

rule's loan-to-value ratios, except for nonnatural person member credit cards. 12 CFR 723.7(a), (c). The Board has approved four state rules that permit credit unions with a net worth of at least 7% to make other unsecured MBLs under various conditions.

Under the proposal, a credit union may make unsecured MBLs if: (1) The credit union is "well-capitalized" as defined in 12 CFR 702.102(a)(1); (2) the aggregate of unsecured MBLs to one borrower does not exceed the lesser of \$100,000 or 2.5% of the credit union's net worth; (3) the aggregate of all of the credit union's unsecured MBLs does not exceed 10% of the credit union's net worth; and (4) the credit union addresses unsecured loans in its written MBL policy. The Board also proposes that the rule permit a credit union to apply for waivers from the unsecured loans to one borrower limitation and the aggregate unsecured loan limitation under this section. In connection with adding these provisions to § 723.10 on waivers, § 723.10 has been reorganized and revised to make it easier to follow.

Reserves for Classified Loans, Sections 723.14 and 723.15

The Board proposes to delete and reserve §§ 723.14 and 723.15, which address classification of loans for losses and reserving requirements. The Board recently adopted the Interpretive Ruling and Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions (IRPS 02-3). 67 FR 37445, May 29, 2002. IRPS 02-3 supercedes the current regulatory provisions.

IRPS 02-3 provides federally insured credit unions guidance on the design and implementation of ALLL methodologies and supporting documentation practices consistent with existing GAAP. NCUA requires all credit unions to follow GAAP with regard to loan loss estimates to meet the requirements of full and fair disclosure. 12 CFR 702.402(d)(1). IRPS 02-3 recognizes that credit unions should adopt methodologies and documentation practices appropriate for their size and complexity. Federally insured credit unions should follow IRPS 02-3 to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses, regardless of loan type. These sections in the MBL rule about loan loss reserves are no longer applicable.

Standard Risk-Based Net Worth Component for MBLs

The Board proposes to expand the current standard risk-based net worth component for MBLs in Part 702. For purposes of PCA, one of the eight risk portfolios used to calculate an applicable risk-based net worth (RBNW) requirement consists of a credit union's balance of outstanding MBLs. 12 CFR 702.104(b). The standard RBNW component presently divides the portfolio of MBLs by a single threshold—12.25% of total assets. The amount of MBLs less than or equal to that threshold is risk-weighted at 6%; the amount in excess of the threshold is risk-weighted at 14%. 12 CFR 702.106(b). To recognize finer increments of risk, an alternative RBNW component is available that divides MBLs by fixed and variable-rate and then categorizes them by remaining maturity among a set of four, corresponding risk-weighting buckets. 12 CFR 702.107(b). See Appendix D in rule text below. The difference in interest rate risk between variable-rate and fixed-rate MBLs is reflected in the two-percentage point risk-weighting discount that the alternative component generally gives the former compared with the latter.

Among other factors, credit unions' loss experience with MBLs since part 702 was first enacted warrants reconsidering the risk-weighting schedule of the standard RBNW component. First, contrary to expectations, the loss history of MBLs has remained remarkably consistent at 0.1% net charge-offs since 1998. Second, compared to the standard component for long-term real estate loans, 12 CFR 702.106(a), the risk-weighting for MBLs arguably climbs too prematurely and too dramatically. According to December 2001 Call Report data, more than half of all MBLs are real estate loans. In view of this fact, the disparity in risk of loss is insufficient to justify triggering the 14% risk weighting at 12.25% of total assets in the case of MBLs, but at 25% of assets in the case of long-term real estate loans. Commercial real estate is typically more volatile in price than residential real estate. In addition, if the member backs the loan with his or her primary residence, the loan is not an MBL. Third, it is widely recognized that default risk and interest rate risk generally increase as maturity increases, all other factors being constant. But field staff experience indicates that credit union MBLs generally are relatively short-term, maturing in 5 years or less, thereby limiting exposure to these risks,

as demonstrated by MBLs' low loss history in recent years. While both real estate loans and MBLs trigger a 14% risk weighting at 25% of assets under this proposal, the risks being addressed are somewhat different. The purpose of this risk weighting for real estate loans is primarily to target interest rate risk, whereas the target for MBLs is credit risk. Finally, recent research indicates that credit union MBLs carry less risk, on average, than do analogous commercial bank loans, which are risk-weighted at a uniform 8% regardless of percentage of total assets. 12 U.S.C. 325, Pt. 3, App A. See David M. Smith & Stephen A. Woodbury, *Differences in Bank and Credit Union Capital Needs* (File Research Institute 2001). Therefore, risk-weighting a middle range of the balance of MBLs at less than 14% would not present a material risk to the NCUSIF. On balance, these factors justify moderating the upward slope of the risk-weighting schedule for MBLs.

Accordingly, the Board proposes to expand the standard component to three tiers divided by a 15% and a 25% threshold, respectively. The bottom tier, risk-weighted at 6%, would consist of the amount of MBLs less than or equal to 15% of total assets. The middle tier, risk-weighted at 8%, would consist of the amount of MBLs greater than 15%, but less than or equal to 25%, of total assets. The top tier, risk-weighted at 14%, would consist of the amount of MBLs in excess of 25% of total assets. This is set out in line (b) in Table 3 and Appendix A in rule text below.

CUSO Business Loan Origination, Section 712.5

The Board proposes to add business loan origination to the CUSO regulation's list of permissible activities. 12 CFR 712.5. The Board believes that by authorizing CUSOs to engage in business loan origination, CUSOs will better serve credit union members by offering loans to members that their credit unions may be unable to grant. CUSOs are a good vehicle for these loans because the MBL rule and safe and sound underwriting practices require specialized lending experience.

The MBL rule requires credit unions to use the services of an individual with at least two years direct experience with the type of loans the credit union offers. 12 CFR 723.5. The rule permits a credit union to use the services of a CUSO with the appropriate lending experience to meet this requirement. *Id.* As the Board noted in 1998, a credit union "using the CUSO for back office business loan functions can use the CUSO's staff to fulfill its obligations to