NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

REVIEW OF NCUA'S
OVERSIGHT OF INDIRECT LENDING PROGRAMS

Report #OIG-06-07
September 27, 2006

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EXECUTIVE SUMMARY

The National Credit Union Administration (NCUA) has identified indirect lending as a high risk program and the number of credit unions involved in indirect lending has been increasing. Therefore, the NCUA Office of Inspector General (OIG) conducted a review to assess NCUA examiner compliance with agency guidance regarding reviews of credit union indirect lending programs.

We reviewed a judgmental sample of 36 credit unions. We concluded that with regard to these sampled credit unions, examiners assessed the risk of indirect lending programs for all 36. We based our conclusion upon reviews of examiners' workpapers and analyses of call report data and key financial ratios and trends.

A subset of indirect lending programs is indirect auto lending programs which also outsource to third party servicers. The agency recently addressed these types of indirect lending programs in a final rule adopted on June 22, 2006. The rule, which amends NCUA regulations at 12 CFR Parts 701 and 741, imposes concentration limits on indirect vehicle loans serviced by third-parties.

The OIG also assessed whether credit unions were accurately reporting the existence of indirect lending programs to NCUA. We found a need to improve internal controls over 5300 call report data, specifically as it relates to indirect lending programs. The OIG has made two recommendations that should result in improved internal controls over 5300 call report data.

BACKGROUND

Indirect lending is an arrangement where a credit union contracts with a merchant to originate loans at the point of sale (e.g. an auto dealer). Indirect lending is considered a higher risk lending activity that exposes credit unions to a range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. According to NCUA's June 30, 2005 Risk Trends Report, "there is a potential risk for individual institutions involved in indirect loan programs if the program is not properly managed, especially with third party sub-prime auto loans."

According to NCUA call report data, 18.7% of federally insured credit unions had indirect lending programs on June 20, 2005. This was an increase from June 30, 2004, where 15.5% of credit unions had indirect lending programs. Moreover, as of June 30, 2005, there were 4,045,704 indirect loans outstanding at credit unions, amounting to $58 billion. Finally, as of June 30, 2005, indirect lending represented 13.3% of the total amount of credit union loan outstanding balances.

The following chart compares credit unions with indirect lending activity to the universe of credit unions

5300 Date	June 2004	Sept. 2004	Dec. 2004	March 2005	June 2005
# Total CUs	9,210	9,113	9,014	8,945	8,871
# CUs with Indirect Loans	1,430	1,425	1,524	1,554	1,660
% CUs with Indirect Loans	15.5%	15.6%	16.9%	17.4%	18.7%
# Total Loans	40,835,743	41,222,649	41,424,896	41,410,875	41,672,215
# Indirect Loans	3,173,557	3,512,036	3,669,218	3,727,025	4,045,704
% Number Indirect/Total.	7.8%	8.5%	8.9%	9.0%	9.7%
$ Amount Total Loans	$394,881M	$406,305M	$414,252M	$418,976M	$434,503M
$ Amount Indirect Loans	$45,149M	$49,716M	$51,539M	$53,030M	$57,952M
% Amount Indirect/Total	11.4%	12.2%	12.4%	12.7%	13.3%

The typical credit union has an average indirect loan portfolio balance of $35 million; has 20% or less in indirect loans to total loans; and has an average indirect loan outstanding balance between $10,000 and $20,000 (See Appendix B tables B-1, B-2 and B-3).

Agency Issued Indirect Lending Guidance

NCUA has issued examiner guidance addressing the risks associated with indirect lending. This guidance can be found in the NCUA Examiner's Guide, NCUA Instructions, NCUA Letters to Credit Unions, NCUA Supervisory Letters, and NCUA Risk Alerts.

Chapter 10 of the **NCUA Examiner's Guide** addresses examination and supervision policy and procedures for loan reviews. Appendices A and D of the Examiner's Guide address indirect lending more specifically. We have included key elements of that examiner guidance in Appendix E of this report.

Further, to assist credit unions in their oversight of indirect loans, NCUA also issued several letters of guidance dating back to 2001. See Appendix F for specific examples.

All federally insured credit unions submit 5300 **quarterly call reports** to NCUA. These quarterly call reports capture the number and amount of indirect loans outstanding, among other data. During each examination, examiners must verify the accuracy of the 5300 quarterly call report. The risk focused program places heavy reliance on the accuracy of the data in the call report. Inaccuracies in the call report may result in misleading evaluation of data.

Once credit unions submit call report data, NCUA examiners analyze it. The information is then compiled into reports for examiners to consider when deciding which areas pose the most risk within the credit union. Examiners complete the 5300 review questionnaire during the preliminary phase of an examination and then focus their review on the internal controls over the call report. Examiners also use the call report data to monitor credit unions between examinations.

PURPOSE AND OBJECTIVES

Since 2001, NCUA guidance has consistently treated indirect lending as a high risk program. All seven of the risk based exam risks are identified as inherent risks in indirect lending programs. The number and percentage of credit unions involved in indirect lending is increasing, as well as the amount of indirect loans outstanding. Consequently, indirect lending is an inherently risky program that requires increased oversight and due diligence.

Because of the growing risk posed by indirect lending to the share insurance fund, the NCUA OIG conducted a review to assess NCUA examiner compliance with agency guidance regarding reviews of credit union indirect lending programs. In addition, we assessed whether credit unions were accurately reporting the existence of indirect lending programs to NCUA.

SCOPE AND METHODOLOGY

Our review included indirect lending programs as of June 30, 2005. For trend and comparison purposes we analyzed indirect lending programs from June 30, 2004 to June 30, 2005.

In order to meet our objective, we performed the following:

- Interviewed NCUA personnel
- Reviewed NCUA indirect lending guidance
- Analyzed 5300 call report data
- Compared 5300 call report data to the Indirect Automobile Lending Assessment data gathered by NCUA (IALA)
- Reviewed examination and/or supervision contact indirect lending supporting documentation
- Reviewed a stratified sample of credit unions with indirect lending programs (See Appendix A)
- Reviewed a sample of 5300 call report data to IALA data (See Appendix A)
- Reviewed a stratified random sample of credit unions with “large” increases in loans (See Appendix A)

This engagement was performed in accordance with Generally Accepted Government Auditing Standards.

RESULTS

Credit Unions Assessed for Risk

We concluded that examiners are assessing the risk of indirect lending programs, as of June 30, 2005, for the 36 sampled credit unions that we reviewed. We based this conclusion upon our review of the examiners' workpapers relating to indirect lending, analysis of 5300 data, and analysis of key financial ratios and trends. We compared these reviews and analyses to NCUA indirect lending guidance within the scope of a risk focused examination program. Our sample showed comparable CAMEL ratings among all Federally Insured Credit Unions (FICUs) and comparable Return On Assets ratios compared to similar credit unions with indirect lending programs (peer group credit unions). However, our sample showed higher delinquency and charge-off ratios compared to peer ratios (See Appendix B tables B-5, B-6 and B-7). An analysis of call report data for all credit unions with indirect lending programs, as of June 30, 2005, indicated that credit unions with indirect lending programs had lower delinquency and comparable charge-off ratios compared to credit unions that did not have indirect lending programs.

	FICU with Indirect Lending	FICUs with no Indirect Lending	Total FICUs
Delinquency Ratio	.59%	.74%	.64%
Charge-off Ratio	.31%	.29%	.30%

We reviewed three stratified samples of credit unions reported as having indirect lending programs. Our samples included both federal and state chartered credit unions and included credit unions from all five regions (See Appendix B tables B-4 and B-5). These three stratified samples included: (1) credit unions with the largest dollar amount of indirect loans; (2) credit unions with the highest percentage of indirect loans to total loans; and (3) credit unions with the highest average dollar amount per indirect loan as reported on June 30, 2005 call reports.

In the first stratified sample, thirteen of the fifteen credit unions sampled with the largest dollar amount of indirect loans had their indirect lending program risks assessed reasonably well by examiners. One credit union had, in our opinion, a minimal assessment of the indirect lending program and one credit union's indirect lending program had not been assessed since it was converting to a mutual savings bank. These credit unions had at least $100 million in indirect loans as of June 30, 2005.

In the second sample, all ten of the sampled credit unions with the highest percentage of indirect loans to total loans had their indirect lending programs assessed reasonably well by examiners. These credit unions had at least 50% of their total loans in indirect lending programs.

Finally, with regard to the third stratified sample, examiners assessed reasonably well the indirect lending programs of five of the eleven sampled credit unions with the highest indirect loan average balances. Examiners did not review one credit union's indirect lending program because its indirect lending portfolio was only 1.7% of the total loan portfolio. The remaining five credit unions were discovered to have errors in reporting their indirect lending program on the June 30, 2005 call report. The eleven credit unions in this sample had an indirect loan average balance of at least $30,000.

NCUA Regulation

A subset of indirect lending programs is indirect lending programs which also outsource to third party vendors. The NCUA Board adopted a final rule, on June 22, 2006, addressing these types of indirect lending programs. The final rule revised the existing regulation to impose concentration limits on indirect vehicle loans serviced by third-parties.

5300 Quarterly Call Reports

There is a need to improve internal controls over 5300 call report data, specifically as it relates to indirect lending programs. We sampled 30 credit unions that had large increases in the number of loans reported on their June 2005 call report expecting to find indirect lending activity. We found no indication that any of these 30 credit unions had indirect lending programs. However, 17 of the 30 had errors on their call reports in the number of total loans field. Most of these errors represented a material amount. For instance, one credit union's 5300 reported 895 loans, where the actual number was only 358. Another credit union reported 2249 loans on its call report, when the reported loans were approximately 1100. Regional staff could not explain the reason for the increase in loans reported for four of the thirty credit unions. Nor did a cursory review of examiner workpapers for these four credit unions explain the reason for the increases in total loans. Nine of the thirty credit unions had explanations reflected in examiner workpapers, for the increase in the number of loans, but none of the explanations pointed to indirect lending programs.

Our comparison of June 30, 2005 call reports with May 31, 2005 Indirect Automobile Lending Assessment (IALA) data revealed that 180 credit unions reported the existence of indirect lending programs inconsistently between the two reports. Seventy-seven credit unions reported indirect lending on their call report but did not report indirect lending by means of the IALA contact. One hundred three credit unions reported indirect lending by means of the IALA contact but not on their June 30, 2005 call reports. We sampled 45 of the 103 credit unions. Thirty one of the forty five credit unions had call report errors (See Appendix C). In other words, they failed to report indirect lending loans (both number of loans and amount of loans outstanding) on their call report. Seven of the credit unions had errors on their IALA contact information. While the credit unions did not have any outstanding indirect loans, examiners reported that credit unions had indirect lending programs through this contact, and an additional seven credit unions were inactive as of June 30, 2005 thereby explaining the reporting discrepancy.

Examiners review quarterly call reports and Financial Performance Reports (FPRs) as part of their off-site monitoring of credit unions. In addition, examiners must verify call report data at each examination and complete the 5300 questionnaire which contains some questions regarding loan data. The risk focused program places heavy reliance on the accuracy of the data in the call report. The 5300, which includes indirect lending data, is used for credit union analysis. If there is a material increase or decrease in reported total number of loans without a corresponding increase in the dollar amount of outstanding loans on the 5300, this will be reflected by a material change on the FPR in the "average loan balance". We noted this scenario on several credit union FPRs in our samples. The effect of material inaccuracies in the call report may result in misleading evaluation of data and could increase the risk in potentially all seven risk areas.

There are some 5300 report edit checks which are application specific on particular fields that have set parameters specified by NCUA. These edit checks primarily relate to reasonableness checks (e.g. number of loans does not exceed amount of loans). However, there were no edit checks on indirect lending program "existence" (number and dollar amount) as of June 30, 2005 call reporting. NCUA incorporated two additional edit checks in the September 30, 2005 call reports:

- If the dollar amount for indirect loans is 75% greater or less than reported from the prior call report and the increase or decrease is at least $2,500,000 then a warning is generated and forwarded to the credit union and examiner for review; and
- If the number for outstanding indirect loans is 75% greater or less than reported from the prior call report and the increase or decrease is at least 2,500 account then a warning is generated and forwarded to the credit union and examiner for review.

These two edit checks were a good addition to the call reporting system. However, they will not capture reporting errors under 75% or the dollar amount/number of account thresholds. In addition they will not capture errors when there is a non-corresponding increase/decrease in the number of loans compared to the dollar amount of loans. Trend reasonableness edit checks or controls also did not exist for the total number of loans at June 30, 2005. The NCUA Office of Examination and Insurance is considering incorporating additional edit checks regarding the number of indirect loans with changes in the dollar amount.

RECOMMENDATION 1

To further strengthen internal controls over the reporting of credit union indirect loans, NCUA should implement trend reasonableness edit checks or controls to cover the total number of loans.

Management Response: Agree, The Office of Examination and Insurance (E&I) agrees with the need for reasonableness edit checks relating to indirect lending within the 5300 Call Report system. Over the last several years since E&I began collecting call report data on indirect lending, the office has added and/or modified edit checks to help ensure the system contains accurate information for trend analysis. E&I has also modified the actual indirect lending data collected as industry trends have warranted such action.

Since June 30, 2005, E&I has implemented additional edit checks relating to delinquent indirect loans and charged-off indirect loans. They will continue to evaluate the need for any reasonableness edits for indirect lending trends in the 5300 Call Report system, particularly relating to the total number of loans.

OIG Response: Concur with agency response.

RECOMMENDATION 2

NCUA should re-emphasize to examiners the importance of validating the data reported on quarterly call reports.

Management Response: Agree, Office of Examination and Insurance (E&I) agrees with re-emphasizing the importance of validating data contained in quarterly 5300 call reports. These reports are a vital element of the risk-focused examination program and assist in appropriately allocating resources to areas of higher risk within the credit union industry. E&I will continue to emphasize to examiners the importance of validating 5300 Call Report data via written memorandums, as well as face-to-face discussion during upcoming group meetings.

OIG Response: Concur with agency response.

MANAGEMENT RESPONSE

EI/MJB:mjb

Sent via E-Mail

TO: William DeSarno, Inspector General
Office of Inspector General

FROM: Director David M. Marquis
Office of Examination and Insurance

SUBJECT: Comments on Indirect Lending Audit Report

DATE: September 21, 2006

This memorandum responds to your request for comments on the report, titled, Indirect Lending Audit (IG Audit Report #OIG-06-05). My office appreciates the opportunity to comment on the report and we agree with the two recommendations contained in it. We offer the following comments regarding the specific recommendations:

OIG Report Recommendation #1
To further strengthen internal controls over the reporting of credit union indirect loans, NCUA should implement trend reasonableness edit checks or controls to cover the total number of loans.

Office of Examination & Insurance Response:
My office agrees with the need for reasonableness edit checks relating to indirect lending within the 5300 Call Report system. Over the last several years since we began collecting call report data on indirect lending, we have added and/or modified edit checks to help ensure the system contains accurate information for trend analysis. We have also modified the actual indirect lending data collected as industry trends have warranted such action.

Since the effective date of your review, June 30, 2005, my office has implemented additional edit checks relating to delinquent indirect loans and charged-off indirect loans. My office will continue to evaluate the need for any reasonableness edits for indirect lending trends in the 5300 Call Report system, particularly relating to the total number of loans.

OIG Report Recommendation #2
NCUA should re-emphasize to examiners the importance of validating the data reported on quarterly call reports.

Office of Examination & Insurance Response:
We agree with re-emphasizing the importance of validating data contained in quarterly 5300 call reports. These reports are a vital element of our risk-focused examination program and assist us in appropriately allocating resources to areas of higher risk within the credit union industry. We will continue to emphasize to our examiners the importance of validating 5300 Call Report data via written memorandums, as well as face-to-face discussion during upcoming group meetings.

Again, thank you for the opportunity to comment on this report. If you have any questions, please do not hesitate to contact my office.

cc: Office of the Executive Director

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APPENDIX A – SAMPLE METHODOLOGY

SAMPLE 1

Purpose: Assess NCUA examiner compliance with agency guidance regarding reviews of credit union indirect lending programs.

Scope: Sample of 36 credit unions with indirect lending programs as identified per the 6/30/05 call report (5300) stratified as follows:

a. Top 15 credit unions with the largest dollar amount of indirect loans
b. Top 10 credit unions with the highest percentage of indirect loans to total loans
c. Top 11 credit unions with the highest indirect loan average

Methodology: Reviewed exam/supervision supporting documentation for examiner due diligence reviews

- Reviewed 110 contacts
- Reviewed FPRs as of 6/30/05
- Requested regions to supply/cite examiner due diligence supporting documentation
- Reviewed AIRES workpapers

SAMPLE 2

Purpose: Determine if indirect lending programs are reported to NCUA

Scope: Indirect lending programs identified by credit unions on the 6/30/05 call report and/or reported on the 5/31/05 IALA data.

Methodology: Compared indirect lending programs identified by credit unions on the 6/30/05 call report to credit unions with indirect lending programs identified on the 5/31/05 IALA data. Sampled 45 credit unions reported as having indirect lending programs on the IALA data, but did not report having indirect lending programs on the 6/30/05 call report. Reviewed select AIRES workpapers and 110 contact information for the 45 sampled credit unions. Requested regional management to explain the reporting discrepancies between the call report and IALA report.

SAMPLE 3

Purpose: Determine if indirect lending programs are reported to NCUA

Scope: Credit unions with large increases in number of loans as reported on the 6/30/05 call report. Sampled 30 credit unions with 20% more increase in loans from 6/30/04 to 6/30/05.

Methodology: Reviewed select AIRES workpapers of stratified (percentage increase of loans strata) randomly selected credit unions. Sample selection by strata:

% Increase in Total Loans	Number of CUs - Universe	Number of CUs – sampled
> 100%	126	10
51 – 100	142	10
26 – 50	193	5
20 – 25	141	5
Total	602	30

APPENDIX B – SAMPLE 1 STATISTICAL RESULTS

SAMPLE 1

Table B1

Comparison of universe to sample (sample 1a) credit unions for Dollar Amount of Indirect Loans, as of June 30, 2005:

$ Amount of Indirect Loans	# CUs - Universe	# CUs - Sample
$ 1 Billion +	2	2
$500 Million – $1 Billion	9	9
$100 Million - $500 Million	133	4
$50 Million - $100 Million	126	
$1 Million - $50 Million	1,049	
$1 - $1 Million	341	
TOTAL	1,660	15

Table B2

Comparison of universe to sample (sample 1b) credit unions for Percentage of Dollar Amount Indirect Loans to Dollar Amount Total Loans, as of June 30, 2005:

% Amount of Indirect Loans to Total Loans	# CUs - Universe	# CUs - Sample
75 - 100%	4	4
50 – 75%	78	6
30 – 50%	272	
20 – 30%	227	
10 – 20%	354	
1 – 10%	725	
TOTAL	1,660	10

Table B3

Comparison of universe to sample (sample 1c) credit unions for Indirect Loan Average Amount, as of June 30, 2005:

Average Indirect Loan	# CUs - Universe	# CUs - Sample
$200,000 +	2	2
$100,000 - $200,000	5	5
$30,000 - $100,000	19	4
$20,000 - $30,000	131	
$10,000 - $20,000	1202	
$1 - $10,000	301	
TOTAL	1,660	11

Table B4

Sample (sample 1) selection by region:

	1a. Dollar Amount Indirect Loans	1b. Indirect Loan Percentage	1c. Indirect Loan Average
Region 1	0	1	4
Region 2	0	1	4
Region 3	4	2	1
Region 4	4	2	1
Region 5	7	4	1
Totals	15	10	11

Table B5

Return on Asset (ROA) ratios for sampled (sample 1) credit unions compared to peer ratios, as of June 30, 2005:

ROA	Higher	Equivalent	Lower	Negative	Total
FCUs	7	3	4	0	14
FISCUs	10	0	10	2	22
Total	17	3	14	2	36

Table B6

Delinquency and Charge-Off ratios for sampled (sample 1) credit unions compared to peer ratios, as of June 30, 2005:

Delinquency	Higher	Equivalent	Lower	Total
FCUs	9	1	4	14
FISCUs	8	5	9	22
Total	17	6	13	36
Charge-offs	Higher	Equivalent	Lower	Total
FCUs	5	4	5	14
FISCUs	10	7	5	22
Total	15	11	10	36

Table B7

Composite CAMEL ratings for sampled (sample 1) credit unions, as of June 30, 2005:

CAMEL	1	2	3	4/5	Total
FCUs	6	8	0	0	14
FISCUs	8	11	3	0	22
Total	14	19	3	0	36

Comparison CAMEL ratings of sample to universe, as of June 30, 2005:

	CAMEL 1/2	CAMEL 3	CAMEL 4/5	Total
Agency	94.22%	4.80%	.98%	100.00%
Sample	91.67%	8.33%	0.00%	100.00%

APPENDIX C – SAMPLE 2 STATISTICAL RESULTS

SAMPLE 2

Table C1

Comparison of universe to sample, by region, for inconsistent reporting of credit unions with indirect lending programs at June 30, 2005:

	Universe – Reported IALA Not Reported 5300	Sample – Reported IALA Not Reported 5300	Universe – Reported 5300 Not Reported IALA	Sample – Reported 5300 Not Reported IALA
Region 1	19	12	12	0
Region 2	7	1	15	0
Region 3	15	3	15	0
Region 4	20	8	27	0
Region 5	25	14	8	0
Inactive	17	7	0	0
Total	103	45	77	0

Table C2

Comparison of universe to sample, by asset size, for inconsistent reporting of credit unions with indirect lending programs at June 30. 2005:

Credit Union Assets	Universe – Reported IALA Not Reported 5300	Sample – Reported IALA Not Reported 5300	Universe – Reported 5300 Not Reported IALA	Sample – Reported 5300 Not Reported IALA
$ 1 Billion +	2	0	1	0
$100-999 Mil	15	9	25	0
$10-99 Mil	57	26	45	0
$10 Mil -	12	3	6	0
Inactive	17	7	0	0
Total	103	45	77	0

APPENDIX D – SAMPLE 3 STATISTICAL RESULTS

SAMPLE 3

Table D1

Comparison of universe to sample for percentage increase in the number of total loans for credit unions, as of June 30, 2005:

% Increase in Total Loans	Number of CUs - Universe	Number of CUs – sampled
> 100%	126	10
51 – 100	142	10
26 – 50	193	5
20 – 25	141	5
Total	602	30

Table D2

Sample selection, by region, for percentage increase in the number of total loans, as of June 30, 2005:

	> 100%	51-100%	26-50%	20-25%
Region 1	1	2	0	1
Region 2	3	3	1	0
Region 3	0	2	0	2
Region 4	4	3	4	2
Region 5	2	0	0	0
Total	10	10	5	5

Table D3

Sample selection, by asset size, for percentage increase in the number of total loans, as of June 30, 2005:

	> 100%	51-100%	26-50%	20-25%
$ 1 Billion +	0	0	0	0
$100-999 Mil	0	0	0	0
$10-99 Mil	1	2	2	3
$10 Mil -	9	8	3	2
Total	10	10	5	5

APPENDIX E - NCUA EXAMINER'S GUIDE

CHAPTER 10 – LOANS—GENERAL LOAN REVIEW

Part 1 of Chapter 10 discusses general loan reviews. The examiner should:

- Evaluate management's ability to identify and manage risk
- Evaluate loan portfolio quality and related risks
- Evaluate lending standards and controls
- Determine adequacy of lending program plans
- Assess financial capacity to conduct lending safely
- Analyze the loan portfolio's performance for profitability, delinquency and losses
- Consider management's response to adverse performance trends
- Determine effectiveness over consumer protection compliance risks
- Determine effectiveness of internal loan grading system

Part 2 of Chapter 10 discusses credit risk, delinquency and charge-offs. The examiner should:

- Determine loan portfolio credit risk
- Determine accuracy and timeliness of delinquency reports
- Determine collection policies and procedures are adequate
- Determine collection efforts are adequate
- Determine reasonableness of extension and refinancing polices and procedures
- Determine reasonableness of charge-off policy

Appendix A of Chapter 10 discusses Indirect Dealer Financing Programs (IDFP). Credit unions should:

- Evaluate the stability of dealerships before entering into a business relationship
- Incorporate the IDFP into a written business plan
- Have a sound overall lending program
- Document management's due diligence, include cost/benefit analysis
- Have an asset-liability management strategy which includes the IDFP
- Have a detailed lending policies and procedures
- Have experienced IDFP lending management and staff
- Have a comprehensive dealership agreement
- Have legal opinions on the dealership agreement and consumer compliance laws
- Have a strong internal control program
- Have a strong collection department with vehicle repossession expertise
- Have monitoring procedures by dealer

Appendix F -Additional NCUA Indirect Lending Guidance

NCUA Letter to Credit Unions 04-CU-13, Specialized Lending Activities, dated 9/22/204 was issued alerting credit unions to higher risk lending activities (sub-prime, indirect and outsourced lending programs). It stated further that, an indirect lending program can lead to rapid growth changing the structure and risk profile of a credit union's balance sheet quickly. Risks include credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. Credit unions need proper planning, experienced staff, adequate controls and monitoring. Credit unions should periodically review approved dealers with on-going review and monitoring of loan statistics. Credit unions need written contracts addressing dealer compensation, credit criteria, documentation standards, and dealer reserves.

Supervisory Letter 04-02, Specialized Lending Activities, dated 9/22/04 was issued to examiners providing information regarding higher risk lending activities (sub-prime, indirect, outsourced lending programs). Some credit unions are involved in sub-prime and indirect lending in combination with outsourced lending. Examiners should scrutinize the credit union's ability to monitor and control higher risk lending programs. Examiners are encouraged to determine if credit unions are doing proper due diligence reviews prior to engaging in new or expanded specialized lending activities. Examiners should initially evaluate a credit union's initial planning into the new market, including the credit union's legal review, detailed policies and procedures, program controls, monitoring and reporting, and staff qualifications and experience. An assessment of the magnitude of the risk of the specific lending activity should guide an examiner's scope determination. Three examination questionnaires will be utilized by examiners to assist in evaluating programs. These are indirect controls, outsourced lending and sub-prime lending questionnaires.

NCUA Letter to Credit Unions 01-CU-20, Due Diligence Over third Party Service Providers, issued 11/01 requested that credit union officials perform a due diligence review prior to entering into any arrangement with a third party, including:

- Controls – policies and procedures, staff oversight and performance monitoring
- Planning – within business strategy and risk tolerances
- Background checks
- Legal review of contracts (i.e. who bears costs collateral disposition; recourse arrangements)
- Financial review- review financial statements of contracting party
- Return on Investment – projected revenue, expenses, net income and economic changes

NCUA Instruction 4000.3, Indirect Automobile Lending Assessment (IALA), was issued 6/13/05 to quantify the potential systemic risk associated with outsourced, indirect, sub-prime automobile lending and participation activity in such loans. Examiners were instructed to perform an off-site contact and upload information by 6/27/05. Information related to the credit union's controls and practices regarding third party sub-prime, indirect and participation lending.