Chapter 23

LOW-INCOME CREDIT UNIONS

TABLE OF CONTENTS

Chapter 23

LOW-INCOME CREDIT UNIONS

Examination Objectives

- Determine that any nonmember deposits comply with limitation, use, and recording requirements
- Determine that any waivers received proper approval
- Determine that Community Development Revolving Loan Fund for Credit Unions' funds meet the requirements of that program
- Evaluate management's ability to identify, measure, monitor, and control (i.e., manage) risk
- Determine the credit union's current and potential risk
- Evaluate the adequacy and accuracy of management's risk reporting mechanisms
- Assess the credit union's ability to withstand any negative effects of risks taken in relation to its financial condition and net worth position
- Work with management to reach agreeable solutions to reduce levels of unwarranted risk

Risk Categories

Low-income credit unions, like all credit unions, are subject to the seven categories of risk, discussed in the Risk-Focused Program chapter. These risks include Credit, Interest Rate, Liquidity, Transaction, Compliance, Strategic, and Reputation. As with other credit unions, low-income credit unions must mitigate their risks by implementing measures such as management's due diligence, sound internal controls, the audit process, and well-trained management and staff. These should coincide with the size and complexity of the credit union.

Overview

Low-income credit unions have the same mission as other credit unions, with an additional requirement: a majority of their members must meet or fall below the income standard set by the *NCUA Rules and Regulations*. For many low-income members, their credit union serves as the only access to financial services.

The task of operating a low-income credit union challenges its officials and management for a number of reasons, including:

- The membership tends to include more renters, who may move more often than homeowners;

- Members often need high cost, labor-intensive services such as money orders, financial counseling, and check cashing;

- Members tend to have limited financial reserves and have fewer resources to overcome the effect of setbacks such as illness, an expensive car repair, or a job cutback; and

- Member share account balances tend to be low for these credit unions. To provide needed services, low-income credit unions may have to augment savings with nonmember deposits. Low-income credit unions often have cooperative relationships with a variety of social services and other organizations.

The *FCU Act* uses the term "low-income" credit union to refer to credit unions having "predominantly" low-income members. §701.34(a)(2) of the *NCUA Rules and Regulations* defines low-income members to mean those members (1) who make less than 80 percent of the average for all wage earners as established by the Bureau of Labor Statistics; (2) whose annual household income falls at or below 80 percent of the national median household income as established by the Census Bureau; or (3) who otherwise qualify as low-income by order of the NCUA Board. The NCUA Office of Credit Union Development (OCUD) annually publishes the qualifying thresholds for the national average wage and median household income. In applying standards, the NCUA regional director shall make allowances for geographical areas with higher costs of living.

The term "low-income" also includes student credit unions. Student credit unions may accept nonmember deposits, but cannot participate in the Community Development Revolving Loan Program discussed later in the chapter.

Credit unions that NCUA designates as "low-income" can (1) receive nonmember deposits from any source in addition to deposits from public units and other credit unions, (2) offer secondary capital accounts and include this account in the credit union's net worth, (3) qualify for an exception from the aggregate member business loan limit, and (4) participate in the Community Development Revolving Loan Fund for Credit Unions.

Qualifying for the Low-Income Designation

Examiners should understand that a credit union may meet the income standard that makes it eligible for the low-income designation, but has not yet applied for or received the designation. Lower-than-average account balances, loan balances, and member incomes (as documented in the loan files) may indicate an institution qualifies as a low-income credit union. §701.34 of the *NCUA Rules and Regulations* outlines the low-income designation requirements. Examiners should encourage any credit union that may qualify to request the low-income designation.

Examiners should also discuss the opportunity to expand credit union services to underserved communities in certain credit unions identified for such possible expansion by the region, the supervisory examiner, or the examiners themselves. When meeting with credit union officials, either at the joint conference or exit interview, examiners must clearly state that the discussion regarding increasing credit union service to underserved communities is not part of the examination. Examiners should briefly document whether they held such a discussion and the credit union's response in the Confidential Section of the examination report.

Credit unions requesting the low-income designation should support their requests with sufficient documentation to demonstrate that they serve predominately low-income members by providing the following:

- Individual documentation of the members' individual incomes;
- Individual documentation of the members' household incomes;
- Membership surveys; and/or
- Income levels of members identified by zip codes or census block data, or demographic information customarily used and accepted to document low-income eligibility for federal and state programs.

Any credit union, not just one with a community charter, can use these methods for qualifying. For example, a church-based associational credit union could meet the standard if most of its members live in a cluster of zip codes or census blocks, which if averaged together, meet the income standard.

Credit unions can obtain this income information from U.S. Census publications in public libraries and on the Internet at the Census Bureau's website (http://www.census.gov/). Examiners can obtain demographic information on behalf of the credit union from their NCUA regional offices. If the demographics fail to show that the credit union's operational area has a median household income within regulatory limits, the credit union can document the wages of its members.

State-chartered credit unions should first approach their state supervisory authority (SSA) to obtain the designation, which is subject to NCUA regional concurrence. If the state has no such designation, then the credit union should apply to NCUA. NCUA's procedures for state-chartered credit unions will mirror those for federal credit unions. In the event that state law does not provide for a low-income designation, the regional director would approve the designation after obtaining concurrence of the SSA. The possibility exists that state laws would prohibit certain activities, such as acceptance of nonmember accounts.

The examiner should notify the supervisory examiner of any low-income designation problems before discussing them with the officials. If examiners review problems associated with the low-income designation, they should disclose the results of that review in accordance with regional policy.

Field of Membership and Chartering

A prospective credit union may submit a separate low-income designation request with its charter application. The potential field of membership forms the base for a charter applicant's low-income designation. If the prospective credit union provides the appropriate documentation, NCUA may grant the low-income designation and charter simultaneously.

Nonmember Deposits

Low-income designated credit unions can accept nonmember accounts. They can use these nonmember accounts to (1) fund loans, (2) arbitrage and build reserves, or (3) cover expansion or services costs. Generally, these deposits have interest rates at or below market rates.

Nonmember accounts in a low-income designated credit union mean shares, share certificates, share drafts, or other types of nonmember deposit accounts approved by the NCUA Board. Unless the regional director has approved a greater amount, the maximum amount of all public unit and nonmember shares cannot, at any given time, exceed the greater of 20 percent of the credit union's total shares or $1.5 million. During each examination, the examiner should review compliance with the nonmember deposit limit. (Credit unions eligible for Part 742, the Regulatory Flexibility Program, may be exempt from some of the nonmember share limitations.)

The examiner may assist the credit union in understanding the need and proper use for nonmember deposits. The credit union should negotiate a mutually acceptable time span for the deposit, with adequate notice before withdrawal. It must guard against interest rate risk resulting from an interest rate agreement that could force it into a negative spread position if market rates change. Deposits that create a negative spread, whether brokered or otherwise, are unsuitable for any credit union, including low-income credit unions.

Booking Nonmember Deposits

Where permitted, low-income credit unions record accounts of nonmembers as "nonmember deposits," not as notes payable, and report them in the equity section of the balance sheet. Some states do not permit nonmember accounts. In these states, the credit union records the funds as notes payable. NCUSIF insurance does not cover notes payable.

Use of Nonmember Deposits

Credit unions may invest nonmember deposits using the safety, liquidity, and yield (SLY) principle, or they may loan out nonmember deposits. To mitigate interest rate and liquidity risks, management should have a plan that coordinates the maturity of the loan or investment with the maturity of the deposit.

Waiver of the 20 Percent or $1,500,000 Rule

A low-income credit union must apply to the regional director for a waiver of the 20 percent of total shares or $1.5 million threshold. Federally insured state-chartered credit unions must also obtain the concurrence of the appropriate state regulator. (Credit unions eligible for Part 742, the Regulatory Flexibility Program, may be exempt from some of the nonmember share limitations.)

The application for a waiver serves as a check to determine that the nonmember funds do not pose an undue risk to the NCUSIF. All requests for a waiver must include a plan outlining the need and proposed use of the deposits. §701.32 of the *NCUA Rules and Regulations* contains specific requirements governing the waiver process.

When determining the nonmember deposit ratio, §701.32 permits exclusion of (1) matching funds required under the Community Development Revolving Loan Program for Credit Unions, (2) Treasury Tax and Loan Depositaries accounts, and (3) Depositaries and Financial Agents of the Government. This chapter discusses funds specified in (1) above in more detail.

There is a presumption in favor of granting the credit union's request when the credit union has mitigated its risk through sound financial condition, good management, and a reasonable plan for the funds. The regional office will provide a written determination within 30 calendar days of receipt of the request. The credit union has the right of appeal in the case of denial.

Community Development Revolving Loan Fund

NCUA administers the Community Development Revolving Loan Fund (Fund) for Credit Unions. The Fund consists of two programs: (1) a loan/deposit program, and (2) a technical assistance program. Part 705 of the *NCUA Rules and Regulations* contains detailed information about the governance and operation of the Fund.

The purpose of the Fund supports the efforts of participating credit unions through loans to them for (1) providing basic financial and related services to residents in their communities, and (2) stimulating economic activities in the communities they service, which will result in increased income, ownership, and employment opportunities for low-income residents, and other community growth efforts. (As noted earlier, student low-income credit unions may not participate in the Fund.)

Credit unions can apply for Fund loans any time during the year. Loans repay in five years; however, NCUA will consider shorter repayment periods. Generally, credit unions repay the loans in semiannual installments, with no principal balance repayment due until the second semiannual installment. The last installment will require a double principal payment.

The aggregate loan limit to one credit union is $300,000. No credit union may have more than two separate loans at any one time. There is no minimum loan amount. While the OCUD can tailor the terms and conditions of the loans to an individual credit union's circumstances, all loans carry a fixed interest rate, which the NCUA Board sets annually. Credit unions may record a Fund loan or deposit as either a note payable or as a nonmember deposit, at NCUA's discretion.

The Fund's loan agreement requires the credit union to develop other sources of matching funds as described in §705.7(b). Credit unions can match loan funds "dollar-for-dollar" with nonmember deposits. However, they can match loan funds with <u>member</u> deposits as a "two-for-one" match. Within one year of receiving the Fund loan, the credit union must match the loans with member shares or nonmember deposits. Nonmember deposits accepted to meet the matching requirement are <u>not</u> subject to the 20 percent limitation on nonmember deposits under §701.32.

The examiner should understand that credit unions need not reduce the matching deposits as they pay down the loan. As a result, the <u>matching</u> funds may exceed the loan balance once principal repayments begin. A credit union may continue to exclude the full amount of matching funds consisting of nonmember deposits from the nonmember deposit rule calculation as long as the credit union has any loan balance on its books.

In addition, the examiner should understand that the presence of the Fund's loan <u>plus matching deposits</u> could significantly affect financial ratios of small asset size credit unions, lowering every ratio having assets, average assets, or shares as the denominator.

The income earned by the Fund's loan program supports the Fund's technical assistance program. Examiners should know about the Fund and encourage its use, when appropriate.

Credit unions can request Fund loan applications from either OCUD or the applicable regional office. The Director of the OCUD serves as the Community Development Revolving Loan Fund Chairman, and assumes administrative responsibilities. The Fund's chairman may restrict the use of funds, approve less than the full amount requested, or deny the loan. The chairman may require a credit union to invest the funds in a specified way and take the positive spread as income. No special restrictions apply to the use of matching funds except the usual safety and soundness considerations, unless specifically noted in the loan agreement.

Technical Assistance Program

The income earned on the Fund's assets and possibly congressional appropriations provide monies for technical assistance grants to credit unions. NCUA makes these grants to aid participating credit unions in providing services to their members and in the efficient operation of the credit unions. Only a credit union with a NCUA low-income designation may participate in the Technical Assistance Program (i.e., low-income student credit unions can not participate in this program.)

Credit unions submit technical assistance applications to OCUD. The agency has a goal of using technical assistance grants for credit unions where this funding could make the greatest impact on improving their operations. Since NCUA has limited technical assistance funds available, smaller grants enable a larger number of credit unions to participate. No specific limitation on the amount of the grant request exists; however, the average technical assistance grant approved is under $5,000.

Credit unions may apply for technical assistance grants anytime during the year. <u>They must obtain approval of the technical assistance grant before committing to, or contracting for, the service or purchase</u>. Once OCUD approves the request for technical assistance, the credit union must submit an original invoice showing proof of service or purchase for payment.

NCUA Rules and Regulations §705.10 describes the technical assistance program and provides guidance for completing the technical assistance application.

Mentoring

When appropriate, examiners should encourage credit union management to network and seek assistance from trade groups, associations, credit unions, and banks. Mentoring can help small credit unions mitigate several risk factors and provide them the assistance they need with little or no direct dollar expense.

Mentoring can take many forms including:

- Nonmember accounts. Credit unions can use nonmember accounts to fund lending, build shares, arbitrage and build reserves, or cover costs of expanding services.

- Training. Inexperience in credit union operations is the leading reason many small credit unions fail. Due to limited financial resources, volunteers in small credit unions often do not have an opportunity for training.

- Marketing advice. Small credit unions that have limited access to network with other credit unions may have difficulty developing plans for increasing membership. A mentor's marketing tips could help extend the credit union's outreach programs.

- Supervisory committee training. The annual audit is a major expense for small credit unions. Small credit unions usually have basic share and loan operations. A mentor could actually perform the supervisory committee audit or assist the supervisory committee in performing the audit.

- Credit committee training. Low-income credit unions often serve members for whom proper credit evaluation is essential. Understanding the need for proper documentation on collateral or the ability to identify appropriate collateral could enable the credit union to reduce delinquency and write-offs. A minimal commitment by a larger credit union to allow their loan specialist to train employees of the low-income credit union could help mitigate credit risk and improve operations.

- Fee-based back-office services. Many small credit unions do not have the personnel available or the expertise to fill all operational functions. A mentor could provide these services on a fee-based or no-cost arrangement.

- Loan participation. Properly managed, loan participation could benefit both participants. Larger credit unions can help low-income credit unions provide liquidity for loans needed by the low-income credit union's membership. Low-income credit unions can benefit from the lending expertise and policies of the larger credit union. Examiners should review the loan participation agreement.

Secondary Capital

A federal credit union with a low-income designation may offer secondary capital accounts to non-natural person members and non-natural person nonmembers. Uninsured secondary capital accounts are part of the low-income designated credit union's net worth. Examiners should refer to §701.34(b) for information regarding secondary capital accounts conditions and requirements.

The NCUA Board established key safety and soundness element, to ensure (1) the availability of secondary capital accounts to absorb losses, and (2) the investor understands the risks involved. In §701.34, the NCUA Board permits credit unions to offer secondary capital accounts providing the credit union does the following:

- Offers the accounts to organizational investors only, not to natural persons;

- Subordinates the accounts to all other claims on the assets of the credit union, including claims of creditors, shareholders, and the NCUSIF;

- Does not offer the accounts as share accounts and discloses they are not insured by the NCUSIF, or any other government entity;

- Makes the funds available to cover losses after depletion of reserves and undivided earnings, but before liquidation;

- Establishes the accounts with a minimum maturity of five years, which may not be redeemable before maturity;

- Requires that the investors sign standard account agreements and disclosures (per the Appendix to §701.34) and retain them for at least the life of the loan;

- Recognizes the capital value of an account having a remaining maturity of less than five years on a declining scale for each subsequent year (i.e., accounts with maturities between four and five years will have capital value of 80 percent of the balance, those with three to four years remaining – 60 percent, two to three years remaining – 40 percent, one to two years remaining – 20 percent, and accounts with maturities of less than one year - zero capital value). All of the funds, however, will remain at risk; and

- Adopts and submits to the regional director a written plan that addresses the use of the funds and provision for liquidity upon maturity. The credit union need not wait for approval.

Finally, under prompt corrective action (PCA), NCUA can restrict payment of principal or interest on uninsured secondary capital of a low-income designated credit union classified as critically undercapitalized.

Examiner's Respon-sibility

To determine the existence of compliance risk, examiners should review outstanding Fund loan agreements for compliance during each examination. If the credit union has a compliance problem, the examiner should seek direction from the supervisory examiner about the approach to use in discussing it with the officials. As a minimum, the examiner should disclose the results of the Fund's loan review in the Confidential Section of the examination report.

Record Keeping

The examiner should ensure that the credit union understands transaction risk and the importance of keeping accurate and complete records. If necessary, the examiner should help the credit union obtain the assistance and training it needs to gain competence in record keeping.

Delinquency and Charge-Offs

The credit union needs a functioning, written, effective loan collection program. Improving the loan collection program would benefit many low-income credit unions. Examiners should encourage low-income credit unions to react quickly (within a few days after a missed first payment) to each delinquency. Many low-income credit union members have a difficult time recovering if they get behind in their payments. The loan collection program may benefit from expanding the role of credit counselor to include community resources referral.

When classifying loans, managers often have personal knowledge of individual members who, despite high debt ratios or slow repayment records, are of good character and likely to repay. Examiners should consider management's judgment when discussing which loans the credit union should charge off.

Expense Ratios

As a result of some characteristics of low-income credit unions (discussed in the Overview section of this chapter), these credit unions sometimes have higher expense ratios than other credit unions. In addition, delinquency (e.g., collection costs, loss of income, provision for loan loss expense) and net charge-offs may have more periodic volatility.

Compared to other credit unions, low-income credit unions generally have slightly higher employee compensation and benefits expense ratios. Low-income credit unions tend to have a slightly larger full-time staff than do occupational groups that receive payroll deductions, and tend to pay slightly more per employee. Office operations and occupancy expense ratios are also higher on average.

Examiners should counsel management and the board on expense control. Although NCUA recognizes that low-income credit unions operate with higher expenses, this counseling can help management with the budget process, cost-benefit analysis, and maximize earnings potential.

Business Lending

Low-income credit unions historically have regarded lending to small businesses as a major part of their mission. The examiner should obtain a historical perspective on the credit union's previous success with this kind of lending before commenting to the credit union about its program.

For low-income credit unions that have not previously engaged in business lending, examiners should help ensure the credit union obtains needed expertise to succeed in this program, either through training or hiring. The examiner should remind the credit union that it must meet the requirements of the business lending regulations in §723 of the *NCUA Rules and Regulations*. In addition, the examiner may:

- Encourage the low-income credit union to obtain training through technical assistance;
- Suggest help from other credit unions; or
- Assist the manager in identifying the qualities and expertise needed in prospective employees.

Low-income designated credit unions may also participate in various mortgage and business loan funding sources sponsored by government or private programs. The examiner should review outstanding contracts governing the use of the funds and reporting requirements to determine if the credit union's activities with regard to such programs present significant risk. Examiners must ask sufficient questions to (1) understand the funding arrangement (some are complicated), (2) determine the legality of the arrangement, and (3) determine that the arrangement serves the credit union's best interest from a safety and soundness standpoint. If examiners have concerns about a funding arrangement, they should discuss those concerns with their supervisory examiners before discussing them with the officials.

Contributions Received

Sponsors or other parties occasionally provide the credit union a gift or donation such as cash or a fixed asset. Low-income credit unions are more likely than other credit unions to receive such assistance. Credit unions under $10 million may accept fixed asset gifts and record them as donated equity. Credit unions with assets of $10 million or more must follow GAAP and record unconditional gifts as income when received. All credit unions must record gifts of cash as income. The examiner must ensure that the credit union properly records such gifts on its books. Credit unions should use the gifts for the purpose for which they were donated.

Asset-Liability Management

While sufficient liquidity is the objective of asset-liability management (ALM), proper matching of sources and uses of funds has particular importance in low-income credit unions with their nonmember deposits, the Fund's loan, and matching deposits. To maintain an adequate match, credit unions should invest nonmember deposits and loan funds in instruments that have maturities compatible with the term of the loan or deposit.

Board and Management

Well-trained officials and paid staff remain as crucial to low-income credit unions as to any other credit union. A well-diversified board, which includes community leaders, brings a variety of talents to work for the credit union and encourages the sharing of collective knowledge among all officials. Every credit union management team should develop a plan addressing four basic elements of operation:

- Get Money In,
- Get Money Out,
- Get Money Back with Interest, and
- Make a Profit.

Often, in smaller credit unions, the lack of sufficient internal controls, including inadequate segregation of duties and insufficient backup support for the manager and key staff, can present a serious concern when knowledge about the credit union's operation is concentrated in one or a few staff members. Frequently, the officials and volunteers assume verification and backup responsibilities by taking on some of the more labor-intensive services (e.g., collection efforts and bank reconcilements.) The officials must address the need for management continuity and succession planning.

The officials can often increase the credit union's viability by seeking out ways to increase their participation in the credit union. This may include encouraging board members to participate in loans and savings, or it may mean increasing membership by penetrating potential fields of membership.

§715.4 and §715.8 of the *NCUA Rules and Regulations* and §115 of the *FCU Act* require the officials to obtain an annual audit and verification of the members' accounts at least once every two years. §715.5 requires an outside, independent CPA audit under certain conditions. If the credit union receives $300,000 or more in government funds (including the Fund's loan, other public monies or federal government appropriation funds), it must obtain an independent audit as required by the Single Audit Act Amendment of 1996, §7501(a)(14) and §7501(b)(3) of Title 31. The examiner must monitor the credit union's use of federal awards and assess the quality of their audits.

The examiner should recognize the importance of meeting directly with the officials. As in any credit union, the examiner should:

- Recognize the credit union's progress;
- Discuss with the officials areas in need of strengthening and ensure that the officials and necessary staff understand the concerns;
- Develop and prioritize action plans with the credit union's help; and
- Ensure that the credit union has resources to implement action plans. Technical assistance may aid the credit union in these efforts.

References

- *Federal Credit Union Act*
  - Part 115
- *NCUA Rules and Regulations*
  - §701.32
  - §701.34
  - §715.4
  - §715.5
  - §715.8
  - Part 705
  - Part 723
- NCUA *Chartering and Field of Membership Manual*
- *Accounting Manual for Federal Credit Unions*