A MESSAGE FROM COMMISSIONER ENTRINGER

First, let me wish you all a Happy and Prosperous New Year! 2016 was certainly an interesting year especially for me; some of you were aware of my plans to retire at yearend 2016. Obviously, I did not retire! After visiting with a number of people and of course some personal reflection, I decided to seek reappointment by Governor Doug Burgum. On December 12th the Governor announced his cabinet and I was pleased to be reappointed! I would like to thank all of you who supported my decision to seek reappointment; your confidence in me is certainly humbling.

Now for the New Year; the legislature is in full swing. On the second day of the session, the only bill introduced by the department was scheduled for a hearing. As luck would have it, our appropriation bill was scheduled for a hearing on day 3. I would like to thank Jeff Olson for testifying in support of the department's appropriation request; at this time it is much too early to tell what action the legislature will take regarding our appropriation request.

As you all know, Initiated Statutory Measure No. 5 related to medical marijuana passed rather handily and I am sure many of you are wondering what to do should a medical marijuana business approach your institution to open an account. Our staff has been diligently working to find answers to the questions we anticipate receiving. We are looking to plan a Day with the Commissioner at which we hope to be able to provide some useful guidance to you and your staff.

You may recall last year the department hosted an Executive Leadership of Cybersecurity Seminar. The speaker from the US Secret Service made a comment that bankers are considered experts in the area of cybersecurity. Upon hearing this comment, one financial institution attendee started working to provide a cybersecurity seminar for their institution's business customers. In September, this institution hosted a workshop entitled "Cybersecurity for Business Made Simple." The reason I mention this workshop is to seek your input. An individual from the National Cybersecurity Alliance who helped put together the above referenced workshop has reached out to our department to see if we would be interested in hosting a similar workshop which would essentially be a "train-the-trainer" so your staff would be able to sponsor such an event for your business customers. My thought is this would be part of a Day with the Commissioner, such as an afternoon workshop for your staff members to be trained to host such an event. If you think this is something you would be interested in please contact either myself (REntring@nd.gov) or Chief Examiner Corey Krebs (CKrebs@nd.gov).

Once again Happy New Year and I look forward to meeting with you in the coming months at a Day with the Commissioner. If you have other topic suggestions for the Day with the Commissioner please feel free to let Corey or myself know .

Commercial and Member Business Loan Rule

NCUA's commercial and member business loan regulation becomes effective January 1, 2017. Substantial changes were made to this rule as it is less rigid in a number of areas including the elimination of firm loan to value limits. However, the rule puts much more onus on the Board of Directors and Management to demonstrate that risks are measured and mitigated. We strongly encourage you to review the following documents to ensure your policy and procedures are consistent with the rule:

- NCUA Rule: https://www.federalregister.gov/documents/2016/03/14/2016-03955/member-business-loans-commercial-lending
- NCUA Examiners Guide: https://publishedguides.ncua.gov/examiner/Pages/default.htm#ExaminersGuide/Home.htm%3FTocPath%3D_____1

The Department has received numerous questions on the associated borrower rule. The above guidance does give multiple examples to help explain the rule. This rule is also very similar to the OCC's rule. If the above guidance does not explain the specific circumstances of your borrowers, you could also look to established guidance and interpretation from the OCC. While they are not your regulator, NCUA will likely interpret their rule in a similar manner. While not all inclusive, the links below provide some useful OCC guidance:

- https://www.occ.gov/static/interpretations-and-precedents/jul02/int938.pdf
- https://www.occ.gov/static/interpretations-and-precedents/feb03/int951.pdf

As noted, changes will need to be made to your policies to comply with this new rule. While there is a need to review all sections of your policies and procedures to ensure they comply with the rule, below are some key changes in the rule to keep in mind:

- Credit Unions meeting certain criteria are not required to follow NCUA Rules and Regulations 723.3 and 723.4
- The definition of an associated borrower changed materially (RR 723.2)
- The criteria for being a qualified lender has changed with the elimination of the 2-year lending experience requirement (RR 723.3)
- Firm loan to value limits have been eliminated; however, there is a requirement that all commercial loans are appropriately collateralized. NCUA's Examiner Guide provides industry loan-to-value benchmarks.
- Unsecured commercial lending limits have been eliminated; however, regulation indicates such lending should be limited, tracked and reported to the board of directors, and portfolio limits should be set in policy.
- Unconditional personal guarantees are no longer required; however, management must determine and document in the loan file mitigating factors that offset the risk of not obtaining the guarantee. (RR 723.5)
- Valuation of collateral for Construction and Developmental (C&D) loans must be based on the lesser of the cost or market value. (RR 723.6)
- The borrower must provide a line item budget for C&D loans that is reviewed and approved by a qualified credit union individual. (RR 723.6)
- There are no firm minimum equity requirements for C&D loans, but reasonable equity levels consistent with industry equity benchmarks is warranted
- Existing waivers for commercial lending will be moot with the exception of waivers granted for borrower relationship limits. The credit union will not be able to grant additional loans to these borrowers until the loan amounts are below regulatory limits, or can participate part of the credit with another lender.
- The aggregate limit for net business loan balances is the lesser of 1.75 times net worth or 1.75 times the minimum net worth required for a credit union to be well capitalized (the 12.25% of assets limit no longer applies).
- The policy will need to be updated, at a minimum, to address the following:
    - Lending authority for approving credit decisions

Commercial and Member Business Loan Rule Cont.

- Underwriting standards will need to be based on the complexity of the borrower:
  - Financial statement quality based on complexity of the borrower.
  - Thorough due diligence of the principals sufficient to determine the global condition and the debt service ability of the borrower.
  - Establishing loan-to-value limits based on the collateral characteristics and risk associated the with borrower relationships
  - Additional requirements to reasonably support borrower prepared projections including comparisons to historical and industry performance.
  - Appropriate risk management processes which include:
    - Use of Loan Covenants
    - Periodic Loan Review
    - Credit Risk Rating System, including the use of the classification categories of watch / special mention, substandard, doubtful, and loss (state requirement)
    - Process to identify, report, and monitor loans approved as exceptions to policy

Over the next year, examiners will be reviewing your policies and procedures to ensure they comply with this new rule and guidance. We recognize this is a change, and fully expect that we will have findings related to this new rule during the first examination following the effective date of the rule. As long as a good faith effort is being made to comply with the new rule, and the related findings are not adversely impacting credit quality, we expect that the findings will have minimal impact upon management or overall CAMEL composite rating.

It is also worth noting that the Department has a **draft** North Dakota specific Commercial and Member business loan rule. These **draft** rules will closely mirror the NCUA rules, so your efforts to comply with the NCUA rules will mostly translate into compliance with proposed state rules should they be adopted. Any differences between the NCUA rule and the state rule will be communicated to you once they are effective.

Finally, we should note that the existing North Dakota rule is no longer effective due to federal preemption. As you review and revise your policies, please disregard any conflicts established by the old state rule as it is not longer applicable.

Facts and Figures:

As of 12-2-2016:

- Average Adversely Classified Loans to Equity Ratio: 28.66%
- Average Adversely Classified Loans to Loans Ratio: 5.20%
- Average Adversely Classified Loans to Assets Ratio: 3.76%
- Third Quarter Average Allowance for Loan and Lease Loss to Loans Ratio: 1.42%
- Third Quarter Average Delinquency Ratio: 0.97%

Averages are of the 21 North Dakota state-chartered credit unions.