NCUA LETTER TO CREDIT UNIONS

NCUA LETTER NO. 124

DATE: June 1991

TO THE BOARD OF DIRECTORS OF THE FEDERALLY INSURED CREDIT UNION ADDRESSED:

Real estate secured loans at federally insured credit unions have increased over 137 percent in the last 5 years. This growth is the result of increased demand for real estate secured credit by members, as well as a drop in demand for other "consumer" loans for such items as automobiles.

Although growth during 1990 slowed to a 9-percent rate by yearend, over 34 percent of all loans outstanding to federally insured credit unions were secured by residential real estate. For many credit unions, real estate secured credit is the single largest balance sheet item.

Credit union boards of directors must clearly understand the risks and issues which must be addressed before becoming involved or expanding their involvement in real estate lending. These matters go far beyond the usual credit risk evaluation process required for "consumer" loans. In general, residential real estate loans are granted for larger amounts and for longer terms than "consumer" loans, and cash flow is lower than for shorter term loans. These distinguishing characteristics can create interest rate and liquidity risks. In addition, there is collateral risk that residential property values may drop due to local, regional or national market changes. Finally, diversification risk exists to the extent that the volume of real estate loans held in portfolio becomes a major portion of the credit union's income-producing assets.

Real estate lending is a necessary loan category for many credit unions. These guidelines are not intended to curtail such lending, but rather to clarify areas of risk and concern. NCUA Letter No. 112 and other real estate lending guidelines recently issued by some of the NCUA regional offices are superseded by these guidelines. These guidelines do not apply to "other real estate owned" (OREOs).

Credit unions which deviate significantly from these guidelines are expected to support and justify their policies and practices. The level of expertise expected in developing written real estate lending policies, asset/liability management strategies, use of secondary market conduits and other principles described in this letter shall be directly related to the level of involvement and exposure in real estate loans. Failure to recognize or to properly address the risks involved with residential real estate lending shall be considered an unsafe and unsound lending practice by NCUA examiners. Although this letter is intended to provide guidance and is not a regulatory requirement, we do expect to propose regulatory provisions in the areas of documentation, written lending policies, asset/liability management and staffing within the near future. The need to include additional regulatory provisions will be considered based on a review of examination findings.

The following guidelines apply to credit unions which grant residential real estate loans:

- Written Lending Policies. A written policy must be developed and approved by the board of directors. Policies should be reviewed periodically (at least annually). Since each credit union is unique, there is no single policy that can best serve all credit unions. Each credit union must tailor its policies and procedures to accomplish its goals and to meet the needs of its own members. Nevertheless, all policies should include, at a minimum, the following:

- Types of loans that will be offered, i.e., first mortgage, second mortgage, home equity line of credit, fixed equity, conventional, VA or FHA;

- Loan limits concerning the percentage or amount of assets that will be committed to residential real estate loans. A limit by each loan type is recommended;

- Loan limits concerning the maximum amounts to be made available in aggregate to any single borrower (excluding loans sold into the secondary market);

- Debt ratios used to qualify loan applicants. Due consideration should be given that debt ratios in real estate lending differ from consumer lending and include factors such as the downpayment, LTV ratio, disposable income and market or collateral risk issues;

- Trade area in which residential real estate loans will be offered, consistent with the provisions of the Fair Housing Act; - Qualification and experience requirements of personnel involved in making and administering loans;

- Maximum loan-to-value ratios for the various types of loans made available, including requirements for PMI at certain LTV levels. Provisions for adjusting LTV ratios based on changing market conditions may be appropriate;

- Pricing policy;

- Quality control policies to ensure adequate underwriting, servicing, follow-up and collection procedures; and

- Monitoring policies to assess the interest rate, credit and collateral risks.

- Secondary Market. Although credit unions are not required to sell loans to the secondary market, underwriting standard loans which conform to secondary market investor requirements provide a number of advantages to lenders:

- Standard loans meet proven industry standards which minimize credit risk;

- Standard loans are saleable, providing some protection from interest rate and liquidity risks;

- Standard loans produce improved yield on sale versus nonstandard products; and

- Standard loans are widely accepted by consumers (members) as the industry norm - simplifying marketing efforts.

Nonstandard loans should be limited to those which the credit union is safely able to hold to maturity, including asset/liability management concerns. The determination of "able to hold" should consider the level of capital in a credit union. Interest rate and liquidity risk are virtually eliminated for loans which are immediately sold into the secondary market. For loans that are not sold, these risks can be managed effectively by granting loans which are saleable into the secondary market and by careful adherence to an asset/liability management program which measures risk and indicates the point at which loans should be sold to minimize losses.

Writing loans to secondary market investor requirements does not require that a credit union qualify as a seller/servicer or master seller with one of the two dominant participants in the secondary market, the

Federal National Mortgage Association (FNMA) or the Federal Home Loan Mortgage Corporation (FHLMC). Loans may also be sold to other mortgage conduits, including some who are credit union service organizations (CUSOs).

- Asset/liability Management. Credit unions engaged in residential real estate lending should adopt an asset/liability management policy that addresses, at a minimum, the rate sensitivity of the balance sheet, asset/liability maturity matching, liquidity and cash flow needs and interest rate risk. Examiner's have noted several instances where mortgage programs funded by high cost certificates of deposit have resulted in serious liquidity and interest rate mismatches. It is advisable to develop simulation models to test the effect of reasonable interest rate fluctuations on profitability and capital adequacy. Contingency plans should be considered to determine when and if loans should be sold in order to maintain cash flow, liquidity and profitability.

- Fixed Rate Loans. Because of the high level of interest rate risk, fixed rate long-term mortgages should only be carried by credit unions that have made them in conjunction with an ALM plan that is well thought out, carefully executed and regularly reviewed. Future saleability is an important factor with fixed rate loans.

- Adjustable (Variable) Rate Loans. The short repricing periods of adjustable rate loans (and balloon mortgages) help to reduce interest rate risk. However, infrequent adjustment periods with annual and lifetime interest rate caps mean that interest rate risk is not entirely eliminated. Balloon mortgages carry an additional risk of default during periods of rising interest rates because a borrower's ability to repay at the higher rate is limited. Interim monitoring of these loans is necessary. In addition, these loans are limited by the fact that their low interest rates mean lower earnings. Further, the low first-year rates that are offered to attract borrowers can mean negative earnings for a year, or longer, under some circumstances.

- Staffing. Credit union personnel who underwrite and administer residential real estate loans should be adequately trained and experienced prior to becoming involved with this type of lending. The use of untrained or inexperienced personnel shall be considered an unsafe and unsound lending practice. Credit unions may want to consider the use of qualified outside underwriters to review loans before closing to ensure that secondary market standards are met.

Following are some of the issues that must be considered to ensure that loans meet secondary market standards:

- Documentation - Uniform Instruments. Uniform instruments, as accepted by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), FNMA and FHLMC, are highly recommended. Use of other documents may be appropriate when the underlying loan is subject to sale to the secondary market and the contracting investor has stipulated the documentation which will be required. In general, most secondary market investors insist on the use of Uniform Instruments.

- Appraisals. Part 722 of the NCUA Rules and Regulations pertains to appraisal requirements. After January 1, 1992, an appraisal by a licensed or certified appraiser, as appropriate, is required for each residential real estate loan over $50,000. Transactions of $50,000 or less require a written estimate of value performed by an independent, qualified individual. Credit unions must ensure that the appraiser is competent to perform the work assigned. This requires investigation concerning the training and experience of the appraiser. Note, however, that for loans to be saleable on the secondary market, the appraisal must be completed by a licensed or certified appraiser, regardless of amount.

- Loan-to-Value (LTV) Ratio Limits. LTV limits should be established. For conventional loans, the maximum LTV permissible should be no greater than 80 percent of the lower of the appraised value or sales price unless private mortgage insurance (PMI) is obtained. The PMI should be obtained from a company acceptable to the credit union and to established secondary markets. On government insured loans, the LTV may not exceed the applicable FHA or VA guidelines.

- Credit Reports. Credit unions should normally obtain a credit report before granting a residential real estate loan. Credit reports should be acceptable to the established secondary market. Typically, secondary market investors require the use of a "residential mortgage credit report" as opposed to an "in file" credit report.

- Hazard Insurance. A hazard insurance policy, naming the credit union as loss payee, should be required on all residential real estate loans. The policy should be in the amount of the original loan balance or the replacement value of the structure, whichever is less. Coverage should be sufficient to pay the mortgage balance including prior liens, if any.

- Grace Periods and Interest Calculations Basis. Residential real estate loans documented for possible sale in secondary markets should have interest calculation bases acceptable to those markets. Generally, to satisfy this objective, loans must be based on a 30-day month/360-day year interest calculation basis and have a 15-day grace period. Use of a 30-day month, 15-day grace period and a late payment fee is consistent with member expectations, easier to administer and also facilitates future sale of the loan, if that should become necessary.

- Title Search and Abstract. A title search or abstract must be performed prior to the closing of all residential real estate loans to ensure that there is enough unencumbered equity in the property to secure the loan.

- Title Insurance. Credit unions which desire to originate first mortgage loans for possible sale into established secondary markets must obtain a lender's title insurance policy. Even if loans are not intended for sale, credit unions should consider the benefits of requiring lender's title insurance to protect the credit union's interests. Title insurance is also encouraged on second mortgage loans.

- Indexes for Adjustable Rate Loans. The index used to establish the rate for adjustable rate loan programs should be acceptable to secondary markets and appropriate to the type of loan granted. Use of internal indexes for adjustable rate loans are normally not acceptable to secondary market investors or consumers. Finally, margins over the index should be acceptable to the secondary market.

In addition to policies and practices generally required by the secondary market, credit union real estate lending programs should also address the following:

- Construction Loans. Loans should be limited to those which finance the acquisition and construction of a member's principal residence. Construction involves the risks associated with the uncertainties of building. These loans carry a higher risk of default and, therefore, entail more extensive underwriting and administration than financing completed homes. Construction loans are expected to meet, at a minimum, the following requirements:

- Detailed cost estimates and building plans should be obtained from the member before approval of the loan; - An evaluation of the quality of the builder including financial stability, experience, and track record should be performed. Builder's risk insurance should be considered; - Building permits should be acquired prior to disbursal of loan proceeds; - The member should provide substantial equity in the project (30 percent is suggested) consisting of funds or land value. The members' funds should be used before disbursing the proceeds of the loan. Loans involving unimproved land are considered highly speculative and lower LTV ratios should be required (50% to 60%); - An appraisal, meeting the requirements of Part 722 of the NCUA Rules and Regulations, must be obtained before approval, based on an "as is" condition, and as if completed to specified plans; and

- Funds must be released in stages based on the percentage of the home's completion, verified by on-site inspections. On-site inspections should be made only by qualified individuals, such as the original appraiser, independent of the underwriting function of the credit union. Before disbursing "draws", credit unions should consider updating the title search to ensure that the title remains clear.

- Compliance with Consumer Protection Laws. Residential real estate loans are subject to a number of special provisions concerning consumer protection. These include requirements of the Home Mortgage Disclosure Act, the Truth in Lending Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Flood Disaster Protection Act and the Real Estate Settlement Procedures Act, including the recent disclosure provisions regarding a change in loan servicers. Other requirements may also apply including state provisions and Internal Revenue Service reporting requirements. Credit unions involved with residential real estate lending must ensure that the provisions of these laws are met before granting such loans. Home equity line of credit loans (HELOCs) require the same careful underwriting and administrative attention that is required of closed end loans (first and second mortgages, fixed equity loans). The following guidelines specifically apply to HELOCs:

- Written Lending Policies - The guidelines applicable to closed end loans apply equally to HELOCs. - Secondary Market - HELOCs are generally not saleable at this time; therefore, standard underwriting standards are not available. - Asset/liability Management - The guidelines applicable to closed end loans apply equally to HELOCs. - Staffing - The guidelines applicable to closed end loans apply equally to HELOCs. - Documentation - Uniform Instruments are not available. Credit unions should ensure that documents meet all state and federal laws. - Appraisals - Part 722 of the NCUA Rules and Regulations applies equally to HELOCs.

- Loan-to-Value (LTV) Ratios - LTV limits should be established. - Credit Reports - A credit report should be obtained prior to granting the loan. - Hazard Insurance - A hazard insurance policy, naming the credit union as loss payee, should be required. The policy should be in an amount sufficient to pay the maximum credit line granted, including any prior liens. - Title Search and Abstract - A title search or abstract must be performed prior to closing the loan. - Title Insurance - Credit unions are encouraged to consider the benefits of title insurance in connection with HELOCs. - Indexes for HELOCs - The use of an internal index is not permissible under the Federal Truth in Lending Act. Indexes selected should be outside of the control of the credit union, and readily available to the public.

The secondary market for home equity loans is extremely limited; therefore, these products require careful underwriting and administration in order to avoid creating undue levels of risk. HELOCs generally feature long draw periods (up to 10 years) and extended repayment periods (5 years after the end of the draw period). Credit unions should tailor HELOCs to meet the needs of the members and the ability of the credit union to manage such programs.

Payments should be required at least quarterly, if not monthly. Repayment terms should call for regular principal and interest payments over the term of the loan and should provide for full amortization within a reasonable period after the close of the "draw" period. Credit risk can be managed by monitoring draws and repayments to ensure that, at the end of the draw period, borrowers have the capacity for repayment and sufficient collateral in case they can't pay. Agreements should allow for the periodic review of creditworthiness and collateral suitability.

In summary, real estate lending is a valuable service to credit union members and an important part of many credit union lending programs. Careful management of the risks associated with real estate lending is an important factor in creating a successful and profitable lending program. NCUA is committed to helping credit unions better understand and manage these risks. These guidelines provide a foundation for safe and sound real estate lending.

For the National Credit Union Administration Board,

Roger W. Jepsen
Chairman