NATIONAL CREDIT UNION ADMINISTRATION
OFFICE OF INSPECTOR GENERAL

REAL ESTATE LENDING SURVEY

Report #OIG-07-07
September 5, 2007

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EXECUTIVE SUMMARY

As of December 31, 2006, federally chartered credit unions held approximately $131 billion in real estate loans. In addition, within the past year the U.S. Congress has shown an interest in regulatory practices with regard to sub-prime mortgage lending, particularly with certain types of adjustable rate mortgages.

Therefore, the Office of Inspector General conducted an audit survey to determine if there are any real estate lending risks in federally chartered credit unions which could lead to an audit engagement. Initially, we attempted to review the area of sub-prime mortgages. However, we determined that NCUA does not collect data on sub-prime mortgage loans via the credit union quarterly call reports. Currently, these loans are captured for reporting purposes within a much larger group of mortgage loans that include adjustable rate mortgages as well as balloon/hybrid loans. Consequently, it was not possible to specifically identify sub-prime mortgage loans.

The Office of Inspector General determined through this survey that an audit of credit union real estate lending is not warranted at this time primarily because, as explained above, NCUA does not collect data on sub-prime mortgages. Furthermore, our sample review of credit unions with high real estate loans to total loan ratios indicated that such credit unions pose no greater overall risk than all federally chartered credit unions viewed as a whole. In reaching this conclusion, we conducted a survey the objectives of which were to:

1. Determine the significance of real estate lending in the credit union industry;
2. Identify potential real estate lending risks in the credit union industry; and
3. Determine what NCUA is doing to mitigate identified potential real estate lending risks.

Real estate lending is a significant program of federally chartered credit unions. A significant percentage (34%) of federally chartered credit unions has real estate lending programs. Real estate loans comprise 49% of total loans in federally chartered credit unions and 34% of total assets. Approximately 20% of federal credit unions have 25% or more real estate loans to assets and over 4% have 50% or more real estate loans to assets.

Real estate lending potentially impacts all seven risk component areas NCUA has identified in its Examiners Guide:

- Credit risk due to loan underwriting quality and products offered;
- Interest rate risk due to mortgage mismatches with the types of funding and rising interest rates;
- Liquidity risk that can occur with high loan to share ratios and holding of loans;
- Compliance risk with regard to real estate consumer compliance regulations;
- Transaction risk due to the complexity of real estate transactions and products;
- Strategic risk due to the complexity and foresight in planning; and

- Reputation risk whereby a credit union may be impacted by all of the above risks.

NCUA appears to be identifying and addressing most potential real estate lending risks. This is evidenced through the agency's issuance of extensive guidance for examiners and credit unions, identification of risk trends in quarterly reports, and statistical data analysis. However, we identified the following areas where potential risk may be elevated due to current practices:

- A lack of examination documentation[1] in support of examiner loan reviews and consumer compliance reviews;
- A lack of credit union management planning and oversight in such areas as business plans, asset liability management, and budgeted/planned parameters directly related to real estate lending.

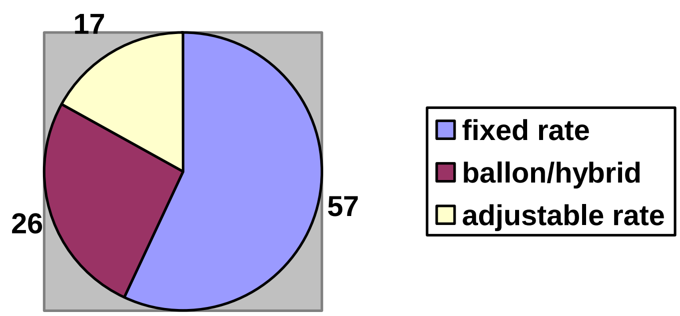
These items are discussed in the results section of this report.

[1] It is not NCUA policy for examiners to detail work performed during an examination as long as no problems were found by the examiner. Consequently, while we could not identify all of the examination procedures performed, we did find that examiners were following established procedures.

BACKGROUND

As of December 31, 2006, federally insured credit unions held over $244 billion in real estate loans. This amount represented 49 percent of total loans and 34 percent of total assets. Over $159 billion of these loans were first mortgage loans and more than $84 billion were other real estate loans such as lines of credit. Fifty seven percent of the first mortgage loans were fixed rate loans; twenty six percent were balloon/hybrid loans; and seventeen percent were adjustable rate loans.

Figure 1 - Percentage First Mortgage Loans



In 1977, credit unions were authorized to make first lien mortgages. Since then, laws, regulations, and guidance have continued to evolve to address real estate secured loans, risk management, real estate appraisals, and consumer compliance.

Within the past year, the U.S. Congress has shown an interest in regulatory practices with regard to sub-prime mortgage lending, particularly with certain types of adjustable rate mortgages. Since NCUA does not collect specific data on sub-prime loans on credit union quarterly call reports, the Office of Inspector General could not effectively review this area.

The agency issues real estate lending guidance to examiners and credit unions. The majority of this guidance is found in the NCUA Examiner's Guide and in various Letters to Credit Unions. In addition, the agency monitors trends in credit unions and produces risk trend reports. Examiners perform examination and supervision risk-based procedures in credit unions, which include reviews of real estate lending.

PURPOSE AND OBJECTIVES

The purpose of this audit survey was to determine if real estate lending risks exist in federally chartered credit unions which could lead to an audit engagement.

The objectives of this survey were to:

1. Determine the significance of real estate lending in the credit union industry;
2. Identify potential real estate lending risks in the credit union industry; and
3. Determine what NCUA is doing to mitigate identified potential real estate lending risks.

SCOPE AND METHODOLOGY

The scope included federally chartered credit unions, as of December 31, 2006, with real estate lending programs.

The engagement methodology included the following:

- Review of agency real estate lending guidance;
- Review of applicable laws and regulations;
- Interviews with Office of Examination and Insurance staff;
- Assessment of real estate inherent and program risks;
- Review of a sample of ten federally chartered credit unions with the highest real estate loans to total loans ratio; and
- Analysis of quarterly call report data and reports.

RESULTS

The Office of Inspector General has determined through this survey that an audit of credit union real estate lending is not warranted at this time.

Objective 1: Determine the significance of real estate lending in the credit union industry.

Real estate lending is a significant program of federally chartered credit unions. A significant percentage (34 percent) of federally chartered credit unions has real estate lending programs. Real estate loans comprise 49 percent of total loans in credit unions and 34 percent of total assets. Approximately 20 percent of federal credit unions have 25 percent or more real estate loans to assets and over 4 percent have 50 percent or more real estate loans to assets. In addition, the Office of Examination and Insurance considers real estate lending a significant program.

Because NCUA does not collect specific data on sub-prime loans on call reports, we could not determine the percentage of loans in this category. In February 2007, NCUA reported to the Senate Banking Committee and House Financial Services Committee, based on the Committee's requests for information on subprime mortgage lending. In particular, the Committee inquired about 2/28 and 3/27 type adjustable rate mortgages. NCUA could not report how many loans were sub-prime but could report that these types of mortgages are captured in the quarterly call report under the Hybrid /balloon ARMs less than five years. As of December 31, 2006, this pool of loans accounts for less than 6 percent of all federally insured credit union loans. In addition, the subprime loans account for only a portion of this category and reflect an even small percentage of loans.

As mentioned previously, our survey did not specifically identify and review sub-prime mortgages because NCUA does not collect specific data on sub-prime loans on credit union quarterly call reports. As a result, NCUA cannot provide statistics on sub-prime mortgages and cannot readily identify credit unions that may have a more significant portfolio of sub-prime mortgages.

Recommendation:
NCUA management should review the current tracking and reporting of sub-prime mortgages and determine if these mortgages should be specifically reported on the credit union quarterly report.

Management Response:
Management has reviewed this recommendation and stated that "Since no specific empirical definition of subprime lending exists, it would be difficult for credit unions to gauge which loans were subprime and were thus required to be reported if a reporting requirement were enacted."

Objective 2: Identify potential real estate lending risks in the credit union industry.

Real estate lending potentially impacts all seven risk component areas identified by NCUA in its Examiners Guide. The potential real estate lending risk for each component is as follows:

- Credit risk is inherent in loan programs with the degree of risk dependent upon the quality of loan underwriting and the products offered.
- The primary interest rate risk involves low fixed rate mortgages mismatched with the types of shares/borrowing in the credit union and rising interest rates.
- Liquidity risk can occur with high and/or increasing loan to share ratios, holding of loans, and migration of shares.
- Compliance risk is present due to the fact that many consumer compliance regulations are related to real estate lending.
- Transaction risk is related to the complexity of real estate transactions and products.
- Strategic risk is due to the complexity of and foresight involved in planning for the types and amounts of various real estate products.
- Reputation risk to the credit union is impacted by all of the above risks.

Objective 3: Determine what NCUA is doing to mitigate identified potential real estate lending risks.

NCUA appears to be identifying and addressing most potential real estate lending risks. This is evidenced through the issuance of extensive guidance, identification of risk trends in quarterly reports, and statistical data analysis. However, there are a few areas where potential risk may be elevated due to the following:

- A lack of examination documentation in support of examiner loan reviews and consumer compliance reviews; and
- A lack of credit union management planning and oversight in such areas as business plans, asset liability management, and budgeted/planned parameters directly related to real estate lending.

The Office of Examination and Insurance issues real estate lending guidance. Regional examiners review real estate lending programs based upon risk and address safety and soundness concerns. In addition, examination policy and procedures are extensive and provide comprehensive real estate lending guidance. Furthermore, NCUA is actively involved with other federal and state regulators to address the risk of foreclosure due to sub-prime or nontraditional mortgages.

The Office of Examination and Insurance identified the following risk trends in real estate lending in its December 31, 2006, Risk Trends Report:

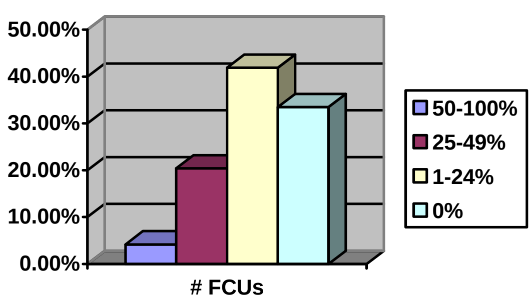
- Continued real estate growth and expansion into more variable rate credit products;
- The majority of loan growth is seen in real estate lending and, if loan growth continues to exceed share growth, liquidity pressures could emerge;
- Without an adequate asset-liability process with the dominant loan category identified as real estate, the level of interest rate risk could be elevated;
- Real estate delinquency has increased, which is counter to the trend in total delinquency; and
- Increasing loan rates may continue to put pressure on consumers to seek fixed rate real estate products as variable rate loans begin to reprice, particularly with any exotic variable rate real estate loans with special balloon options. These loans will continue to pose a higher degree of credit risk.

Call Report Statistical Analysis

We conducted a statistical analysis of federally chartered credit unions with a heavy concentration of real estate loans as of December 31, 2006. Our testing showed that credit unions with a concentration of real estate loans show a no greater overall risk position than all federally chartered credit unions.

We analyzed December 31, 2006, call report data and financial performance ratios for all federally chartered credit unions with real estate loans to assets greater than 50 percent and having at least $100 million in total assets. We identified 97 federally charted credit unions with total assets of at least $100 million and with a heavy concentration of real estate assets; 119 federally charted credit unions with total assets under $100 million with a heavy concentration of real estate assets; and 5,187 total federally charted credit unions at December 31, 2006.

Figure 2 – Percentage FCUs by Real Estate Loans/Assets Ratio



The results of the analysis are as follows:

Overall CAMEL –

- 97.9 percent of the sampled 97 FCUs had a composite 1 or 2 CAMEL rating. Whereas, 78.3 percent of all FCUs had a composite 1 or 2 CAMEL rating. This indicates that overall, these credit unions are in better condition than all other federally chartered credit unions.

Capital –

- 73 percent of the sampled FCUs had a Net Worth ratio lower than their peer average. This indicates that these credit unions do not have as large a cushion of safety as other credit unions within their peer.

Asset Quality –

- 75 percent of the sampled FCUs had Delinquency ratios below their peer average.
- 89 percent of the sample FCUs had Charge-Off ratios below their peer average.
- 67 percent of the sample FCUs had Real Estate Loan Delinquency ratios below their peer average. In addition, 77 percent of the 119 FCUs under $100M had Real Estate Loan Delinquency ratios below their peer averages. These ratios indicate that, at least presently, these credit unions have a lower credit risk compared to their peers.

Earnings –

- 51 percent of the sampled FCUs had a Return on Assets ratio greater than peer. This ratio indicates that these credit unions have earnings relatively equal to their peers.

Asset Liability Management –

- 89 percent of the sampled FCUs have a higher Loan to Share ratio compared to their peers.
- 72 percent of the sampled FCUs have a higher Net Long Term Asset ratio compared to their peers.
- 78 percent of the sampled FCUs have lower Core Shares to Total Shares and Borrowings ratios compared to peer.
- 66 percent of the sampled FCUs have Average Loan Yields below peer.
- 54 percent of the sampled FCUs have a Net Interest Margin below peer. These ratios indicate that the sampled FCUs have an elevated Asset Liability Management risk, primarily in liquidity risk.

Potential Concerns from Testing

During our testing of federally chartered credit unions with the highest concentrations of real estate loans to total loans, some potential audit issues were identified as follows:

- We found a lack of examination documentation in support of examiner loan reviews. For instance, there were several instances where the supporting loan review workpaper(s) were not present in the downloaded examination.
- We found a lack of examination documentation in support of examiner consumer compliance reviews. In reviewing the available documentation we could not determine if examiner consumer compliance reviews were completed. According to the Office of Examination and Insurance and upon examiner inquiry, we learned that there may be no specific consumer compliance review workpapers. Examiner-identified consumer compliance violations should be documented in the examination workpapers.

- We found several instances where Examiners noted and addressed in the workpaper a lack of credit union management planning and oversight in such areas as business plans, asset liability management, and budgeted/planned parameters that directly related to real estate lending.
- We noted indications of potential issues in credit union asset liability management. For instance, planning as mentioned above, mortgage sale issues for liquidity (e.g., approval, expertise), long term asset mismatches, and "hot" shares fueling growth.

It should be noted that it is not NCUA's policy that examiners detail all work that they performed in the course of an examination, so long as the Examiner found that no problems existed. Consequently, while we could not identify all of the examination procedures performed, we could conclude that the examiners were following established procedures.

APPENDIX I – MANAGEMENT COMMENTS

SENT VIA E-MAIL

TO: William DeSarno, Inspector General
Office of Inspector General

FROM: ***J. Leonard Skiles, Executive Director***

SUBJ: Real Estate Lending Survey
Report #OIG-07-07

DATE: September 4, 2007

We agree that an audit of credit union real estate lending is not warranted at this time; however, we have some concerns about comments made in the report. Please find our comments below.

Lack of Documentation

We have reservations with the assertion in the Executive Summary and Results sections of the report (pages 3, 7, and 9) that a lack of examination documentation exists in support of examiner loan and consumer compliance reviews. Under NCUA's current risk-focused examination program, documentation is not required for all areas of review when concerns or risks are not identified in the course of examination or supervision scoping. Additionally, certain review areas may not be included at all in the scope of the examination or supervision contact, based upon the examiner's professional consideration and judgment of existing risk areas. These assessments and the examination steps completed are documented in the scope workbook. Additionally, we have on-going quality control processes in place to evaluate the adequacy of examination documentation.

NCUA's Examiner's Guide indicates that when loan reviews are warranted, an AIRES loan review or self-designed workpaper can be used to support the loan area reviewed, and noted concerns should be documented in the AIRES Loan Exceptions or self-designed workpapers. Likewise, when consumer compliance reviews are warranted or occur as part of the required examination process, examiners are required to document compliance violations in the examination questionnaires, as well as in the compliance violation log. In footnote 1, the report indicates "...examiners were following established procedures..." with regard to examination documentation.

APPENDIX I – MANAGEMENT COMMENTS

Tracking of Subprime Mortgages

One recommendation in the report (page 6) indicated that NCUA management should review the current tracking and reporting of subprime mortgages and determine if these mortgages should be specifically reported on the call report. While we do not object to this recommendation, the Office of Examination and Insurance continually reviews and updates the required reporting content for the quarterly 5300 call report and has previously considered whether to require reporting in this area. A significant barrier to the collection of this data exists. NCUA's definition of subprime lending, which closely matches the definition of subprime lending agreed upon by the federal banking regulators, includes loans made to borrowers who have weak credit histories (e.g., delinquent payments, charge-offs, judgments, bankruptcies), or reduced payment capacity (e.g., high debt ratios or low credit scores). Since no specific empirical definition of subprime lending exists, it would be difficult for credit unions to gauge which loans were subprime and were thus required to be reported if a reporting requirement were enacted.

Thank you for the opportunity to comment. If you have any questions, please contact me.