU-05 (March 2022), CAMELS Rating System; and NCUA Letter to FCUs 02-FCU-09 (March 2002), Risk-Focused Examination Program.[122] The purchase of loans can provide an FCU with a wide range of benefits, including achieving strategic loan growth, managing liquidity, adjusting risk exposures, and enhancing the services provided to members. However, an FCU that starts a new lending program, including the purchase or sale of loans, or engages with third parties without fully understanding the associated risks, may expose itself to credit, interest rate, liquidity, transaction, compliance, strategic, or reputation risk. Risk assessments allow credit unions to better understand the risk involved in new products and services to ensure the board has effective processes in place to control the risk. Not understanding these associated risks may result in the FCU operating outside of the board's risk appetite and can result in elevated risk to the Share Insurance Fund. FCUs are ultimately responsible for safeguarding member assets and ensuring sound operations.

Adequate risk management processes include ongoing monitoring and oversight of the loan purchase program. This includes formal reporting to the board of directors and the FCU's senior management, which will ensure the board is able to fulfill its duties. An FCU's management reporting should be timely and commensurate with the size, complexity, and risk exposure of the FCU. For example, the board of directors should be informed when targets are met or exceeded, or limits breached. Reports should also consist of appropriate information that

[122] *Available at* https://ncua.gov/regulation-supervision/letters-credit-unions-other-guidance.

the board of directors and management could use to make informed decisions and take timely corrective action when warranted. For effective governance, an FCU's board of directors and senior management must understand the nature and level of risk associated with the FCU's purchased loan portfolio and program and receive periodic updates and reports on its performance.

The final rule provides FCUs the flexibility to tailor their risk assessment and management processes to fit within their governance framework and other operations, while providing a basic framework to follow when developing their initial and ongoing risk assessment and management processes. Accordingly, new § 701.23(b)(6)(ii) provides that the purchasing FCU's internal written purchase policies must establish risk assessment and risk management process requirements that are commensurate with the size, scope, type, complexity, and level of risk posed by the planned loan purchase activities.

New § 701.23(b)(6)(iii)

New § 701.23(b)(6)(iii) requires FCUs to establish certain internal underwriting and ongoing monitoring standards for eligible obligation purchase activities. Underwriting is the foundation of lending. Without ensuring that underwriting standards are in place that adequately address how to analyze a borrower's ability to repay their debt, the board will not be able to fulfill its responsibilities for the safety and soundness of the FCU's lending activities. By this same logic, the board must also monitor the level of credit risk within the credit union's loan portfolio. Changing economic conditions at the local, regional, or national level can materially impact the likelihood that the credit union's outstanding loans are repaid. For example, the closure of a local business that is a large employer of the credit union's members could significantly change the risk profile of the credit union's loan portfolio. Changing levels of credit risk within the FCU's existing loan portfolio (including eligible obligations) may necessitate strategic changes or mitigating actions. If the level of credit risk begins to exceed the

board's risk appetite, then risk exposures may need to be adjusted. Depending on the circumstances, this could include, but is not limited to, restricting the purchase of new eligible obligations, implementing more conservative underwriting standards, or potentially divesting parts of the existing loan portfolio.

The FCU's internal policies must address the level of underwriting to be performed for the purchase of loans. Underwriting should identify all risks that could materially influence the purchasing FCU's decision to proceed with a loan purchase. Appropriate underwriting standards that adequately address how to analyze a borrower's ability to repay their loan and the support provided by collateral are a basic tenet of lending and help ensure that the FCU will be repaid, which protects its members and the Share Insurance Fund. Without appropriate underwriting standards, an FCU will not be able to accurately assess its risk of credit loss. Originating or purchasing loans to high credit risk borrowers without appropriately understanding and planning for that risk can result in unexpectedly high loss rates that negatively impact earnings and net worth, which may impair the viability of the credit union and pose a risk to the Share Insurance Fund. A lack of adequate underwriting standards can also result in adverse risk selection, whereby high credit risk borrowers are only able to obtain loans from institutions with lax underwriting, resulting in the FCU attracting borrowers with a much higher risk of default.

An FCU engaging in loan purchases should conduct an independent credit analysis and assessment of the borrower's creditworthiness and ability-to-repay, the support provided by collateral if relied on as part of the credit decision, and changes to the risk profile of the purchased loans. A purchasing FCU should not rely on the underwriting and analysis performed by the seller, or work performed by other third-party underwriters on behalf of a seller. To do so is an unsafe and unsound practice.

An FCU can leverage its current internal underwriting policies for similar loan types when developing its loan purchase policies. Performing credit and collateral analysis as if it

were the originator should result in purchased loans that are consistent with the board of director's overall business strategy, risk tolerances, and credit quality standards. To the extent a purchasing FCU relies on a third party's credit models for credit decisions, the purchasing FCU should perform due diligence on the credit model. An FCU is not prohibited from relying on a qualified and independent third party to perform model validation. However, the purchasing FCU should review the model validation to determine if it is sufficient.

The purchasing FCU's internal loan purchase policies should outline and identify the loan types that are acceptable for purchase. For example, acceptable loan types could include residential real estate (one-to-four family or multi-family first lien and/or junior lien), solar loans, automobile loans, student loans, unsecured loans, out-of-territory loans, commercial loans, or government guaranteed loans (guaranteed and/or unguaranteed portion).

The loan purchase policy should address the level and depth of the underwriting and analysis that is required for loan purchase activities based on the specific loan category, type, size, complexity, and risk profile of the borrower. The proposed rule allows flexibility to establish those parameters, while providing a basic framework for FCUs to follow when developing their policies.

Accordingly, new § 701.23(b)(6)(iii) provides that the purchasing FCU's internal written purchase policies must establish underwriting and ongoing monitoring standards that are commensurate with the size, scope, type, complexity, and level of risk posed by the loan purchase activities. Amended paragraph (b)(6)(iii) would provide further that underwriting and ongoing monitoring standards must address the borrower's creditworthiness and ability to repay, and the support provided by collateral if the collateral was used as part of the credit decision.

New § 701.23(b)(6)(iv)

New § 701.23(b)(6)(iv) provides that the purchasing FCU's internal written purchase policy must require that the written purchase agreements include certain language. A well-

written loan purchase agreement can minimize conflicts between the FCU and other parties to the agreement. The Board believes that any written loan purchase agreement must clearly delineate the roles, duties, and obligations of the seller, the purchasing FCU, servicer, and any other parties associated with the agreement, as applicable. The final rule establishes minimum provisions that any well-written loan purchase agreement must address.

The written loan purchase agreement is a critical component of any third-party relationship. In addition to establishing the rights and obligations of each party to the loan agreement, it should clearly address how the relationship operates. The written loan purchase agreement should fully describe the roles and responsibilities of all parties to the agreement, including any subcontractors. A well-written loan purchase agreement should address dispute resolution, requirements for any ongoing credit information if necessary for the loan type, remedies upon loan default and bankruptcy, which party bears the costs of collateral disposition, whether there are recourse arrangements for early pay-off, and if there is an obligation for the purchasing FCU to make any additional purchases or credit advances.

The purchasing FCU's board of directors and senior management should understand that they may have limited control over credit decisions for loans purchased in part, including, for example, limitations on the ability of the purchasing FCU to participate in loan modifications, act on defaulted loans, or decline to make additional advances if the purchasing FCU deems such advances are not prudent in relation to the loan quality. The written loan agreement must address these circumstances, and other conditions under which the parties to the agreement may replace the servicer if services are not performed in accordance with the terms of the written loan purchase agreement. The purchasing FCU must also know the location and custodian for the original loan documents if the original loan documents are not required to be transferred to the purchasing FCU as part of the loan purchase transaction. The purchasing FCU could be required to provide the original loan documents to various parties involved in the administration and

collection of the purchased loans. Therefore, the purchasing FCU needs to know where the original documents are located and whom to contact if the FCU needs to obtain the documents.

The written loan purchase agreement must, prior to the loan purchase transaction, identify the specific loan or loans purchased, and the interest purchased. A loan purchase transaction may involve a single or multiple loans, purchased in whole or in part. The documentation, for example, can be as simple as an addendum or schedule identifying each loan, provided the addendum or schedule is incorporated by reference into the loan purchase agreement. This provision clarifies in the existing rule that the loan purchase transaction involves the purchase of an individual loan or loans, and it is not the purchase of an investment interest in a pool of loans. FICUs should also keep in mind the requirements under GAAP for participation interests, which were discussed earlier in the part of the preamble about the changes to § 701.23(a).

Accordingly, for the reasons outlined in this portion of the preamble, new § 701.23(b)(6)(iv) provides that the purchasing FCU's internal written purchase policy must require that the written purchase agreement include the specific loans purchased (either directly in the agreement or through a document that is incorporated by reference into the agreement); the location and custodian for the original loan documents; an explanation of the duties and responsibilities of the seller, servicer, and all parties with respect to all aspects of the loans being purchased, including servicing, default, foreclosure, collection, and other matters involving the ongoing administration of the loans, if applicable; and the circumstances and conditions under which the parties to the agreement may replace the servicer when the seller retains the servicing rights for the loans being purchased, if applicable.

New § 701.23(b)(6)(v)

New § 701.23(b)(6)(v) requires that FCUs establish certain portfolio concentration limits. Excessive concentration risk can severely impact the financial condition of an FCU. High concentrations in areas experiencing economic distress could result in significant losses

exceeding an FCU's net worth. An FCU's board of directors and senior management have the responsibility to identify, manage, monitor, and control the risks facing the FCU, including concentration risk. FCU management must know what their concentration risks are and be able to demonstrate appropriate risk management and mitigation practices to minimize the risk of significant financial condition decline. Accordingly, new § 701.23(b)(6)(v) provides that a purchasing FCU's internal written purchase policies must establish portfolio concentration limits by loan type and risk category in relation to net worth that are commensurate with the size, scope, and complexity of the credit union's loan purchases. New paragraph (b)(6)(v) provides further that the policy limits must consider the potential impact of loan concentrations on the purchasing credit union's earnings, loan loss reserves, and net worth.

An FCU's loan purchase policy should establish credit underwriting and administration requirements that address the risks and characteristics unique to the loan types permitted for purchase. An FCU's loan purchase policy concentration limits should be considered for the aggregate amount of total purchased loans, for each loan type, risk factor, or category permitted. For example, concentration limits can be set by loan or collateral type but may also be set by associated borrower, origination channel, geographic area, or other risk category as applicable.

An FCU's board of directors should establish concentration risk limits commensurate with its net worth levels and consider how the limits fit into the overall strategic plan of the FCU. When credit union loan portfolios are concentrated in a small number of loan products that are significantly exposed to similar or correlated risk factors, a single event can impact a large portion of the loan portfolio and result in elevated losses that, if not managed appropriately, can lead to the credit union's failure. Since the year 2000, more than 50 percent of the NCUA's postmortems and material loss reviews have cited concentration risk as a central component of credit union failures. An FCU's board of directors should use a comprehensive perspective when developing loan purchase concentration policy limits, including identifying outside forces

(such as economic or housing price uncertainty) that would affect the ability to manage concentration risk. The parameters set by the board of directors should be specific to each portfolio and should include limits on loan types and third-party relationship exposure, at a minimum. The concentration risk limits should correlate to the FCU's overall growth objectives, financial targets, and net worth plan. The concentration risk limits set forth in the FCU's policy should be closely linked to those codified in related policies, including, but not limited to, real estate loans, member business loans, asset/liability management, and investment policies. Concentrations that exceed net worth must be monitored carefully, and the board of directors should document an adequate rationale for undertaking that level of risk.[123]

New § 701.23(b)(6)(vi)

New § 701.23(b)(6)(vi) addresses when a legal review of agreements or contracts would be required. The written loan purchase agreement is a critical component of the third-party relationship and, as such, the requirement for a legal review is a key element in the overall risk mitigation and management process. By obtaining legal advice regarding third-party contracts, an FCU can ensure its legal and business interests are appropriately protected, and the board of directors and senior management understand the risks, rights, and responsibilities of each party to the written loan purchase agreement. Accordingly, new § 701.23(b)(6)(vi) provides that an FCU's internal written purchase policy must address when a legal review of agreements or contracts will be performed to ensure that the legal and business interests of the credit union are protected against undue risk.

A legal review of the written loan purchase agreements and contracts will help an FCU ensure that the board of directors and senior management understand the rights and responsibilities of each party. For example, the review could identify which party bears the costs

[123] *See* attachment to NCUA Letter to FICUs 10-CU-03 (March 2010) available at https://www.ncua.gov/files/letters-credit-unions/LCU2010-03Encl.pdf.

of collateral disposition, whether there are recourse arrangements, or whether the agreement includes a commitment for the purchasing FCU to make additional loan purchases and describe the interest being purchased. A legal review may also reduce a credit union's legal, compliance, or reputation risk by ensuring that the written loan purchase agreement complies with all applicable state and federal laws.

Further, an FCU should understand what actions it may take if the contract is breached or services are not performed as expected. For example, the legal review could determine if the written loan purchase agreements include recourse language that requires a seller to buy back loans with missing documents, made outside of policy, or otherwise not in conformance with representations and warranties. The written loan purchase agreement is a critical component of the third-party relationship and, as such, a legal review is a key element in the overall risk mitigation and management process.

Section 701.23(c) Sale

The final rule makes a non-substantive conforming change to current § 701.23(c)(1). In addition, the final rule makes certain substantive changes to paragraph (c)(2) and adds new paragraphs (c)(3) and (4), which are discussed in more detail in the following paragraphs. No changes are made in the introductory sentence to current § 701.23(c).

Section 701.23(c)(1)

As required by the changes discussed in the following paragraphs, the final rule makes a conforming amendment to current § 701.23(c)(1). The conforming amendment removes the "and" at the end of the provision to allow for an additional provision to be added under § 701.23(c)(2). No substantive change to this provision is intended.

Public Comments

One commenter recommended amending proposed § 701.23(c)(1) to provide that "the Board or a committee of the Board assigned with that responsibility by the Board approves the

sale." The commenter suggested it is not necessarily an investment committee that would normally be dealing with loan issues—indeed, an overarching asset liability management committee, or a lending committee, or an executive committee, could each be tasked with such a role as within their core activities and competencies—and various institutions use different names for their committees, and the reference to "investment committee" is highly specific.

Discussion

The Board did not propose substantive changes to § 701.23(c)(1), so the changes suggested above would go beyond the scope of this rulemaking. The comments will be retained, however, for consideration in future rulemakings related to § 701.23. Accordingly, the Board adopts the changes to paragraph (c)(1) as proposed for the reasons set forth in the notice of proposed rulemaking.

Section 701.23(c)(2)

The final rule amends current § 701.23(c)(2) to change the retention requirements for the written agreement and schedule of eligible obligations sold by an FCU. The Board believes that this would result in only a minor technical change to current §701.23(c)(2). Under the final rule, the FCU selling the eligible obligations will still be required to retain the written loan sales agreement and a schedule of the eligible obligations covered by the agreement. The Board acknowledges the requirement for the FCU to retain the written loan sales agreement and schedule of the eligible obligations in the seller's office could imply that the written loan sales agreement and schedule be retained in a hard-copy format, which is outdated given the current digital environment. An FCU might choose to store its records in electronic format, in the cloud, or housed in off-site servers or databases.

This change will align § 701.23(c)(2) with the NCUA's regulations and guidelines for FICUs on records preservation programs. Under part 749, the NCUA does not require or recommend a particular format for record retention. If the credit union stores records on

microfilm, microfiche, or in an electronic format, the stored records must be accurate, reproducible, and accessible to an NCUA examiner.[124] If records are stored on the credit union premises, they should be immediately accessible upon the examiner's request; if records are stored by a third party or off site, then they should be made available to the examiner within a reasonable time after the examiner's request. The credit union must maintain the necessary equipment or software to permit an examiner to review and reproduce stored records upon request. The credit union should also ensure that the reproduction is acceptable for submission as evidence in a legal proceeding.[125] Accordingly, § 701.23(c)(2) of the final rule provides that a written agreement, and a schedule of the eligible obligations covered by the agreement, is retained by the selling credit union that identifies the specific loans being sold either directly in the agreement or through a document that is incorporated by reference into the agreement.

New § 701.23(c)(3)

The final rule adds new paragraph (c)(3) to § 701.23 to require a legal review of the written agreement to protect the legal and business interests of the selling FCU. A legal review of the written loan sales agreements and contracts will help an FCU ensure that the board of directors and senior management understand the rights and responsibilities of each party. For example, the legal review would make clear which party bears the costs of collateral disposition, whether there are recourse arrangements, whether the agreement includes a commitment for the purchasing credit union to make additional loan purchases, and whether the agreement describes the interest being purchased. The legal review would also ensure that the written loan sales agreement complies with all applicable state and federal laws, helping to minimize a credit union's legal, compliance, and reputation risk. The legal review should address loan and collateral documentation and information that the selling party is required to share with the

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[124] *See* 12 CFR 749.5.
[125] *See generally* part 749; *and* NCUA Legal Op. 07-0812 (Jan. 2008), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2008/electronic-retention-records.

purchasing party, status reports on payments and interest accrual, exit strategies, procedures for modifying loan terms, notification of adverse loan events, and collection procedures if servicing rights are retained by the seller. Further, an FCU should understand what actions it may take if the contract is breached or services are not performed as expected. The written loan sales agreement is a critical component of the third-party relationship and, as such, the requirement for a legal review is a key element in the overall risk mitigation and management process.

Accordingly, new § 701.23(c)(3) requires a legal review of the written agreement is completed that includes the terms, recourse, and risk-sharing arrangements, and, as applicable, loan administration and controls, to ensure that the selling FCU's legal and business interests are protected from undue risks.

Public Comments

One commenter noted their support for the proposed legal review requirement in § 701.23(c)(3) regarding the sale of eligible obligations for the reasons provided in the proposal. Another commenter suggested that requiring a legal review of agreements seems unnecessary, as most credit unions already use legal counsel for the drafting or review of agreements, and those that do not perhaps have adequate internal expertise or expect to engage in a certain activity in such a modest way that it poses no material risk. The commenter suggested further that the requirement for legal review seems overly intrusive to a credit union's responsibility to understand and manage its risks.

Discussion

In response to comments received, the Board is adopting the changes to § 701.23(c)(3) as proposed, for the reasons set forth in the notice of proposed rulemaking, with one amendment. After reviewing the comments, the Board agrees that there may be types of routine agreements that do not require legal review by an attorney and that FCUs should be responsible for understanding and managing their own risks. In recognition of this, the final rule removes the

word “legal” the first place it appears in proposed § 701.23(c)(3). This change allows FCUs to determine, consistent with safety and soundness, what level of review is required to *ensure* that the selling FCU’s legal and business interests are protected from undue risks. For example, for most complex transactions FCUs must perform a legal review of the agreements because only a qualified attorney can reasonably ensure that the selling FCU’s legal and business interests are protected in such situations. On the other hand, for routine transactions involving simple agreements, review by a non-attorney member of the FCU’s staff may be all that is necessary to ensure that the selling FCU’s legal and business interests are protected. Accordingly, § 701.23(c)(3) of the final rule requires that a review of the written agreement is completed that includes the terms, recourse, and risk-sharing arrangements, and, as applicable, loan administration and controls, to ensure that the selling FCU’s legal and business interests are protected from undue risks.

Section 701.23(d) Pledge

The final rule amends current § 701.23(d)(1)(iii) to amend the retention requirements for agreements covering eligible obligations pledged by an FCU. The Board believes that this will result in only a minor technical change to current §701.23(d)(1)(iii). Under the final rule, the FCU pledging the eligible obligations would still be required to retain the written agreement covering the pledging arrangement. The Board acknowledges the requirement for the FCU that pledges the eligible obligations to retain the written agreement in the office could imply that the written agreement should be retained in a hard-copy format, which is outdated given the current digital environment. An FCU might choose to store its records in electronic format, in the cloud, or housed in off-site servers or databases. The Board’s intent is that the FCU that pledges the

eligible obligations make the written agreement covering the pledging arrangement available upon request.[126]

This change will align this requirement with the NCUA's regulations and guidelines for FICUs on records preservation programs. Under part 749, the NCUA does not require or recommend a particular format for record retention. If the credit union stores records on microfilm, microfiche, or in an electronic format, the stored records must be accurate, reproducible, and accessible to an NCUA examiner.[127] If records are stored on the credit union premises, they should be immediately accessible upon the examiner's request; if records are stored by a third party or off site, then they should be made available to the examiner within a reasonable time after the examiner's request. The credit union must maintain the necessary equipment or software to permit an examiner to review and reproduce stored records upon request. The credit union should also ensure that the reproduction is acceptable for submission as evidence in a legal proceeding.[128]

Accordingly, § 701.23(d)(1)(iii) of the final rule requires that a written agreement covering the pledging arrangement is retained by the credit union that pledges the eligible obligations.

Section 701.23(g) Payments and Compensation

The final rule amends current § 701.23(g) by adding a paragraph heading. The Board believes that this amendment will result in only a minor technical change to paragraph (g). The amended rule would add the three-word descriptive heading "*Payments and compensation*" for this section of the rule but does not add any additional requirements or make any other changes. Accordingly, § 701.23(g) has the paragraph heading "*Payments and compensation*."

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[126] *See* § 749.2.
[127] *See* 12 CFR 749.5.
[128] *See generally* part 749; *and* NCUA Legal Op. 07-0812 (Jan. 2008), *available at* https://www.ncua.gov/regulation-supervision/legal-opinions/2008/electronic-retention-records.

Section 701.23(i) Temporary Regulatory Relief in Response to COVID-19

The final rule does not extend the regulatory relief in § 701.23(i) that the Board approved in April of 2020 in response to COVID-19. Paragraph (i) provided that, notwithstanding § 701.23(b), during the period commencing on April 21, 2020, and *concluding on December 31, 2022*, an FCU may: purchase, in whole or in part, and within the limitations of the board of directors' written purchase policies, any eligible obligations pursuant to paragraph (b)(1)(i) and (b)(2)(i) without regard to whether they are loans the credit union is empowered to grant or are refinancing to ensure the obligations are ones the purchasing credit union is empowered to grant; and purchase and hold the obligations described in § 701.23(b)(2)(i) through (iv) if the FCU's CAMELS composite rating is "1," "2," or "3."[129] This temporary relief sunset on December 31, 2022, and was removed from the NCUA's regulations by the Office of the Federal Register shortly thereafter as part of their regular editing and review process.

Public Comments

One commenter recommended the NCUA study the extent to which the flexibility provided in the expired temporary regulatory relief was used by credit unions, along with any increased risk associated with transactions made that would not otherwise have been permitted and consider providing such regulatory relief to address future system challenges that may not necessarily rise to the level of the COVID–19 pandemic.

Discussion

The Board appreciates the comments that were submitted regarding expiration of the temporary regulatory relief under § 701.23(g). The temporary regulatory relief provided under

[129] Emphasis added.

paragraph (g) expired on December 31, 2022. The Board will consider approving temporary regulatory relief again in the future if circumstances warrant.

B. Part 714—Leasing

Section 714.2(b)

In the proposal, the Board requested comment on the placement of the definition of indirect leasing arrangement in § 701.21, as opposed to part 714 of the NCUA's regulations. In particular, the Board requested comments on whether stakeholders would find it clearer or more user-friendly to codify the definition of indirect leasing arrangement in part 714. The Board received no comments directly in response to this question.

Although not raised by commenters, the Board believes the relationship between the indirect leasing provisions in § 701.21 and part 714 should be clarified by pointing out the relationship between the two sections to readers of part 714. To do this, the final rule adds brief language and a cross citation to the first sentence in § 714.2(b) pointing readers to § 701.21(c)(9) and helping them to make the connection between the two sections. No substantive change to the NCUA's regulations is intended by adding this clarifying cross citation. Accordingly, the first sentence in § 714.2(b), as amended, provides that an FCU may engage in indirect leasing as described under § 701.21(c)(9) of the NCUA's regulations.

Section 714.9 [Removed and Reserved]

Current § 714.9 provides that the indirect leasing arrangements of an FCU are not subject to the eligible obligation limit if they satisfy the provisions of § 701.23(b)(3)(iv) that require that FCUs make the final underwriting decision and that the lease contract is assigned to the FCU very soon after it is signed by the member and the dealer or leasing company. The reference in current § 714.9 cites to § 701.23(b)(3)(iv), but there is no paragraph (b)(3)(iv) in that section. It is clear from the "eligible obligations limit" language in current § 714.9, however, that the cross citation is intended to reference the exclusion from the 5-percent limitation in current

§ 701.23(b)(4)(iv). Because this final rule amends § 701.23(b)(4) to remove paragraph (b)(4)(iv) and will no longer apply the 5-percent limitation to any purchases of eligible obligations, as explained earlier in the preamble, current § 714.9 is rendered moot by this final rule. Accordingly, this final rule removes the language in current § 714.9 and reserves the blank section for future use.

IV. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) generally requires that, in connection with a final rulemaking, an agency prepare and make available for public comment a final regulatory flexibility analysis that describes the impact of the final rule on small entities. A regulatory flexibility analysis is not required, however, if the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include credit unions with assets less than $100 million)[130] and publishes its certification and a short, explanatory statement in the *Federal Register* together with the rule.

The Board fully considered the potential economic impact of the changes made by this final rule during its development. As noted in the preamble, the final rule clarifies the NCUA's current regulations and provides additional flexibilities to FICUs, making it easier to take advantage of advanced technologies and opportunities offered by the fintech sector.

The final rule does not impose any new significant burden on FICUs and may ease some existing requirements. Small FICUs are not obligated to buy and sell eligible obligations and loan participations. Additionally, while the final rule introduces risk management and due diligence policy expectations, FICUs have the flexibility to tailor required processes and policies to fit within their existing governance framework and commensurate with their size and

[130] *See* 80 FR 57512 (Sept. 24, 2015).

complexity. Accordingly, the NCUA certifies that this final rule will not have a significant economic impact on a substantial number of small FICUs.

Paperwork Reduction Act

The Paperwork Reduction Act of 1995 (PRA) applies to rulemakings in which an agency by rule creates a new paperwork burden on regulated entities or modifies an existing burden.[131] For purposes of the PRA, a paperwork burden may take the form of a reporting, disclosure, or recordkeeping requirement, each referred to as an information collection. The NCUA may not conduct or sponsor, and the respondent is not required to respond to, an information collection unless it displays a currently valid Office of Management and Budget (OMB) control number.

The rule as previously published contains information collections in the form of a written policy requirement and a transaction documentation requirement, covered by OMB control numbers 3133-0127 (Purchase, Sale, and Pledge of Eligible Obligations) and 3133-0141(Organization and Operations of Federal Credit Unions – Loan Participation). The proposed changes to part 701 did not affect the burdens under OMB Control Numbers 3133-0127 and 3133-0141. Adjustments to the burdens reflect a reduction in the current number of credit unions or to reflect a more accurate response rate per respondent. Under OMB Control Number 3133-0127, the number of respondents decreased; thereby, decreasing the burden to 1,830 annual hours. The NCUA estimates that the burden will increase, however, under OMB Control Number 3133-0141 by 4,994 annual burden hours because the responses per respondent will likely increase.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their actions on state and local interests. The NCUA, an independent regulatory

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[131] 44 U.S.C. 3507(d).

agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the principles of the executive order to adhere to fundamental federalism principles. This final rule would reduce regulatory burdens on, and expand the authority of, federally insured credit unions, including federally insured, state-chartered consumer credit unions to purchase certain loans and loan participations. It may have, to some degree, a direct effect on the states, on the relationship between the federal government and the states, or on the distribution of power and responsibilities among the various levels of government. It does not, however, rise to the level of material impact for purposes of Executive Order 13132.

Assessment of Federal Regulations and Policies on Families

The NCUA has determined that this final rule will not affect family well-being within the meaning of section 654 of the Treasury and General Government Appropriations Act, 1999, Pub. L. 105-277, 112 Stat. 2681 (1998).

Small Business Regulatory Enforcement Fairness Act (Congressional Review Act)

The Small Business Regulatory Enforcement Fairness Act of 1996 (Pub. L. 104-121) (SBREFA) generally provides for congressional review of new agency rules that qualify as "major" under criteria specified in the Act.[132] Analysis performed by the Office of the Chief Economist (OCE) at NCUA indicates the rule falls well short of qualifying as a "major" by those criteria. As required by SBREFA, the NCUA is submitting this final rule and its economic impact analysis to the Office of Management and Budget for concurrence on the "not major" determination. The NCUA also will file all other appropriate congressional reports.

[132] 5 U.S.C. 801–804.

List of Subjects

12 CFR Part 701

Advertising, Aged, Civil rights, Credit, Credit unions, Fair housing, Individuals with disabilities, Insurance, Marital status discrimination, Mortgages, Religious discrimination, Reporting and recordkeeping requirements, Sex discrimination, Signs and symbols, Surety bonds.

12 CFR Part 714

Credit unions, Leasing, Reporting and recording keeping requirements.

By the National Credit Union Administration Board on September 21, 2023.

Melane Conyers-Ausbrooks,

Secretary of the Board.

For the reasons discussed in the preamble, the Board amends 12 CFR parts 701 and 714 as follows:

PART 701 - ORGANIZATION AND OPERATION OF FEDERAL CREDIT UNIONS

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

Authority: 12 U.S.C. 1752(5), 1755, 1756, 1757, 1758, 1759, 1761a, 1761b, 1766, 1767, 1782, 1784, 1785, 1786, 1787, 1788, 1789. Section 701.6 is also authorized by 15 U.S.C. 3717. Section 701.31 is also authorized by 15 U.S.C. 1601 et seq.; 42 U.S.C. 1981 and 3601–3610. Section 701.35 is also authorized by 42 U.S.C. 4311–4312.

2. Amend §701.21 by adding paragraph (c)(9) to read as follows:

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

* * * * *

(c) * * *

(9) *Indirect lending and indirect leasing arrangements*—(i) *Definitions*. For purposes of this chapter, the following definitions apply:

Indirect leasing arrangement means a written agreement to purchase leases from the leasing company where the purchaser makes the final underwriting decision, and the lease agreement is assigned to the purchaser very soon after it is signed by the member and the leasing company.

Indirect lending arrangement means a written agreement to purchase loans from the loan originator where the purchaser makes the final underwriting decision regarding making the loan, and the loan is assigned to the purchaser very soon after the inception of the obligation to extend credit.

(ii) *Indirect lending*. A loan acquired pursuant to an indirect lending arrangement, and that meets the requirements of this section, is classified as a loan and not the purchase of a loan for purposes of this chapter.

(iii) *Indirect leasing*. A lease acquired pursuant to an indirect leasing arrangement, and that meets the requirements of part 714 of this chapter, is classified as a lease and not the purchase of a lease for purposes of this chapter.

* * * * *

3. Amend § 701.22 by:

a. Revising the introductory text; and

b. Revising the definition of "Originating lender" in paragraph (a).

The revisions read as follows:

§ 701.22 Loan participations.

This section applies only to loan participations as defined in paragraph (a) of this section. It does not apply to the purchase of an investment interest in a pool of loans. This section establishes the requirements a federally insured credit union must satisfy to purchase a participation in a loan. Federally insured, state-chartered credit unions are required by § 741.225 of this chapter to comply with the loan participation requirements of this section. This section does not apply to corporate credit unions, as that term is defined in § 704.2 of this chapter.

(a) * * *

Originating lender means the participant with which the borrower initially or originally contracts for a loan and who, thereafter or concurrently with the funding of the loan, sells participations to other lenders. Originating lender includes a participant that acquires a loan through an indirect lending arrangement as defined under § 701.21(c)(9).

* * * * *

4. Amend § 701.23 by:

a. Revising the introductory text, paragraph (a), the heading to paragraph (b);

b. Adding a heading to paragraph (b)(1);

c. Revising paragraph (b)(1)(ii);

d. Adding a heading to paragraphs (b)(1)(iii) and (iv);

e. Removing the word “mortage” from the first sentence in paragraph (b)(1)(iv) and adding in its place the word “mortgage”;

f. Revising paragraphs (b)(2) introductory text, and (b)(2)(ii);

g. Adding a heading to paragraph (b)(3);

h. Revising paragraph (b)(3)(ii), and (b)(4) and (5);

i. Adding paragraph (b)(6);

j. Revising paragraphs (c)(1) and (2);

k. Adding paragraph (c)(3);

l. Revising paragraph (d)(1)(iii); and

m. Adding a heading to paragraphs (g) and (h)(1). The revisions and additions read as follows:

§ 701.23 Purchase, sale, and pledge of loans.

This section governs a Federal credit union's purchase, sale, or pledge of all or part of a loan to one of its own members, subject to certain exceptions. For purchases of eligible obligations, except as otherwise described under paragraph (b) of this section, the borrower must be a member of the purchasing Federal credit union before the purchase is made.

(a) *Definitions*. For purposes of this section:

Eligible obligation means a whole loan or part of a loan (other than a note held by a liquidating credit union) that does not meet the definition of a loan participation under § 701.22(a).

Liquidating credit union means:

(i) In the case of a voluntary liquidation, a credit union is a liquidating credit union as of the date the members vote to approve liquidation.

(ii) In the case of an involuntary liquidation, a credit union is a liquidating credit union as of the date the board of directors is served an order of liquidation issued by either the NCUA or the state supervisory authority.

Student loan means a loan granted to finance the borrower's attendance at an institution of higher education or at a vocational school, which is secured by and on which payment of the outstanding principal and interest has been deferred in accordance with the insurance or guarantee of the Federal Government, of a state government, or any agency of either.

(b) *Purchase of loans*. (1) *Purchase of obligations from any source*. * * *

(i) *Eligible obligations*. * * *

(ii) *Notes of a liquidating credit union's individual members*. Notes of a liquidating credit union's individual members, from the liquidating credit union;

(iii) *Student loans*. * * *

(iv) *Real estate-secured loans*. * * *

* * * * *

(2) *Purchases of obligations from a FICU*. A Federal credit union may purchase and hold the following obligations, provided that it would be empowered to grant them:

* * * * *

(ii) *Notes of a liquidating credit union*. Notes of a liquidating credit union, without regard to whether they are notes of the liquidating credit union's members;

* * * * *

(3) *Other requirements*. * * *

(ii) A written agreement and a schedule of the eligible obligations covered by the agreement are retained by the purchaser; and

* * * * *

(4) *Five-percent limitation*. The aggregate of the unpaid balance of notes purchased under paragraphs (b)(1)(ii) and (b)(2)(ii) of this section shall not exceed 5 percent of the unimpaired capital and surplus of the purchaser.

(5) *Grandfathered purchases*. Subject to safety and soundness considerations, a Federal credit union may hold any of the loans described in paragraph (b) of this section that were acquired before [EFFECTIVE DATE OF THE FINAL RULE]; provided the transaction complied with this section at the time the transaction was executed.

(6) *Written purchase policies*. Purchases of eligible obligations and notes of liquidating credit unions must comply with the purchasing Federal credit union's internal written purchase policies, which must:

(i) Require that the purchasing Federal credit union conduct due diligence on the seller of the loans and other counterparties to the transaction prior to the purchase.

(ii) Establish risk assessment and risk management process requirements that are commensurate with the size, scope, type, complexity, and level of risk posed by the planned loan purchase activities.

(iii) Establish internal underwriting and ongoing monitoring standards that are commensurate with the size, scope, type, complexity, and level of risk posed by the loan purchase activities. Underwriting and ongoing monitoring standards must address the borrower's creditworthiness and ability to repay, and the support provided by collateral if the collateral was used as part of the credit decision.

(iv) Require that the written purchase agreement include:

(A) The specific loans being purchased (either directly in the agreement or through a document that is incorporated by reference into the agreement);

(B) The location and custodian for the original loan documents;

(C) An explanation of the duties and responsibilities of the seller, servicer, and all parties with respect to all aspects of the loans being purchased, including servicing, default, foreclosure, collection, and other matters involving the ongoing administration of the loans, if applicable; and

(D) The circumstances and conditions under which the parties to the agreement may replace the servicer when the seller retains the servicing rights for the loans being purchased, if applicable.

(v) Establish portfolio concentration limits by loan type and risk category in relation to net worth that are commensurate with the size, scope, and complexity of the credit union's loan purchases. The policy limits must consider the potential impact of loan concentrations on the purchasing credit union's earnings, loan loss reserves, and net worth.

(vi) Address when a legal review of agreements or contracts will be performed to ensure that the legal and business interests of the credit union are protected against undue risk.

(c) * * *

(1) The board of directors or investment committee approves the sale;

(2) A written agreement, and a schedule of the eligible obligations covered by the agreement, is retained by the selling credit union that identifies the specific loans being sold either directly in the agreement or through a document that is incorporated by reference into the agreement; and

(3) A review of the written agreement is completed that includes the terms, recourse, and risk-sharing arrangements, and, as applicable, loan administration and controls, to ensure that the selling Federal credit union's legal and business interests are protected from undue risks.

(d) * * *

(1) * * *

(iii) A written agreement covering the pledging arrangement is retained by the credit union that pledges the eligible obligations.

* * * * *

(g) *Payments and compensation*—* * *

(h) *Additional authority*. (1) *Expanded purchase authority*. * * *

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PART 714 - LEASING

5. The authority citation for part 714 continues to read as follows:

Authority: 12 U.S.C. 1756, 1757, 1766, 1785, 1789.

6. Amend § 701.2 by revising paragraph (b) to read as follows:

§ 714.2 What are the permissible leasing arrangements?

* * * * *

(b) You may engage in indirect leasing as described under § 701.21(c)(9) of this chapter. In indirect leasing, a third party leases property to your member and you then purchase that lease from the third party for the purpose of leasing the property to your member. You do not have to purchase the leased property if you comply with the requirements of § 714.3.

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§ 714.9 [Removed and Reserved]

7. Remove and reserve § 714.9.