Supervising Community Development Credit Unions—

Balancing Their Mission and NCUA's Regulatory Responsibilities

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Examiner Guidance White Paper

What are Community Development Credit Unions?

Community Development Credit Unions (CDCUs) define themselves as credit unions dedicated to serving and revitalizing low-income communities. The majority of CDCUs serve predominately people of modest means. They are committed not only to serving their members, but also to serving the broader community as well. CDCUs may be federal or state chartered and can have a community, associational, occupational, or multiple common bond field of membership.

NCUA does not designate credit unions as CDCUs. NCUA designates credit unions serving predominately low-income members as low-income credit unions. The term "low-income members" as defined in §701.34 of NCUA's Rules and Regulations are members

- Whose annual household income falls at or below 80 percent of the median household income for the nation as established by the Census Bureau (the current threshold is $33,595); or
- Who make less than 80 percent of the average for all wage earners as established by the Bureau of Labor Statistics (the current threshold is $21,389).

Low-income designated credit unions may accept non-member deposits, participate in the Community Development Revolving Loan Program, receive technical assistance grants, and offer secondary capital accounts. NCUA insures shares at 982 low-income designated credit unions nationwide with $16.5 billion in aggregate assets.

Characteristics of a Well-Managed CDCU

CDCU officials and management face unique challenges in serving members who typically have low share account balances, limited financial reserves, and often need labor-intensive services such as money orders, financial counseling, and check cashing. Characteristics of a well-managed CDCU will include most of the following:

- Maintains good internal controls;
- Follows its comprehensive business plan and recognizes when changes are needed;
- Retains dedicated staff;
- Keeps up-to-date, accurate records;
- Includes financial counseling as part of the lending process;
- Communicates regularly with its members; and
- Identifies compensating factors supporting the loan decision, especially when income verification is difficult or the credit history is poor, non-existent, or limited.

Characteristics of CDCU Members

CDCU members are typically people of modest means. Additionally, some of these members have one or more of the following circumstances and characteristics that CDCUs are uniquely accustomed and experienced in assisting:

- Unsteady employment (often temporary jobs with long hours),
- Part-time employment with multiple jobs or side businesses,
- Unstable residency (often rent, live in public or subsidized housing),
- No health insurance,
- Limited education level,
- Struggle to find affordable child care,
- Mental and/or physical disabilities (receive supplemental security income or social security disability benefits), and
- English is not their first language.

Examiners should consider these member characteristics when they evaluate the CDCU's loan portfolio, as well as the products and services the CDCU offers.

Examining Non-Traditional Underwriting

Due to the field of membership's characteristics, CDCUs practice non-traditional underwriting. Although the creditworthiness standards may vary from traditional underwriting, examiners should still see a well-documented creditworthiness analysis in each loan file.

Documenting Income Verification
If the member is not able to provide pay stubs, there may be other means of income verification. For example, income tax records for self-employed members. If the member has a history of interrupted employment, the credit union may have noted a pattern of employment or compensating factors that lower the institution's credit risk. For example, the member

- Paid in full other credit union loans,
- Has his/her income direct deposited,
- Pledged shares as collateral,
- Is a long-term member of the credit union,
- Offered an automobile as collateral,
- Presented a larger down payment on the loan,
- Demonstrated a history of making timely rent and utility payments, or
- Has a qualified co-signer on the loan who sufficiently offsets the credit risk.

The member may not have traditional employment income, but still qualifies for the loan with his/her income from social security, social security disability, and other forms of assistance.

These can be valid sources of income for the credit union to consider when making the credit decision about a member's ability to pay.

Documenting Review of Credit History
If the member's credit report demonstrates a poor credit history, examiners should see documentation in the loan file explaining the cause of the poor credit. Loan officers should clarify when the poor credit history is due to a temporary circumstance, such as job layoff, divorce, illness, etc. versus living beyond one's means. If the credit problems are isolated to a specific period of time, such as during a divorce, then the credit union should note this as a compensating factor in the loan file.

The loan officer should also note when collection items, judgments, charge-offs, or delinquent accounts on the member's credit report have been paid but not yet recorded. The member should provide documentation to demonstrate the negative items have been paid or the member has established a repayment plan with the creditor.

A Strong Collection Program is a Must

To mitigate the higher than average credit risk associated with non-traditional underwriting, a strong collection program is a must. A strong collection program for a CDCU should include the following:

- Quick reaction, within a few days of a missed first payment.
- Documented, repeated contacts with delinquent borrowers.
- Firm, but fair, collection officer.
- Accurate, timely delinquency reports.
- If the borrower does not follow through with a promise to pay, follow up occurs within 48 hours. The collection officer remains in contact with the borrower, understands the borrower's situation, and expects payment at some point.
- Procedures to work with longer-term delinquent borrowers who make regular loan payments and eventually refinance the loan.

Keep in mind, workout loans/troubled debt restructurings cannot be classified as current loans. Under Generally Accepted Accounting Principles (Statement of Accounting Standards No. 15 and No. 144), these loans are classified as non-performing because payments do not meet the original terms of the loan. After the borrower demonstrates an ability to repay under the restructured terms, then the credit union can refinance the loan with new loan terms. The financial institution regulatory agencies jointly define the demonstrated ability to repay as making timely, consistent full payments under the restructured terms for 6 consecutive months.

Understand the Impact of Non-Member Deposits

Low-income designated credit unions can accept non-member deposits. Banks, philanthropic foundations, and religious organizations are often interested in making non-member deposits to assist with the mission of serving the underserved. Non-member deposits can provide a crucial funding need for low-income credit unions with small balance natural person share accounts.

Non-member deposits have interest rates at or below market rate. Low-income designated credit unions can use them to

- Fund loans,
- Arbitrage and build reserves,
- Cover the cost of new services, or
- Absorb losses associated with higher risk lending programs, if specified in the non-member deposit agreement.

In some cases, non-member deposits help low-income credit unions establish relationships with organizations that can help them obtain grant funding. Although, at times, non-member deposits can be a relatively expensive source of funds that negatively impacts earnings, returning the non-member deposit prior to term can sometimes injure this relationship. Before recommending a credit union return the non-member deposit, examiners need to look at the entire picture.

- What is management's plan for using the funds made available with the non-member deposit?
- Does the credit union receive other benefits or may it receive future benefits as a result of its relationship with the organization?
- Is the financial impact of the non-member deposit causing the credit union's net worth ratio to slip below 6 percent?

If management does not have a plan to mitigate the interest rate and liquidity risk associated with non-member deposits, then examiners should work with management to establish a sound plan. For example, match the loan or investment maturity with the non-member deposit maturity. Often, non-member deposits have a short-term maturity, but remain in the credit union for five or more years. When credit union management can demonstrate the long-term nature of the deposit, examiners should consider this factor along with the credit union's plan to mitigate interest rate risk.

According to §701.32 of NCUA's Rules and Regulations, unless a greater amount has been approved by the Regional Director, the maximum amount of public unit and non-member shares cannot exceed 20 percent of the credit union's total shares or $1.5 million, whichever is greater (excluding matching funds required under the Community Development Revolving Loan Program). A federal credit union can request an exemption from this limit by submitting a written request to the Regional Director. The items the credit union needs to include in its written request and timeline for a response are outlined in §701.32(b)(3) of NCUA's Rules and Regulations.

The Value of NCUA's Community Development Revolving Loan Program

Since 1986, NCUA has administered the Community Development Revolving Loan Fund (CDRLF), funded by Congress. NCUA's Community Development Revolving Loan Program is described in §705 of the Rules and Regulations. The program's purpose is to

- Provide basic financial and related services to residents in low-income communities, and
- Stimulate economic activities in low-income communities which will result in increased income, ownership and employment opportunities for low-income residents, and other community growth efforts.

Only low-income designated credit unions are eligible to participate in the Community Development Revolving Loan Program. These credit unions can receive up to $300,000 in aggregate in loans from the CDRLF. Within one year, the recipient credit unions are required to match the loan amount with share deposits. The vast majority of low-income credit unions granted a CDRLF loan meet the matching requirement within one year.

CDRLF Loan Matching Example

$100,000 CDRLF Loan
Match With
$50,000 in member deposits
OR
$100,000 in non-member deposits

As of November 30, 2004, the CDRLF had 65 loans outstanding totaling $8.3 million. Currently, the CDRLF has $5 million in additional funds available for loans at 1 percent interest with a maximum term of 5 years. Each year, Congress determines whether to appropriate funds above the $13.3 million already appropriated to the Community Development Revolving Loan Fund.

On a regular basis, examiners should talk with low-income designated credit union managers about the availability of funds through NCUA's Community Development Revolving Loan Program. The Credit Union Development section of NCUA's Internet site contains monthly reports on the funds available, as well as an updated listing of outstanding CDRLF loans. Each year, NCUA issues press releases on the Community Development Revolving Loan Program and NCUA Board members highlight these funds during speeches. Nevertheless, NCUA examiners offer the most effective means of promoting the program.

In 2004, Congress earmarked $1 million to be used specifically for technical assistance grants as part of NCUA's Community Development Revolving Loan Program. These cash grants are intended to help low-income credit union managers acquire specialized skills, equipment or other forms of assistance to improve member services and enhance their credit union's financial strength. In addition to Congressional appropriations, interest earned on the CDRLF loans is used to fund technical assistance grants. The average technical assistance grant is under $5,000. In 2004, NCUA approved 375 technical assistance grants totaling $1.2 million.

Examiners should encourage low-income designated credit unions to consider applying for a CDRLF loan or technical assistance grant. Applications for both programs are available on NCUA's Internet site (http://www.ncua.gov/CreditUnionDevelopment/Programs/CDRLP.pdf and http://www.ncua.gov/CreditUnionDevelopment/Programs/TA-Application.pdf). Credit unions should submit completed applications to the Office of Small Credit Union Initiatives.

Look Beyond the Numbers

A CDRLF loan plus matching deposits on a small credit union's balance sheet can skew the financial ratios. Every ratio using assets, average assets, or shares as the denominator is lower when this type of funding is added to the balance sheet. In fact, with any CDCU, examiners need to look beyond the AIRES financial ratios to accurately analyze the CDCU's financial condition. The following table includes examples of items examiners need to consider when reviewing a CDCU's financial ratios:

AIRES Financial Ratio Trend	**Items to Consider**
↑ in Delinquent Loans/Total Loans	➢ What has been the CU's charge-off history? ➢ Analyze individual loan histories—does the borrower miss only 3 payments in the course of a year? ➢ How often does the CU communicate with its members? Is the communication well documented? ➢ Have local economic conditions caused a rise in delinquency? (Economy.com, local news articles)
↓ in Return on Average Assets (ROAA)	➢ Any increase in CDRLF loan? ➢ Attracted large non-member deposits? ➢ Loan growth outpaced growth in income? ➢ Increase in expenses from new services offered? ➢ Is the examiner comparing ROAA with other low-income designated credit unions?
↑ Operating Expenses to Gross Income	➢ Is there a program funded with grant income that causes the expenses to appear high? ➢ If expenses associated with a grant-funded program are backed out, would the ratio appear more in line with the industry?

AIRES peer ratio data is not specific to low-income credit unions. Therefore, examiners should not focus on the AIRES peer data as a benchmark. A more appropriate industry benchmark when examining CDCUs is to run reports using the Consolidated Balance Sheet program. This program allows examiners to query call report data by charter type, region, and peer group. It also gives examiners the option to select only low-income designated credit unions. The financial ratio page of the produced report may provide more meaningful industry averages.

For newly-chartered CDCUs subject to prompt corrective action, examiners should refer to §702 of NCUA's Rules and Regulations and the CDCU's approved initial or revised business plan when analyzing profitability.

Preserving CDCUs

Mergers
After considering all viable options, sometimes struggling CDCUs merge into stronger credit unions. To ensure the merged CDCU's members continue to receive services and efforts to revitalize their community, NCUA and CDCU officials need to explore the possibility of merging with another CDCU. To assist with this effort, each regional office will maintain a list of CDCUs interested in bidding on CDCU mergers. During on-site supervision contacts, examiners should inquire whether the CDCU is interested in this type of bidding and register the CDCU with their regional office. NCUA is mandated to merge the financially unsound CDCU at the lowest cost to the National Credit Union Share Insurance Fund. However, NCUA will consider financially healthy CDCU bids in conjunction with those from other types of credit unions.

Supervising Newly Chartered CDCUs
Regions should assign Small Credit Union Subject Matter Examiners responsibility for supervising newly chartered CDCUs. These experienced examiners have a wealth of knowledge on small credit unions and can provide newly chartered CDCUs with the guidance they need to grow. Small Credit Union Subject Matter Examiners are equipped to bring "best practice" suggestions from other low-income credit unions to the management team of the newly chartered CDCU. These examiners can also provide information and answer questions regarding the variety of potential funding sources available to low-income credit unions, including the Community Development Financial Institutions Fund managed by the U.S. Department of Treasury.

Conclusion

One of the primary reasons for the creation of credit unions is to make credit available to people of modest means for productive purposes. CDCUs are helping NCUA fulfill this mission. However, NCUA also is obligated to regulate federally-insured credit unions and protect the National Credit Union Share Insurance Fund. As described in this white paper, there are some unique challenges to examining low-income credit unions, but these credit unions face the same risks all credit unions face. Both NCUA and CDCUs agree on one common goal--to ensure CDCUs have the financial strength to continue serving people of modest means for years to come.