

NCUA RISK ALERT

NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314

DATE: June 2005 **RISK ALERT NO.:** 05-RISK-01

TO: Federally Insured Credit Unions

SUBJ: Specialized Lending Activities—Third-Party Subprime Indirect Lending and Participations

REF: Specialized Lending Activities (LTCU 04-CU-13)

Dear Board of Directors:

Since September 2004, there has been a sharp increase in the number of credit unions engaged in outsourced, indirect, subprime¹ automobile lending, and participation activity in such loans. We have a heightened concern that credit unions engaged in this type of lending activity may not have effective controls and monitoring systems in place. Based on the volume of activity, engaging in this type of lending without effective controls and monitoring systems may pose a risk to your credit union's net worth.

As a result of NCUA's heightened concern, your examiner will contact you in the near future to discuss your controls and practices relative to this risk alert. Your examiner may also conduct on-site supervision contacts to evaluate your progress in accomplishing appropriate due diligence, as reflected in this risk alert.

Subprime lending is an activity that, if properly implemented and controlled, can be an acceptable segment of your lending portfolio in meeting your members' needs. Still, if your credit union engages in subprime lending or purchases participations in such loans, adequate due diligence and control measures are required. Your control measures increase in importance if your credit union allows a third-party vendor to perform activities related to subprime auto loan underwriting, servicing, repossession, or insurance processing. It is NCUA's

¹ Subprime loans are loans to borrowers with weakened credit histories that include payment delinquencies, charge-offs, judgments, or bankruptcies. They may also display a reduced repayment capacity as measured by credit scores and debt-to-income ratios.

position that sound business practices for subprime lending require, at a minimum, your credit union to:

- Regularly analyze the program's impact on your credit union's net worth,
- Properly evaluate and oversee any third-party vendor's subprime underwriting criteria,
- Limit any third-party vendor's authority to alter loan terms,
- Test the accuracy of any third-party vendor's reports, and, if appropriate,
- Include an exit clause in any third-party vendor's servicing agreement.

Failure to implement effective controls and monitoring systems will result in frequent supervision contacts and may result in a CAMEL downgrade and other appropriate administrative actions.

Analyze Impact on Net Worth

Sound business practice requires you to assess the potential risk to your net worth by analyzing appropriate factors, including:

- The interest rate you will receive,
- Delinquencies and charge-offs,
- Insurance coverage and payout amounts,
- Loan prepayments,
- Insurance premiums,
- Program fees, and
- Other costs, such as for due diligence.

Estimating how all these factors interrelate is complex, particularly for an indirect subprime program. Be aware that when you have evaluated all these factors your expected return may be negative. This is the risk to net worth.

The following section discusses the process for evaluating a third-party vendor's subprime underwriting criteria. This process will provide you with estimates of your expected return from the program.

Evaluate Subprime Underwriting Criteria

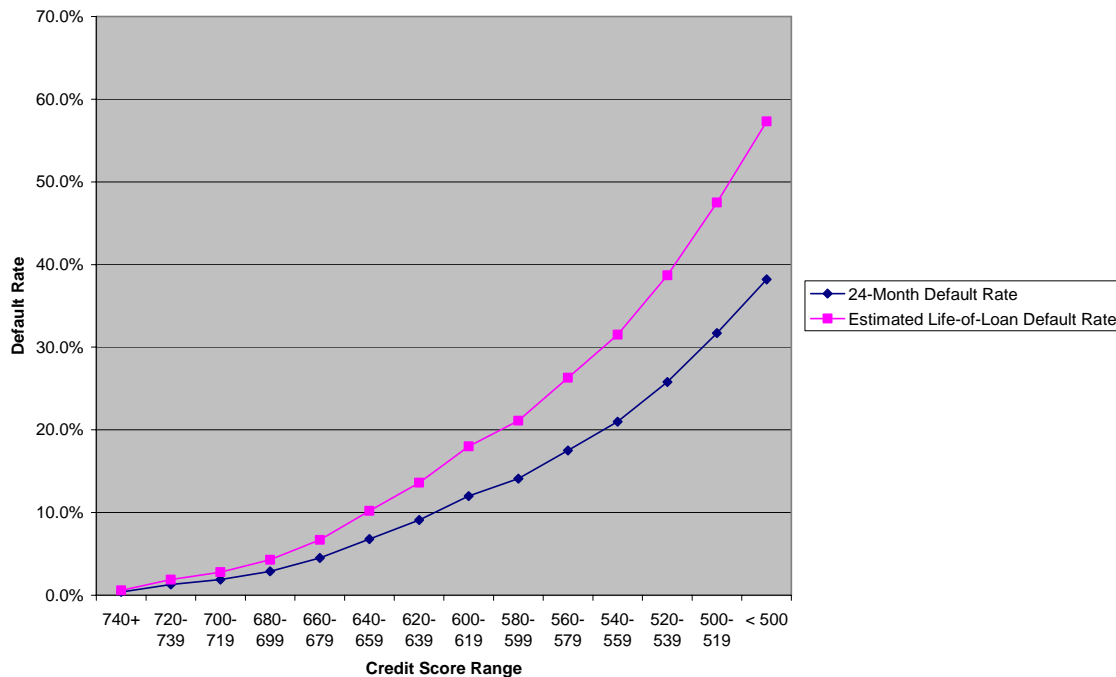
Subprime lending carries higher credit risk because historically, subprime borrowers have a higher default rate. Furthermore, lenders tend to incur greater loss severity than on loans to prime borrowers. In September 2004, we issued Letter to Credit Unions, *Specialized Lending Activities* (LTCU 04-CU-13), and encouraged you to review the letter's three questionnaires related to controls over outsourced, indirect, and subprime lending. As we stated in LTCU No. 04-CU-13, "[s]ound underwriting practices, effective control and monitoring systems, and sufficient capital levels are key components to a well-

managed program.” Some credit unions, however, are employing underwriting practices established by third-party underwriters without first ensuring that those practices are sound for their credit unions.

All lending programs, including subprime, depend on adequate policies, procedures, and practices. **You should analyze the vendor’s program to ensure you understand how the loan application, underwriting, servicing, and collections processes work. You should also monitor the program on an ongoing basis to ensure the vendor is executing the program as described.**

While there is no industry standard range of credit scores that describe subprime borrowers, those borrowers with credit scores below 620 generally have a higher loan default rate. The following table contains industry data on cumulative historical default rates² for automobile loan borrowers over a 24-month period:³

Auto Loan Default Rates by Credit Tier



² The default rate in the graph and table includes loans with charge-offs or any derogatory credit information, such as repossession or foreclosure.

³ The graph and chart represent NCUA’s analysis of data obtained from Experian/Fair Isaac for an observation period beginning July 1995. Note: the data represents the default rate over a 24-month period for a set of loans originated at different times before the 24-month period. Most subprime loans are paid off within 24 months (for example, by default, refinance, sale of collateral, or prepayment). After 24 months, using asset-backed securities’ performance information as a proxy, the data suggests additional defaults of about 50%. To illustrate, in the range between 540–559, after 24 months, an additional 10.5% default rate may be expected, bringing the life-of-loan default rate to 31.5%. NCUA does not endorse any particular private entity, including Experian or Fair Isaac Corporation. Credit unions may use other independent sources of credit data and credit risk.

FICO Credit Score Range	24-Month Default Rates	Estimated Life-of-Loan Default Rate
740+	0.4%	0.6%
720-739	1.3%	1.9%
700-719	1.9%	2.8%
680-699	2.9%	4.3%
660-679	4.5%	6.7%
640-659	6.8%	10.2%
620-639	9.1%	13.6%
600-619	12.0%	18.0%
580-599	14.1%	21.1%
560-579	17.5%	26.3%
540-559	21.0%	31.5%
520-539	25.8%	38.7%
500-519	31.7%	47.5%
< 500	38.2%	57.3%

Clearly, as the credit score declines, the default rate increases markedly. Despite these severe default rates for borrowers with very low FICO credit scores, NCUA believes some credit unions may have adopted third-party underwriting criteria permitting loans to these borrowers, *with little or no substantive analysis*. **Adoption of any third-party's subprime underwriting criteria without careful and comprehensive evaluation is unsafe and unsound. For federal credit unions, this is a violation of the board's responsibility under §113 of the Federal Credit Union Act (Act) to establish lending policies and internal controls. For all federally-insured credit unions, this is an unsafe and unsound practice subject to possible NCUA action under §206 of the Act.**

The most effective method of evaluating the probable performance of a vendor's proposed underwriting criteria is through an analysis of static loan pool data. This analysis uses a pool of loans underwritten with these criteria during the same month, quarter, or year, and tracks its performance over time. The static loan pool data should show delinquency rates, defaults, cumulative losses, and prepayments. Using a static loan pool report, you can make assumptions about life-of-loan performance to project expected rates of return. Unlike other methods of performance review, such as Return on Average Assets (ROAA), the static pool data is not skewed or diluted by new loans.

You should ask the vendor to prepare a static pool report. The data should include at least 24 months of history. Ideally, the vendor will provide the credit union with data on static pools that have completely amortized and resemble the general quality of the loans the credit union intends to purchase. In addition, as you gain experience with your pools of loans, you should prepare reports to monitor performance.

With any static loan pool data, it is critical to verify the source of the cash flows. **If the vendor provides the report, sound business practice requires an**

independent auditor to verify the reporting process, including verifying the source of the cash flows. If you prepare the report, sound business practice requires you to verify the source of the cash flows independently of the vendor, including affirmative confirmation of a sample of borrowers' payments and payoffs and insurance payouts.

In addition to projecting expected rates of return based on static pool data, sound business practice requires you perform a sensitivity analysis to calculate the impact on the expected rates of return by varying your assumptions. This sensitivity analysis should be based on published subprime auto industry statistics such as default rate and loss severity (the dollar amount lost per loan relative to the original loan amount). These statistics may be obtained from credit bureaus for loans or brokerage houses for securitized pools of loans. **If the expected performance based on static pool data is significantly different than the expected performance based on published industry statistics, you should ask the vendor to explain why. If the vendor claims that the vendor's underwriting process or servicing is somehow better than industry standards, you should ask the vendor to provide details and proof of this claim. You should consider such claims very carefully.**

Some vendors provide GAP (repossession) insurance to mitigate losses associated with the credit risk of subprime lending. **Even with repossession insurance, however, *thousands of dollars* may be at risk on each repossessed vehicle.** Repossession insurance:

- Is expensive, typically with an up-front, nonrefundable premium of nine percent or more of the total amount of each loan,
- Does not provide coverage if the vehicle cannot be located and repossessed,
- Does not cover the entire outstanding principal balance of the loan, and
- Does not cover the costs of vehicle repossession and reconditioning.

Repossession insurance also does not protect against losses due to loan prepayments. To recoup the large insurance premiums and other significant upfront fees paid to the vendor, the credit union needs to collect a significant amount of interest over the life of the loan. If the loan prepays too rapidly, the credit union will not collect enough interest to offset these upfront costs.

Corrective Actions

To carry out your responsibilities, sound business practice requires you to:

- (a) **Perform a due diligence review of the vendor's policies, procedures, and practices, ensuring consistency with your policies and risk appetite;** and

(b) Consult with, or retain on staff, an independent expert in subprime automobile financing to:

- (1) Calculate on a periodic basis your credit union's anticipated subprime auto loan yield using assumptions based on the audited or verified static pool data, and
- (2) Conduct sensitivity analyses of changes to expected return from varying assumptions based on industry statistics.

You may conduct alternative due diligence in lieu of (a) and (b) if the alternative satisfies the concerns expressed in this section. *Analysis based solely on marketing claims or unaudited performance data is not, however, acceptable alternative due diligence.*

Without acceptable due diligence, sound business practices require you discontinue purchasing loans or participation interests underwritten with the vendor's criteria. If you have signed a future funding commitment, you should consult with legal counsel to terminate your commitment as provided for in the funding agreement.

Approve Underwriting Criteria Modifications

Sound business practice requires that your credit union approve all vendor underwriting criteria and any subsequent modifications. Some existing agreements permit the vendor (1) to make exceptions allowing for the approval of loans outside the underwriting criteria or (2) to modify the underwriting criteria without your prior written approval. **For federal credit unions, allowing the vendor control over underwriting criteria violates §113 of the Act. For all federally-insured credit unions, this is an unsafe and unsound practice subject to possible NCUA action under §206 of the Act.**

Corrective Actions

To carry out your responsibilities, sound business practice requires you:

- (a) Review and test a sample of individual loans for adherence to your approved underwriting criteria to ensure vendor compliance,
- (b) Ensure your written policies and vendor agreements require formal, written credit union approval of any proposed vendor changes to the underwriting criteria before purchasing additional loans, and
- (c) **Discontinue funding loans if the vendor agreement permits exceptions or allows unilateral change in criteria. If you have signed a future funding**

commitment, you should consult with legal counsel to terminate your commitment as provided for in the funding agreement.

Limit the Servicer's Authority to Alter Loan Terms

Sound business practice requires you not permit third-party servicers unlimited authority to alter loan terms. The Outsourced Lending Relationships questionnaire attached to LTCU 04-CU-13 asks “[d]oes the written contract . . . [s]pecify limits on extensions, deferrals, renewals, or rewrites of loans?” Despite this query, some credit unions have entered into outsourced servicing agreements that give a third-party servicer virtually unlimited authority to change due dates, grant payment deferrals, grant loan extensions, and enter into settlements, without notifying the credit union in advance or obtaining the credit union’s prior approval.

For federal credit unions, permitting third-party servicers to make such alterations without any limitations violates §113 of the Act. For all federally-insured credit unions, this is an unsafe and unsound practice subject to possible NCUA action under §206 of the Act.

Typically, for subprime loans, a payment deferral or extension of maturity only delays the date of default. Based on subprime auto industry data, only 10 to 12 percent of subprime loans receive an extension or payment deferral in any given year.⁴ **If your servicer modifies a majority of the loans in your portfolio one or more times, it is a significant risk indicator.**

Sound business practice calls for the servicer to obtain your prior written approval before making any alteration to the terms of the loan. You may, however, agree to allow the servicer to unilaterally make one minor alteration over the life of the loan to the terms of a loan, such as one payment deferral or one extension of maturity not to exceed 30 days. The agreement should specify under what circumstances the servicer may make this change.

You should also be aware that a substantial formal modification of loan terms that: (1) results from a member’s financial difficulty and (2) grants a concession to the member that the credit union would not otherwise grant may qualify as a troubled debt restructuring within its meaning under generally accepted accounting principles (GAAP). This restructuring may require recognizing impairment, asset re-measurement, if applicable, and financial statement presentation (e.g., refer to Financial Accounting Standards 15 and 114 among other statements).⁵

⁴ 2004 Non-Prime Automotive Financing Survey (National Automotive Finance Association), p. 14.

⁵ Guidance in evaluating impairment consistent with GAAP can be found in NCUA Interpretive Ruling and Policy Statement (IRPS) 02-3 *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions*, 67 Fed. Reg. 37445 (May 29, 2002). You should

Corrective Actions

(a) **You should not permit the servicer to make major modifications to the loan terms**, such as entering into settlements, or to make more than one minor modification to any particular loan, without first obtaining your credit union's prior written approval for each proposed modification. **If the servicing agreement permits major modifications or multiple minor modifications, sound business practice requires you seek amendment of the agreement.**

(b) **You should obtain written amendments to your servicing agreements to specify the necessary limits on loan modifications.** If you are unable to obtain such agreements, sound business practice requires that you immediately discontinue purchasing loans subject to such servicing. If you have signed a future funding commitment, you should consult with legal counsel to terminate your commitment as provided for in the funding agreement.

(c) **Sound business practice requires you not purchase any subprime loans or participation interests from any source unless the servicing agreement limits the servicer's authority as described above.**

(d) **You should test for vendor compliance with the servicing agreement** by, for example, monitoring the vendor's collection notes and recalculating individual loan aging and amortization.

(e) **You should periodically evaluate loans for impairment** in accordance with GAAP and report on your Call Report to the NCUA Board consistent with GAAP as required by §202(a)(6)(C) of the Federal Credit Union Act. Weaknesses in internal controls or improper measurement, valuation and financial statement presentation of loans, including the evaluation of impairment consistent with GAAP, warrant rigorous supervision, statutory audit remedies as prescribed by §202(a)(6)(A) of the Act for serious and persistent recordkeeping deficiencies, and other administrative actions as necessary.

Replace an Unsatisfactory Servicer

Your servicer works for you. A servicing agreement should contain standards to measure the servicer's performance and a mechanism for you to replace an unsatisfactory servicer (exit clause). As stated in the Outsourced Lending Relationships questionnaire attached to LTCU 04-CU-13, "[c]an the credit union terminate contracts for non-compliance or non-performance by the third party at a reasonable cost?" **For all federally-insured credit unions, a servicing agreement without such provisions is an unsafe and unsound practice subject to possible NCUA action under §206 of the Act.**

also consult with an independent accountant for the application of GAAP to your credit union's particular circumstance.

Corrective Actions

To carry out your responsibilities, sound business practice requires you:

- (a) **Evaluate the servicing agreement to ensure it contains performance standards and an exit clause.** The exit clause should provide a method for measuring servicer performance and a mechanism for you to replace an unsatisfactory servicer. If your insurance coverage requires the insurer to approve the loan servicer, the exit clause should name at least one alternate servicer acceptable to both you and the affected insurance companies.
- (b) **Request the servicer modify the servicing agreement if it does not include performance standards and an exit clause. If the servicer refuses to make these modifications, sound business practice requires you discontinue purchasing loans subject to such servicing. If you have signed a future funding commitment, you should consult with legal counsel to terminate your commitment as provided for in the funding agreement.**
- (c) Not purchase participation interests in such loans unless the servicing agreement contains performance standards and an exit clause as described above.

Require Accurate Servicing Reports

Sound business practice requires you ensure that third-party servicers are providing you accurate reports. The Outsourced Lending Relationships questionnaire attached to LTCU 04-CU-13, asks “[a]re reports prepared on a monthly basis that . . . provide sufficient information to properly monitor the activities” and “[d]oes the credit union verify that the outsourced party’s reports are accurate?”

To assess accuracy, you should independently test your loan pools for proper aging and amortization. In addition, you should test loans in which the borrower is involved in bankruptcy proceedings to determine whether the servicer notified you of court actions in a timely manner. Without timely notification, you cannot meet your responsibility under § 202(a)(6)(C) of the Act to report on your Call Report consistent with GAAP. For example, if the bankruptcy court modifies the terms the borrower/member must pay, you should evaluate the loan for impairment based on expected future cash flows. Or, if the third party has accepted long-lived assets (e.g., vehicles) in full or partial satisfaction of the receivable, you should evaluate impairment based on the fair value of the collateral less costs to sell. Delinquency balances should be evaluated for impairment and timely charged-off. In either case, GAAP requires you immediately charge-off through the Allowance for Loan and Lease Losses (ALLL) either that portion of the debt discharged by the court, or otherwise deemed uncollectible. Sound business practice requires that servicers provide

you reports that recognize and facilitate bankruptcy-related impairment evaluation and charge-off (e.g., discharge by the court or substantial formal loan modifications) or vehicle repossession (reports on repossession, fair value of collateral repossessed, etc.).

Corrective Actions

To carry out your responsibilities, sound business practice requires:

(a) **The servicing agreement provide for accurate and timely reporting. Sound business practice requires you discontinue purchasing loans, or participation interests in loans, subject to such servicing if the servicing agreement does not provide for accurate and timely reporting.** If you have signed a future funding commitment, you should consult with legal counsel to terminate your commitment as provided for in the funding agreement.

(b) You test your servicer's reports to ensure compliance with proper accounting requirements.⁶

Conclusion

This risk alert expresses NCUA's heightened concern regarding outsourced, indirect, subprime lending and outlines minimum due diligence requirements for this type of lending involving third-party vendors. It does not, however, address all potential safety and soundness problems, nor are the remedial actions listed above the only actions you may need to take in a particular situation. The facts and circumstances may require additional corrective actions. Unsafe and unsound practices that put your credit union's net worth and the National Credit Union Share Insurance Fund at risk must be corrected immediately.

⁶ Reports must provide adequate information for you to comply with FAS 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring; FAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets; and FAS 114, Accounting by Creditors for Impairment of a Loan.

If your credit union engages in subprime lending with the assistance of third-party vendors, your examiner will contact you in the near future to discuss the issues outlined in this risk alert and determine whether you are taking appropriate actions to address identified concerns. In the meantime, if you have any questions, please contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/s/

JoAnn Johnson
Chairman

/s/

Deborah Matz
Board Member