

	A	B	D
3	Outsourced Lending Relationships		
4	INTRODUCTION AND PURPOSE		
5	Background	Yes/No	Comments
6	1. Identify the third-party company(ies) or firm(s) with which the credit union outsources lending.		
7	2. Describe the scope of services provided by the third party.		
8	3. Does the credit union have reasonable rationale for outsourcing the services described above?		
9	Planning	Yes/No	Comments
10	1. Has the credit union performed a cost/benefit analysis to determine the need to outsource to a third party?		
11	2. Has the credit union evaluated the costs of monitoring, or providing support to, the third party (e.g., staffing, capital expenditures, communications, and technological investment)?		
12	3. Has the credit union considered the risks involved with outsourcing operations to a third party?		
13	4. Has the credit union determined a course of action should the third-party not be able to perform its responsibilities and does it have the ability to execute this course of action?		
14	5. Has the credit union performed a due diligence review and provided a formal written report to the board prior to executing an agreement with a third party, including:		
15	(a) Contacting references?		
16	(b) Evaluating the third party's expertise and operational capacity to meet its responsibilities?		
17	(c) Engaging legal counsel to review all contracts to understand each party's rights and responsibilities?		
18	(d) Evaluating the financial condition of the third party prior to any contract commitment and at least annually thereafter to determine that it will remain a going concern?		
19	(e) Reviewing financial audits conducted by independent parties?		
20	(f) Reviewing operational audits (including SAS 70 audits) conducted by independent third parties?		
21	(g) Reviewing the credit union's insurance requirements?		

	A	B	D
3	Outsourced Lending Relationships		
22	(h) Contacting oversight agencies (e.g., Federal Trade Commission, Better Business Bureau, other regulators) to determine whether the business is in good standing?		
23	6. Does the credit union's internal or external audit scope provide for a comprehensive, independent review of any outsourced lending activities?		
24	Policies & Procedures	Yes/No	Comments
25	1. Do the credit union's policies (e.g., lending, collecting, ALM) appropriately address the outsourced relationship?		
26	2. Do policies place limits on loans originated or serviced by the third party based on:		
27	(a) Total loans outstanding?		
28	(b) Type of loan?		
29	(c) Collateral?		
30	(d) Credit quality?		
31	Monitoring	Yes/No	Comments
32	1. Are reports prepared on a monthly basis that adequately reflect the amount of activity with the third party and do reports provide sufficient information to properly monitor the activities?		
33	2. Are informative summary reports provided to senior management or the board of directors?		
34	3. Has the credit union assigned appropriate staff to oversee the outsourced relationship to determine compliance with responsibilities and contracts?		
35	4. If the third party originates loans, does the credit union verify the loan documents with the borrower?		
36	5. If the third party services/collects loans, does the credit union receive periodic reports on the loan portfolio?		
37	(a) Are reports received and reviewed timely?		
38	(b) Do they contain sufficient information to determine how the portfolio is performing?		
39	(c) Do report balances agree with the credit union's trial balances?		
40	(d) Do reports reflect quality collection efforts?		
41	6. Does the credit union control account verifications?		
42	7. Does the credit union verify that the outsourced party's reports are accurate?		

	A	B	D
3	Outsourced Lending Relationships		
43	8. If the third party services loans, does the credit union verify that member payments are remitted to the credit union in compliance with the contract?		
44	9. Are funds received by the servicer required to be deposited in a trust account for the credit union's behalf? Alternatively, does the servicer use a third party "retail lockbox?"		
45	10. Are there reports received that show that returned or bounced payments are reversed, the loan re-aged, and any servicing fees are reversed?		
46	Legal	Yes/No	Comments
47	1. Does the credit union have a legal opinion on the contracts executed between the credit union and the third party?		
48	2. Is the credit union familiar with the rights, responsibilities, and obligations of both parties?		
49	3. Can the credit union terminate contracts for non-compliance or non-performance by the third party at a reasonable cost?		
50	4. Does the written contract:		
51	(a) Describe the duties, responsibilities, and specific performance standards of each party including the scope of the arrangement?		
52	(b) Specify that the third party comply with applicable laws and regulations?		
53	(c) Specify which party will provide consumer compliance-related disclosures?		
54	(d) Authorize the credit union to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the credit union?		
55	(e) Require the third party to indemnify the credit union for potential liability resulting from action of the third party with regard to the lending program?		
56	(f) Address member complaints including any responsibility for the third party to respond to such complaints or forward them to the credit union?		
57	(g) Specify limitations on extensions, deferrals, renewals, or rewrites of loans, if applicable?		
58	(h) Specify which party physically holds original loan documents including, for example, applications, security agreements, and vehicle titles?		

	A	B	D
3	Outsourced Lending Relationships		
59	(i) Require that the credit union be named as holding a perfected security interest in, for example, a vehicle held as collateral?		
60	Insurance	Yes/No	Comments
61	1. Did the credit union request evidence of current insurance coverage for third party employees?		
62	2. Does the third party purchase loss protection insurance (e.g., GAP insurance) or collateral protection insurance on behalf of the credit union as part of a servicing agreement?		
63	(a) Does the credit union review the financial strength and claims paying ability of the insurer?		
64	(b) Is the credit union named as beneficiary on the policy?		
65	(c) Will the credit union retain coverage in the event the arrangement with the third party is terminated?		
66			

Cell: A4

Comment: Introduction and Purpose

Third party relationships provide credit unions with greater flexibility in offering loans to members. Typically, a credit union will contract with a third party to originate or service loans. These partnerships permit a credit union to implement loan programs more quickly than if the program was administered in-house, outsource experience or technology it does not possess, and enable the credit union to pilot a loan program so it can evaluate it prior to implementation.

However, outsourcing can also expose the credit union to risk, and result in unprofitable ventures if the credit union does not conduct proper oversight. The purpose of this guidance is to assist an examiner in determining whether the credit union is managing its third party lending relationship in a sound manner.

To fully evaluate an outsourced lending program, examiners are encouraged to complete this questionnaire in conjunction with any companion questionnaires focused on the underlying loan program, e.g. indirect lending.

Cell: A8

Comment: Background #3

The credit union should provide rationale for outsourcing the service. Reasons may include costs, inexperience, or lack of technology. However, as the following questions will indicate, outsourcing does not absolve the credit union from properly overseeing the duties performed by the third party.

Cell: A10

Comment: Planning #1

The credit union should thoroughly investigate the costs it would bear to internally perform the duties outsourced. This should be compared with the expected costs and fees incurred if outsourced. Because costs can change (e.g., dependent upon the volume of activity), the analysis should consider alternative scenarios.

In its analysis, the credit union should also consider the costs and benefits from an economic standpoint, not from an accounting standpoint. The credit union should look at the timing of actual cash flows, instead of how GAAP may permit a credit union to amortize costs or fees over time.

For example, a third-party may require fees to be paid up front for services to be performed in the future. If the credit union performed the service internally, it would pay for costs as they were incurred. By paying an up-front fee to the third party, an opportunity cost is borne by the credit union — it could have invested the funds to generate income, for example.

Also, fees may not be refundable leading to write-offs. For example, a company may charge \$500 to originate and service a loan for a credit union. If the loan prepays rapidly, the credit union will have paid a \$500 premium for little economic benefit.

Cell: A11

Comment: Planning #2

When evaluating the cost of outsourcing, the credit union should include costs that it will bear to meet its obligations or foster the relationship. This may include staffing costs associated with monitoring the third party's operations, costs that are passed on to the credit union because they are not covered under the base fee, investments in technology, and additional fees for optional services.

Preferably, the credit union will calculate its expected return on investment in terms of economic yield (e.g., bond equivalent yield [BEY]). Some credit unions may estimate returns on investment simply by estimating accounting income. This methodology is flawed for it generally does not account for the time value of money and is based on accounting cash flows (e.g., amortizing

premiums/discounts over time) instead of actual cash flows.

For example, assume a credit union pays a firm \$100 up front fee per originated loan. This fee reflects a premium paid for the loan. From an accounting standpoint, a credit union may amortize the premium over the life of the loan. Therefore, the “cost” of the premium is mitigated by time. From an economic standpoint, the upfront fee represents a cash outlay today and incurs an opportunity cost to the credit union. This reduces the total return on the originated loan.

Cell: A12

Comment: Planning #3

Risks include lack of total control over operations, lack of direct interaction with members, failure of the third party to meet expectations or contractual responsibilities, reputation risk (should the third party mistreat members), an inability to terminate a relationship that has soured, and liabilities incurred by the third party that may transfer to the credit union (for example, consumer compliance violations).

Cell: A13

Comment: Planning #4

This could lead to the credit union taking over responsibilities that it is not prepared or trained to do. For example, servicing sub-prime loans requires staff with special skills and experience which a credit union may not possess. Failure of the third party servicer could result in significant loan losses to the credit union.

The credit union should also consult legal counsel to determine what action it must take to settle such contractual issues as rescinding outstanding contracts, requiring performance from the third party, settling unpaid fees or obtaining refunds from amounts already paid.

Cell: A14

Comment: Planning #5

Letter to Credit Unions No. 01-CU-20, Due Diligence Over Third Party Service Providers, outlines several elements essential to evaluating a prospective partner.

Cell: A15

Comment: Planning #5(a)

The credit union should request a list of current references, and if possible, a list of clients that have terminated their relationship. The credit union should contact several of the listed references. This can assist the credit union in better understanding how the relationship will succeed, or what pitfalls it may encounter.

Cell: A16

Comment: Planning #5(b)

The credit union should interview several prospective firms to determine which is best qualified to meet its needs. Also, by interviewing several firms, the credit union may better understand the weaknesses of the candidates.

If the credit union is planning on establishing a relationship that will require a significant investment of resources and capital, it should consider hiring a consultant or industry expert to assist in its evaluation.

Cell: A17

Comment: Planning #5(c)

Legal review helps the credit union develop contracts that are fair to both parties. It is imperative the credit union understand what actions it may take in case the third party does not meet expectations or contractual responsibilities.

Cell: A18

Comment: Planning #5(d)

If the third party is a startup company, or is not financially strong, it raises questions whether it will remain in business over the term of the contract. Preferably, the credit union should only do business with well-established and financially-secure third parties.

If a less-established company is considered, the credit union should be certain the third party's failure will not significantly disrupt business. Appropriate contingency plans should be developed to address the potential failure of a third party performing outsourced services (e.g., discontinuing the service, performing the service in-house, or finding a new partner).

Deterioration in a third party's financial condition can lead to failure to perform, resulting in losses to the credit union. Regular monitoring of a third party's financial condition enables the credit union to identify emerging problems and to pursue other alternatives.

Cell: A19

Comment: Planning #5(e)

Audits provide the credit union with a level of assurance that the third party has fairly presented its financial condition. Based on audited financial statements, a credit union can determine the third party's financial stability and project its future ability to perform under the terms of the contract.

Cell: A20

Comment: Planning #5(f)

A SAS 70 audit refers to a situation where a third party performs only certain agreed upon procedures. For example, an auditor may be hired to determine that the controls implemented by a company are being followed. To understand its scope and limitations, an examiner should look to the engagement letter. Following the aforementioned example, the scope may not require the auditor to ascertain whether the company's system of controls is sufficient or to recommend additional controls.

These audits provide the credit union with another level of assurance that the third party can perform the duties expected of it.

Cell: A21

Comment: Planning #5(g)

Third party relationships can expose the credit union to additional liability that merits insurance coverage. The credit union should review its policies and coverage with the appropriate agents.

Cell: A22

Comment: Planning #5(h)

Agencies such as the FTC and Better Business Bureau may provide insightful information regarding complaints filed against the third party or improper practices.

Cell: A23

Comment: Planning #6

The credit union should determine that its internal or external audit reviews independently assesses the outsourced lending activity to ensure, among other things, the integrity of the records, particularly with respect to payment processing.

Cell: A25

Comment: Policies & Procedures #1

When outsourcing duties, the credit union must continue to maintain adequate controls over those functions. Policies should set forth limits and responsibilities that must be followed.

Cell: A26

Comment: Policies & Procedures #2

Policy limits shape the risk tolerance of the credit union. They also alert the third party to restrictions on certain types of programs. Otherwise, the third party may be inclined to engage in the business activity that generates it the most revenue.

Cell: A27

Comment: Policies & Procedures #2(a)

For new loan programs and/or new third party relationships, loan limits are especially prudent. They enable the credit union to evaluate performance prior to engaging in a significant volume of activity before all risks/costs/pitfalls are known.

Cell: A28

Comment: Policies & Procedures #2(b)

Limitations by loan type prevent unacceptable concentration risk. Concentrations can be by type of loan (secured, unsecured, type of collateral). Concentrations can also be by geographic area, by the credit quality of the loan (A, B, C, or D rated paper), by amount, etc.

Cell: A29

Comment: Policies & Procedures #2(c)

Limits ensure the credit union is not approving significant concentrations of collateral. For example, the credit union may prefer loans backed by new autos over those backed by used autos due to projected recoveries or loan performance.

Cell: A30

Comment: Policies & Procedures #2(d)

The credit union must monitor the quality of loans being originated to understand its credit risk exposure. Prudent limits control risk exposure.

Cell: A32

Comment: Monitoring #1

The credit union must monitor the performance of the third party relationship to determine compliance with expectations and contractual agreements. If deficiencies in performance are noted, a process to notify the third party of inadequate performance and to request corrective action should be implemented.

Cell: A33

Comment: Monitoring #2

Senior management and the board must be kept abreast of significant developments. The scope and content of reports should reflect the materiality of the program in relation to the credit union's earnings and net worth. Summary reports should provide enough information to be meaningful and from which management can make sound decisions.

Cell: A34

Comment: Monitoring #3

Failure to monitor the third party can lead to significant risk and losses. Further, the credit union may not recognize breaches of contract. Appropriate senior-level staff should be assigned to monitor compliance.

For example, if the third party servicer fails to repossess collateral in compliance with established

timeframes, the credit union may incur a greater loss on sale or risk not being able to locate collateral.

Cell: A35

Comment: Monitoring #4

It is prudent for a credit union to verify, on at least a sample basis, loan documents, including the application, note, and income/employment information. This is a control to verify the documentation is accurate, and the loan is genuine.

Cell: A36

Comment: Monitoring #5

The credit union should receive monthly reports detailing such information as the portfolio loan balance, credits and debits to borrower accounts, and delinquency status.

At a minimum, the content of reports should be of the same degree of detail that the credit union would expect if it was performing the function in-house. For example, the credit union may expect stratified delinquency reports by origination date, loan program and type, and collateral type.

Cell: A37

Comment: Monitoring #5(a)

Reports should be received no less frequently than monthly. Controls should be in place that require staff oversight.

Cell: A38

Comment: Monitoring #5(b)

The credit union should be able to assess the credit performance of the portfolio, including the aging of delinquency. Reports should also indicate the status of collection activity on each account and recent payment history. This information will help the credit union identify its potential losses and adequately fund the ALLL.

Cell: A39

Comment: Monitoring #5(c)

Balancing the servicer and credit union reports is a basic, but important control to ensure that all member payments are credited properly and all loans are accounted for.

Cell: A40

Comment: Monitoring #5(d)

Collection reports should be reviewed to determine that timely and appropriate actions are taken to protect the interests of the credit union. The credit union should ensure that promises of payment are followed up on and that consistent contact is made with the delinquent borrower.

Cell: A41

Comment: Monitoring #6

As an internal control, the credit union should control the issuance and receipt of all member account verifications. The servicer should be prohibited from this responsibility. Critical attention should be paid to confirmations returned for bad addresses, or accounts containing the servicers address.

Cell: A42

Comment: Monitoring #7

The credit union should sample the individual transactions or member accounts to verify accuracy. For example, the credit union may reconcile reports with payments actually received from the servicer, recalculate delinquency, and determine that payments are properly credited to borrowers' accounts. Errors should be brought to the attention of a supervisor, and if errors are material or chronic, then senior management and/or the board should be notified.

Cell: A43

Comment: Monitoring #8

It is imperative the credit union monitor the flow of member payments between the member, the servicer, and the credit union. Until payment is received by the credit union, the servicer is earning float, and more importantly, the credit union is exposed to credit risk—the risk that the servicer will fail or otherwise abscond with funds.

Cell: A44

Comment: Monitoring #9

The credit union must ensure member payments are not commingled with the servicer's funds. This prevents inaccurate record keeping and loss to the credit union should the servicer fail or be subject to litigation. As a control, the credit union should require payments collected by the servicer be deposited and accounted for in a separate account that is held for the benefit of the credit union.

A better method for receipt of payments is to have an agreement for a "retail lockbox." This method has the borrower send payments directly to the bank. The bank opens and records the payment and sends the records to the servicer and/or credit union. Independent third party control of funds is achieved.

Cell: A45

Comment: Monitoring #10

Payments that are returned or bounced must be reversed and the loan re-aged to before the payment was credited. Some servicers may assess servicing fees based on payments received. In this case, the credit union should ensure that the servicing fee is credited back to the credit union since a payment was not "technically" received.

Cell: A47

Comment: Legal #1

As with any third party relationship, the credit union must understand its rights, responsibilities, and liability under any executed agreement. Legal review can also assist the credit union in changing language that may be unfairly biased in the third party's favor. The legal review should be performed and documented by a party familiar with contract law prior to the credit union signing any contracts. Lack of a formal, documented legal review indicates a deficiency in the credit union's due diligence review.

Cell: A48

Comment: Legal #2

Management should be aware of each party's contractual obligations (e.g., days between approval of loan by third party and receipt of loan documentation in house), and how management may terminate the contract if the performance expectations or contract obligations are not met. Unfamiliarity with such concepts, may indicate the credit union is not monitoring the program.

Cell: A49

Comment: Legal #3

Determine how costly termination of the contract may be to the credit union. If poorly structured, the credit union may not be able to terminate the contract without significant cost, or in a timely manner.

Long-term servicing commitments by the third party may be a source of loss to the credit union if a contract does not allow for exit. Despite non-performance, the credit union may need to continue paying servicing fees if no exit clause exists.

Cell: A50

Comment: Legal #4

The credit union should have a written contract with the third party that describes, in detail, the

specific duties, responsibilities, and performance standards of each party. It should be reviewed by legal counsel to ensure the credit union's interest are adequately protected and it should be periodically reviewed, especially in light of changing business conditions. The following list is not all-inclusive, however, the credit union should, at a minimum, determine the appropriateness of each item.

Cell: A56

Comment: Legal #4(f)

If the credit union is not responsible for handling the complaints, it should receive copies of member complaints along with the service provider's response.

Cell: A58

Comment: Legal #4(h)

Generally, the credit union should hold the original loan documents. If the credit union does not hold the original documents, the servicing agreement should specify that they are held in trust by an independent party (separate from the servicer).

Cell: A59

Comment: Legal #4(i)

The contract should specify that the credit union is named as lien holder on a title to a vehicle and not the servicer, for example. This further protects the credit union's interests in the collateral securing a loan in the event the borrower defaults.

Cell: A61

Comment: Insurance #1

Insurance coverage, including fidelity and errors and omission coverage, should be carried by third parties providing services to a credit union. It should also cover subcontractors, if applicable. Coverage amounts should be sufficient to mitigate risk associated with the loan services provided by the third party. The credit union should establish a process to confirm the continued maintenance of insurance coverage on a regular basis.

Cell: A62

Comment: Insurance #2

When loss or collateral protection insurance is purchased by a third party as part of a servicing agreement, the credit union should obtain legal counsel's review to ensure the coverage will be maintained and the credit union will receive future insurance payments if the servicing arrangement with the third party is terminated. In addition to the maintenance and payment of collateral protection insurance, the credit union should be certain that collateral protection insurance payments are amortized in accordance with applicable state laws and loan contracts.

The credit union should also review the financial standing and claims paying ability of the insurer. Failure of the insurer could render the policies worthless.

Cell: A63

Comment: Insurance #2(a)

The claims paying ability of insurance companies is rated by third party organizations. This rating should be reviewed as part of the financial strength of the company.

	A	B	D
3	Indirect Lending Controls		
4	INTRODUCTION AND PURPOSE		
5	Planning/Evaluation	Yes/No	Comments
6	1. Does the credit union's business plan address its indirect lending program?		
7	2. Has the credit union evaluated the financial condition and operational structure of participating dealerships?		
8	3. Has a cost/benefit analysis been performed and is it updated at least annually?		
9	4. Is the indirect lending program specifically addressed in the credit union's asset liability management program?		
10	5. Has the credit union evaluated its dealer compensation program to make it competitive, yet fair to members?		
11	6. Is the credit union monitoring indirect lending growth in relation to its strategic plan and appropriateness to its balance sheet?		
12	7. Does the credit union compile data capturing whether additional services are used by the new members they acquire through indirect lending?		
13	Policies & Procedures	Yes/No	Comments
14	1. Has the credit union developed policies and procedures specifically addressing the indirect lending program?		
15	2. Do policies and procedures address:		
16	(a) Limits?		
17	(1) Volume of indirect loans originated in a given month or period (at least until a program is seasoned)?		
18	(2) Total indirect loans outstanding?		
19	(3) Total loans outstanding to any one dealer?		
20	(4) Total loans per credit quality of the individual borrower (e.g., A, B, C, or D rated loans)?		
21	(5) Total loans outstanding per program?		
22	(6) Credit rating score ranges for A, B, C, and D rated loans?		
23	(b) Reporting requirements to senior management and the board of directors?		
24	(c) Standards for approving dealerships, including at least annual updates of both the dealership's on-going qualifications and the standards?		
25	(d) Dealership compensation?		
26	(e) Dealer reserves?		
27	(f) Recourse provisions?		
28	(g) Documentation standards?		
29	(h) Maximum financing amount per vehicle, including dealer add-ons (e.g., extended warranties, "rust-proofing")?		
30	(i) Creditworthiness requirements?		
31	(j) Qualification under the field of membership?		
32	3. Are the indirect lending policies and procedures being followed?		

	A	B	D
3	Indirect Lending Controls		
33	Legal	Yes/No	Comments
34	1. Is there a comprehensive written dealership agreement with each participating dealer that addresses the rights, duties, obligations, and recourse of the dealer and credit union?		
35	2. Does the credit union have a legal opinion on file regarding the indirect lending program's:		
36	(a) Dealership agreement?		
37	(b) Loan documents?		
38	(c) Consumer compliance?		
39	3. Is the loan assigned to the credit union very soon (within 7 days) after the dealer and member sign it?		
40	Controls	Yes/No	Comments
41	1. Is the credit union's staff adequately trained and experienced in indirect lending?		
42	2. Did the credit union establish creditworthiness and documentation standards for dealers and does the credit union verify that dealers are complying with them?		
43	3. Does the credit union verify collateral values?		
44	4. Does the credit union verify the sales contract with the borrower?		
45	5. Does the credit union retain the right of final approval before the loan is funded?		
46	6. Does the credit union verify field of membership (FOM) eligibility prior to granting an indirect loan?		
47	7. Does the credit union compare the information on the final paperwork to the original information?		
48	8. Is all title work and lien placement controlled or verified by the credit union?		
49	9. Are loan payments made directly to the credit union rather than to the dealer?		
50	10. Does a quality rating system exist for the dealer and is it appropriately applied to fund dealer reserve and holdback accounts?		
51	11. Are controls in place to ensure that charges are not made to the dealer's reserve accounts to disguise delinquent accounts?		
52	12. Are dealer fees/commissions paid by credit union draft, wire, or direct deposit into a dealer account?		
53	13. Are controls in place to ensure the dealer is not making loan payments to disguise delinquent accounts?		
54	14. Are duties properly segregated at the credit union?		
55	15. Does the credit union have a dealer liaison position or clear procedures to market specific dealers?		
56	Monitoring	Yes/No	Comments
57	1. Is management monitoring the indirect lending program?		
58	2. Are reports generated that track each dealer regarding:		

	A	B	D
3	Indirect Lending Controls		
59	(a) Applications submitted, approved, conditioned, and denied?		
60	(b) Total loans outstanding?		
61	(c) Delinquency?		
62	(d) First payment defaults?		
63	(e) Repossessions?		
64	(f) Charge-offs?		
65	(g) Average loan to value?		
66	(h) Average loan term?		
67	(i) Average credit score?		
68	3. Is the board of directors provided information pertaining to the indirect lending program (loans processed, approved, rejected, booked, delinquency, repossessions, etc.) on a periodic basis?		
69	4. Are the loan approvals monitored to ensure members are qualified for the correct loan program?		
70	Collections	Yes/No	Comments
71	1. Does the collection department have adequate expertise in repossessing and disposing of vehicles?		
72	2. Is the collection department adequately staffed?		
73	3. Does the credit union have adequate systems for managing delinquency?		
74	4. Does the Allowance for Loan and Lease Losses adequately include an estimate for probable, incurred losses inherent in the indirect loan program?		
75	5. Does the credit union purchase collateral protection insurance?		

Cell: A4

Comment: Introduction and Purpose

Indirect lending is where a credit union contracts with a merchant to originate loans at the point of sale. Typically, credit unions will partner with automobile dealerships. Indirect lending can be a successful and profitable venture as long as the credit union manages the program within prudent constraints.

The purpose of this questionnaire is to assist the examiner in determining whether the credit union is following sound business practices regarding its indirect lending program. Further guidance may be found in Chapter 10 of the Examiner's Guide.

Cell: A6

Comment: Planning/Evaluation #1

When engaging in indirect lending, a credit union should evaluate whether indirect lending is compatible with the credit union's risk tolerance, administrative capabilities, and strategic goals. The impact on the credit union's financial performance (e.g., profitability, capital, asset quality, balance sheet risks) should be determined. Failing to perform this analysis indicates management is not managing and controlling the program.

What should a business plan include?

A detailed business plan should define terms, state the purpose of the program (e.g., obtain new members, purchase loans, etc.), establish internal controls (e.g., segregation of duties, procedures for monitoring program results and dealer participation), set standard fee/commission computations, establish minimum requirements for dealer contracts, and outline a marketing strategy to maintain a good relationship with dealers.

Cell: A7

Comment: Planning/Evaluation #2

To minimize potential liability, a credit union should evaluate the stability of the dealership prior to entering into a business relationship, and on an on-going-basis thereafter. The credit union's analysis should be documented and available for review.

Factors to consider include the dealership's reputation, number of years in business, financial condition and financial audits, and third-party information (e.g., Dun and Bradstreet, Better Business Bureau). Unless the credit union has extensive experience with indirect lending, independent dealerships may be best avoided because they may not have the financial backing of an auto maker and may not have the administrative capability to engage in indirect lending.

In general, independent used car dealerships are riskier ventures (compared to new car dealerships associated with the major manufacturers). They are typically small businesses; therefore, they may not be going concerns, possess the operational resources to administer an indirect lending agreement, or adopt industry practices. However, a credit union with extensive experience in indirect lending may have the expertise to identify independent used car dealerships that would prove worthy partners.

When starting a program, the credit union may consider using only one or two experienced and reputable new car dealers in its area. As the program seasons, the credit union may slowly expand dealer participants.

Cell: A8

Comment: Planning/Evaluation #3

The benefits of engaging in indirect lending include generating more loan volume, increasing membership, cross-selling other credit union services, and permitting centralized operations. Direct costs include the dealership fee/commission. Disadvantages may include potential dealership fraud or

misrepresentation, increased loan losses, uncontrolled growth, and lost income from add-ons sold by dealership (e.g., loan protection insurance). Further the reputation of the credit union may be at risk if the member has an unpleasant experience with the dealer.

Because the indirect relationship will be dynamic, the credit union must update its analysis periodically, no less frequently than annually.

Cell: A9

Comment: Planning/Evaluation #4

Because indirect lending can lead to rapid growth, a credit union's balance sheet structure can change rapidly as well. This can translate into a different risk profile. Therefore, the credit union should evaluate interest rate and liquidity risks associated with indirect lending as part of its ALM analysis.

Cell: A10

Comment: Planning/Evaluation #5

Dealers are typically compensated in the form of a flat fee or by an interest rate markup. In the case of an interest rate markup, the credit union will establish a "buy" rate—this is the lowest interest rate at which the credit union will offer a loan. The dealership is typically permitted to markup the buy rate by no more than 300 basis points, resulting in a "note" rate. The difference between the buy rate and the note rate, or some percentage thereof, is the dealership's compensation. Also, the dealer is typically paid in a lump sum equal to the present value of the interest markup (instead of being paid monthly interest installments).

The credit union must provide for fair dealer compensation in order to attract business from the dealership and borrowers that meet the credit union's credit standards. If the compensation is too low, the dealer may only forward applications that do not meet other competitors' standards (e.g., high risk borrowers). At the same time, excessive compensation can lead to lower credit union profits, and increased borrowing costs to the member. The credit union must also beware of dealers who consistently charge high markups, leading to members who may be disgruntled to learn that the credit union's lobby rate (rate charged had the member sought the loan directly from the credit union) is significantly lower.

Cell: A11

Comment: Planning/Evaluation #6

Growth in indirect lending can quickly out-pace projections and restructure the balance sheet. The credit union should monitor the growth in indirect loans against its strategic plan taking appropriate action to control unplanned growth.

Cell: A12

Comment: Planning/Evaluation #7

If the purpose of participating in an indirect lending program is to obtain new members, the credit union should be evaluating whether new members are using the credit union's other services to determine if the goal is being met with the program.

Cell: A14

Comment: Policies & Procedures #1

Policies and procedures should be written. Because indirect lending programs require special oversight and controls, those policies are typically differentiated from other lending policies and procedures. This facilitates understanding of limitations, authorities, and practices.

Cell: A16

Comment: Policies & Procedures #2(a)

The board must establish reasonable program limits by both individual dealer and total program. They should reflect the risk tolerance of the credit union (i.e., tighter limits for lower risk tolerance, higher

limits for greater risk tolerance). Preferably, limits should be stated in terms of capital at risk (e.g., total loans will not exceed X% of net worth).

Cell: A21

Comment: Policies & Procedures #2(a)(5)

The credit union may be involved in more than one indirect lending program such as Credit Union Direct Lending and an in-house program. Limits should be established for each program based on the risk profile of each.

Cell: A22

Comment: Policies & Procedures #2(a)(6)

The credit union's credit score rating ranges should be compared to similar national score ranges. Material differences between the two should be explained.

Cell: A23

Comment: Policies & Procedures #2(b)

As the parties responsible for the overall management of the credit union, it is imperative senior management and the board are kept abreast of the performance of the indirect lending program. Reports should clearly show the volume of activity, the credit performance, and compliance with board established limitations. Senior management and the board should also be alerted to any significant problems arising from the indirect lending program such as rising delinquencies or insufficient documentation.

Monthly reports should be submitted to senior management and to the board no less than quarterly. If the volume of activity is increasing rapidly, or the indirect lending program is new, more frequent reporting may also be prudent. (See Monitoring Section for reporting details.)

Cell: A24

Comment: Policies & Procedures #2(c)

Prior to doing business with any dealership, the credit union must determine that the dealership meets certain standards. Factors to consider include the dealership's reputation, experience, financial condition, financial audits, and third-party evaluations (e.g., Dun and Bradstreet, Better Business Bureau). Written standards reduce the risk that an unscrupulous dealer is approved.

Cell: A25

Comment: Policies & Procedures #2(d)

It is important that dealership compensation agreements be in writing so that both the credit union and dealership are aware of the terms. Terms should include the calculation of compensation, disbursement dates, and the right of the credit union to maintain a dealer reserve (a holdback of monies due to the dealer).

If dealers are compensated based on rate differentials between the buy rate and note rate, the credit union should place restrictions on the maximum note rate. Typical differentials will not exceed 300 basis points. This prevents the dealer from abusing the markup and exceeding the NCUA maximum rate or state usury rates.

Cell: A26

Comment: Policies & Procedures #2(e)

A credit union should require a dealer reserve account which is used to charge back non-performing loans to the dealer. The account is controlled by the credit union and is credited with discounts earned by the dealer on its sale of loans to the credit union. Dealer reserves must be tightly controlled for contract compliance and generally should not be used to bring past-due accounts current. (See Examiner's Guide, Appendix 10D for a Sample Dealer Reserve Agreement.)

Cell: A27

Comment: Policies & Procedures #2(f)

There are three basic arrangements for the purchase of “dealer paper:” recourse, limited recourse, and non-recourse. With non-recourse purchases, the credit union assumes the full responsibility for underwriting and the credit union carries all the risk. Recourse agreements can include requiring the dealer to repurchase the loan or pay any deficiencies in the event of non-performance by the borrower. Limited recourse agreements allow non-recourse loans to be treated like recourse loans when agreed-upon conditions exist, such as underwriting outside of policy limits or loans to persons not eligible for membership. Typically, a lender will execute at least a limited recourse agreement where any loan that defaults on its first payment is returned to the dealer.

Generally, the credit union must notify the dealer of the borrower’s default. If this isn’t handled as stipulated in the recourse agreement, the credit union may forfeit its options to recover funds from the dealer. Recourse is not a substitute for good underwriting.

Cell: A28

Comment: Policies & Procedures #2(g)

Because the dealership will process much of the paperwork, the credit union must establish standards for the dealership to follow (and for credit union personnel to later verify). If standards are absent or incomplete, the credit union could experience problems with servicing the loan, securing the credit union’s interest in collateral, and collecting from delinquent borrowers. Further, the credit union will not have a sound basis for evaluating whether the dealership is submitting quality applications for approval.

Examples of documentation include the original loan application, credit report or score, verification of income or employment, purchase order, and security agreement enforceable in the jurisdiction where the collateral is located.

Cell: A29

Comment: Policies & Procedures #2(h)

Taxes, registration fees, freight, and dealership add-ons can increase the amount borrowed. Some add-ons are also of dubious value to the borrower (e.g., rustproofing). Add-ons can increase the loan-to-value ratio to well over 100%, leaving the credit union with greater loss exposure. A credit union should clearly state permissible additional items or add-ons that may be financed, and/or establish a cap on the loan-to-value ratio for each loan. A cap of 115-120% of the MSRP (new cars) or wholesale value (used cars) is typical, although the credit union should determine a cap appropriate for the amount of risk it is willing to take.

Cell: A30

Comment: Policies & Procedures #2(i)

The credit union should define the credit standards for borrowers (e.g., debt ratio, credit history, credit score, etc.). If multiple indirect lending programs exist (e.g., based on the creditworthiness of the borrower and distinguished by interest rate charged), the credit criteria should clearly differentiate between each loan program. This prevents a dealer from incorrectly qualifying a member for a higher or lower interest rate on the loan.

Cell: A31

Comment: Policies & Procedures #2(j)

The credit union should have procedures in place and agreements with the dealer to ensure each borrower qualifies for membership in the credit union prior to accepting (purchasing) the loan.

Cell: A32

Comment: Policies & Procedures #3

Failure to abide by the credit union’s policies and procedures indicates the credit union is not managing or controlling the indirect lending program. If significant violations are noted, immediate corrective

action should be demanded.

Cell: A34

Comment: Legal #1

Dealership agreements should be maintained by the credit union, and updated as necessary. (See Examiner's Guide, Appendix 10D for a Sample Dealer Purchase Agreement.)

Cell: A35

Comment: Legal #2

It is imperative a credit union obtain a legal review of all documents and contracts when dealing with third party relationships. This process helps the credit union ensure it is complying with federal and state laws, and that it understands both party's rights, responsibilities, and obligations.

Cell: A36

Comment: Legal #2(a)

The dealership agreement will detail each party's responsibilities. It should also provide for recourse if a party breaches its responsibility, and identify conditions in which a party can terminate the relationship. The agreement should specify that the credit union can periodically audit or review the dealer's compliance with the contract.

Under Holder in Due Course statutes, a credit union can be liable for certain actions taken by the dealer. A legal review will assist the credit union in drawing up provisions to limit or reduce the credit union's losses in the event of a claim under Holder in Due Course statutes.

Cell: A37

Comment: Legal #2(b)

Generally, the loan documents a credit union uses for its internally generated loans should suffice. Nonetheless, a legal review will ensure such documents are binding in indirect lending arrangements. If a dealership proposes changes, a legal review is also prudent.

Cell: A38

Comment: Legal #2(c)

A credit union can be held responsible for certain actions taken by the dealership that may violate consumer protection laws (e.g., Equal Credit Opportunity Act, Truth-in-Lending). For example, the ECOA may be violated if a dealership steers a protected class to higher interest rate loan programs.

Cell: A39

Comment: Legal #3

Assignment occurs when the dealership actually contracts with the credit union to fund the loan. Until this assignment, the dealer may be shopping the loan application to other lenders.

Under the FCU Act 107(5), and Rules and Regulations §701.21, indirect loans should be assigned to the credit union within a short period of time (e.g., 7 days). Otherwise, the loan may be treated as a purchase of an eligible obligation, subject to the provision of the FCU Act 107(13) and the Rules and Regulations §701.23.

Cell: A41

Comment: Controls #1

Training and experience ensures that staff remains current with the automobile industry and enables them to identify questionable practices such as inflated purchase prices and trade-in values.

While the dealership will process much of the paperwork, this should not preclude the credit union from hiring lending staff experienced with indirect lending. Staff must work with dealership financing personnel to obtain the required documentation, educate them about the credit union's credit standards

and loan programs, and verify final paperwork to ensure it complies with the credit union's standards.

Cell: A42

Comment: Controls #2

An important responsibility is to oversee the dealership's credit evaluation (although the final approval must be made by the credit union) and the final paperwork submitted by the dealer to ensure that it complies with the credit union's standards. This may include obtaining credit reports independently of the dealer, recalculating debt ratios, or verifying income/employment. Failure to perform these functions indicates the credit union is not maintaining control over the program.

A dealer that is constantly submitting applications from borrowers who do not meet the credit union's standards may be trying to pass off poor credit risks with the hopes it is not noticed. If documentation is not complete, it can lead to problems collecting delinquent loans, securing title to collateral, and increased delinquency. It also makes it difficult for a credit union to analyze its credit practices to determine if adjustments may be needed.

Cell: A43

Comment: Controls #3

While loans should not be granted based on the value of collateral, it is important that the credit union understand the true value of the collateral when making credit decisions. A common practice is to obtain a dealer's invoice and compare it to the conditional sales contract. This practice ensures that the trade-ins or down payments are real and not created by an inflated sales price so that the loan meets the loan-to-value (LTV) ratio. This process may be performed on a sample of approved loans, or at the time of loan approval.

Cell: A44

Comment: Controls #4

Dealerships have an incentive to get a purchaser's financing approved; therefore, there is the risk that a dealership will manipulate the sales contract to make sure it meets the credit union's requirements (e.g., LTV, or permissible dealer add-ons). A common practice is for a credit union to call the borrower back to verify the terms of the sales contract. This may be performed on a sample basis.

Cell: A45

Comment: Controls #5

A credit union must retain approval authority to engage in indirect lending (i.e., the dealership is not permitted to approve loans on the credit union's behalf). In application, a credit union will typically grant preliminary approval of a loan based on the dealer's representations to the credit union's loan officer. However, the credit union should also retain the right to deny a loan should it discover the loan does not comply with the credit union's policies or standards upon receipt of the final paperwork.

Cell: A46

Comment: Controls #6

A credit union is only empowered to grant loans to members. Therefore, prior to approving a loan, a credit union must ascertain the borrower is member, or is eligible for membership and joins the credit union as a condition of granting the loan.

Granting loans to non-members can lead to divestiture of all loans and related share accounts, suspension of future indirect lending, and regulatory administrative action.

Cell: A47

Comment: Controls #7

As a final step in the loan approval process, the credit union should review the final paperwork submitted by the dealership. These documents are the binding documents between the borrower, member, and the dealer. If the credit union does not catch mistakes or changes to the initial paperwork, the credit union may not be able to rescind the transaction or execute its right of recourse.

Cell: A48

Comment: Controls #8

As the lien holder, it is the credit union's responsibility to ensure that the title is properly encumbered and recorded. Failure to oversee this function can lead to unrecorded liens, and loss of collateral. The borrower and the dealership should not be delegated this responsibility.

Cell: A49

Comment: Controls #9

Upon assignment of the loan contract, the loan becomes a transaction between the credit union and the borrower. All payments should be directed to the credit union to ensure prompt credit. Payments should not be permitted to be made to the dealer.

Cell: A50

Comment: Controls #10

An important credit union function is to evaluate the quality of the applications submitted by the dealership and their compliance with credit union policies and procedures. A prudent practice is for a credit union to hold back a portion of the dealer's reserve (amount of fees or commission owed for originated loans) until the credit union is able to conduct its evaluation. The amount of reserve maintained and the timing of the remittance are generally inversely proportional to the quality of the dealership's compliance performance. For dealerships that generally comply with the credit union's policies and procedures, the dealer reserve may not be significant; however, for newly established relationships or poor performing relationships, the reserve should be significantly higher.

Cell: A51

Comment: Controls #11

A credit union can disguise delinquency by apportioning the dealer's reserve to delinquent accounts to mask delinquency. Controls should include segregation of duties between the lending and accounting departments.

Cell: A52

Comment: Controls #12

It is important for the credit union to maintain control over the payment to the dealer. The dealer should not be permitted to issue a site-draft—a draft on the credit union's account that the dealership is permitted to sign and authorize.

Cell: A53

Comment: Controls #13

The credit union should monitor a borrower's first payment. Because contracts often permit full recourse for first payment defaults, a dealership has an incentive to pay the first loan payment as a preventive measure. First payments should be monitored that they are drawn on the borrower's account (which may require sight inspection of loan payments received).

Cell: A54

Comment: Controls #14

Separation of these duties is a sound internal control. Without such measures in place an individual could establish fraudulent loans or misappropriate funds.

Specifically, procedures should require that separate personnel approve loans, record loans on the credit union's books, and authorize payment to the dealer. For larger credit unions, the internal audit function should also periodically monitor controls.

Cell: A55

Comment: Controls #15

Larger operations may establish a dealer liaison position to clearly define the line of communication between the credit union and the dealer. This prevents the dealer from contacting other staff people

which could lead to inconsistent or inaccurate information being disclosed to the dealer. It also facilitates communication when problems arise.

Cell: A57

Comment: Monitoring #1

Failure to oversee the indirect lending program is a safety and soundness concern. It evidences management is not meeting its responsibilities to plan, direct, and control the credit union's operations.

Cell: A58

Comment: Monitoring #2

Reports should be segregated by dealer to identify poor performing relationships. This will assist the credit union in determining the amount of dealer reserve to maintain, which dealers are in non-compliance with agreements, and possibly which relationships should be terminated.

Cell: A59

Comment: Monitoring #2(a)

These reports permit the credit union to determine the concentration of loans, which dealers are responsible for the highest percentage of approvals/denials, and which relationships are at least attempting to bring the credit union business.

Cell: A60

Comment: Monitoring #2(b)

This will permit the board to monitor compliance with limitations on total indirect loans. Because the credit union may have relationships with several dealerships, the potential for rapid loan growth is high. This is especially important for new indirect lending arrangements so management can monitor its growth prior to incurring significant loan volume and risk.

Cell: A61

Comment: Monitoring #2(c)

If certain dealers are responsible for a disproportionate share of delinquent loans, it can signal a need to improve oversight procedures, underwriting standards, or credit quality criteria for the dealer.

Cell: A62

Comment: Monitoring #2(d)

Significant first payment default numbers may indicate that the dealer is not properly following lending criteria. At worst, it could indicate fraud. The credit union should closely monitor first payment defaults and take actions to resolve underlying weaknesses or problems.

Cell: A63

Comment: Monitoring #2(e)

Repossessions can signal that certain dealers may not be complying with the credit union's credit evaluation standards, and, thus, require more oversight.

Cell: A64

Comment: Monitoring #2(f)

Charge-offs can be compared to repossessions to determine the average loss per loan originated by the dealer. Poor performance may signal that a dealer is passing along higher credit risks to the credit union, or may be inflating collateral values.

Cell: A65

Comment: Monitoring #2(g)

Tracking the average loan to value ratio for the pool or segregated pools of loans can identify risk exposures for which the credit union should be aware.

Cell: A66

Comment: Monitoring #2(h)

Monitoring the average loan term for indirect loans can assist the credit union manage its balance sheet.

Cell: A67

Comment: Monitoring #2(i)

A declining trend in credit scores can signal increased risk exposure in an indirect loan portfolio. Management should take action to ensure that risks are controlled at determined levels.

Cell: A68

Comment: Monitoring #3

The board must be kept abreast of the indirect lending program's performance to determine how it is impacting the credit union's financial condition. The materiality of the program to the credit union's operations and financial statements should dictate the frequency of reporting. For credit unions with limited exposure (e.g., <100% of net worth), semiannually may be sufficient. For credit unions with new programs or exposure exceeding 100% of net worth, monthly reports would be prudent.

Cell: A69

Comment: Monitoring #4

It can be lucrative for a dealer to qualify a member for a higher risk loan category because it may generate a higher commission or fee. However, this practice can lead to poor relationships between the credit union and the member, and if abusive, could lead to predatory lending allegations.

Cell: A71

Comment: Collections #1

Indirect lending can generate significant loans from persons who were not members prior to applying for the loan. Therefore, they may not have established a relationship with the credit union. This may lead to higher delinquencies, and repossessions. Experience with disposing of collateral can reduce the credit union's write-offs.

Cell: A72

Comment: Collections #2

Indirect lending can generate significant volumes of loans in a short period of time. This growth can lead to more delinquent loans necessitating more collection staff. If staff is overburdened, loan losses can be more severe.

Cell: A73

Comment: Collections #3

If the credit union has not invested in technology to facilitate collections, it may incur higher delinquency and losses.

Cell: A74

Comment: Collections #4

It is important for the credit union to understand the performance of indirect loans in relation to loans originated internally. Disparities in loan performance can lead to different reserving requirements. (Reference IRPS 02-3 "Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions.") If the contract stipulates full recourse back to the dealer, it may not be necessary for the credit union to estimate losses on the covered loans.

The credit union may need a separate pool for indirect loan portfolios to more accurately estimate probable losses for purposes of funding the Allowance for Loan and Lease Losses.

Cell: A75

Comment: Collections #5

Collateral protection insurance, also known as single interest auto insurance, is typically purchased as a

blanket policy by the credit union. Premiums are not explicitly borne by the borrower, but the interest rate may reflect this additional cost to the credit union. Collateral protection insurance can cover losses associated with damage to the collateral, collateral that cannot be located, or unperfected liens. Policy coverage will vary depending upon the insurer and the premium paid.

	A	B	D
3	Sub-Prime Lending Controls		
4	INTRODUCTION AND PURPOSE		
5	Planning/Evaluation	Yes/No	Comments
6	1. Does the credit union have a strategic or business plan addressing sub-prime lending and is the plan consistent with stated risk tolerances?		
7	2. Does the plan establish clear performance objectives and benchmarks based on reasonable projections and assumptions?		
8	3. Did the credit union evaluate its capital exposure prior to implementing a sub-prime lending program and is the credit union's capital sufficient to cover the potential exposure from sub-prime lending activities?		
9	4. Did the credit union "test" its sub-prime lending program for a reasonable period of time prior to launching a large-scale program?		
10	5. Has the credit union established an adequate system for monitoring program performance both on an aggregate portfolio basis and by individual loan?		
11	6. Does the credit union project the impact of the sub-prime lending program on profitability under varied economic conditions (e.g., significant credit deterioration) to determine worst-case results?		
12	7. Does the credit union periodically analyze the staffing and operational costs (e.g., overhead, technology, fixed assets) of implementing a sub-prime lending program?		
13	8. Does the credit union evaluate the profitability of the program on an on-going basis? Are collection expenses, increased personnel expenses, and increased loan losses considered?		
14	9. Does the credit union have staff experienced in administering loans to sub-prime borrowers?		
15	10. Does the credit union periodically assess its sub-prime pricing structure?		
16	(a) Is a bond equivalent yield used to determine the yield in developing pricing scenarios?		
17	11. Does the credit union stress test its sub-prime loan pools including an estimate of the portfolio's susceptibility to deteriorating economic market and business conditions?		
18	12. If credit scoring is used, does the credit union evaluate the scoring attributes to determine that are effective determinants of risk and, in addition, compare them to nationally recognized scores?		
19	13. Does the credit union evaluate that the sub-prime program is in compliance with consumer compliance regulations (e., ECOA, TIL)?		

	A	B	D
3	Sub-Prime Lending Controls		
20	Policies & Procedures	Yes/No	Comments
21	1. Does the credit union have separate policies and procedures for sub-prime lending addressing:		
22	(a) Approved types of loans?		
23	(b) Creditworthiness guidelines?		
24	(c) Pricing guidelines?		
25	(d) Credit file documentation requirements?		
26	(e) Collateral valuation?		
27	(f) Loan approval authorities?		
28	(g) Exceptions to loan policies?		
29	(h) Collection practices?		
30	(i) Reporting requirements?		
31	2. Have limits been placed on sub-prime loans including:		
32	(a) Total exposure to sub-prime loans?		
33	(b) Maximum exposure by credit quality (B, C, D paper)?		
34	(c) Maximum exposure by collateral type?		
35	3. Have quality control procedures been implemented to ensure proper classification of sub-prime loans?		
36	4. Are interest rates charged on sub-prime loans within prescribed NCUA or state usury limits?		
37	Monitoring	Yes/No	Comments
38	1. Are the sub-prime portfolio's credit performance measures (delinquency and charge-offs) monitored on a monthly basis with reports provided to management and the board?		
39	(a) Are delinquency and charge-offs analyzed through "vintage" or "static pool" analysis especially during periods of high loan growth?		
40	2. Are the sub-prime portfolio's credit performance measures stratified by:		
41	(a) Creditworthiness?		
42	(b) Loan origination date?		
43	(c) Loan-To-Value ratio?		
44	(d) Collateral type?		
45	(e) Loan type?		
46	3. Are the sub-prime portfolio's credit performance measures compared to industry averages?		
47	4. Are decisions to "cure" delinquent or non-performing loans subject to managerial approval?		
48	5. Are "cured" loans segregated from other sub-prime loans?		
49	6. Are defaulted loans reviewed to determine changes to underwriting or collection practices?		

	A	B	D
3	Sub-Prime Lending Controls		
50	Controls	Yes/No	Comments
51	1. Is the sub-prime portfolio segregated from other credit union loans?		
52	2. Are post-execution reviews completed to determine that approved loans meet the credit union's pricing, creditworthiness, documentation, and collateral standards?		
53	3. If so, are exceptions:		
54	(a) Brought to senior management's attention?		
55	(b) Tracked by the source of exceptions?		
56	4. Does the Allowance for Loan and Lease Losses adequately include an estimate for probable, incurred losses inherent in the sub-prime loan program?		
57	5. Are periodic audits (internal and/or external) performed to determine whether the credit union is in compliance with its policies and procedures?		
58	(a) Does the scope of the audit include credit evaluation, underwriting/documentation, data integrity, servicing/collection practices, and consumer compliance?		
59	Servicing & Collections	Yes/No	Comments
60	1. Are collections personnel experienced in working with sub-prime borrowers?		
61	2. Is training periodically offered to sub-prime servicing and collections staff?		
62	3. Is servicing performed in a central location or on a decentralized basis?		
63	4. Are contact logs maintained on each borrower?		
64	5. Are first payment notice contacts made?		
65	6. Are monthly loan statements issued?		
66	7. Are payments set up on direct deposit?		
67	8. Are monthly phone contacts made with borrowers?		
68	9. Are collection activities initiated on delinquent accounts in a timely manner?		
69	10. Are sub-prime loans determined to be uncollectible written off in a timely manner?		
70	11. Are loans re-aged or refinanced under limited and prudent conditions?		
71	12. Are repossessions ordered in a timely manner?		
72	13. Is repossessed collateral disposed of quickly?		
73	14. Does the CU force-place insurance on borrowers that fail to show proof of insurance?		
74	15. Does the credit union purchase collateral protection insurance?		
75	16. Does the credit union purchase loss protection insurance (e.g., GAP insurance)?		
76	17. Is the credit union relying upon loss protection insurance as the primary means of controlling loan losses? If yes:		
77	(a) Does the credit union review the financial strength and claims paying ability of the insurer?		

Cell: A4

Comment: Introduction and Purpose

Sub-prime lending is the practice of extending credit 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).

Granting exceptions to a credit union's policies does not necessarily constitute sub-prime lending. Further, risk-based pricing should not be confused with sub-prime lending, although the two are related. Risk-based pricing refers to charging interest rates commensurate with the amount of risk taken on by the credit union granting the loan. A credit union will commonly adopt risk-based pricing when implementing sub-prime lending. However, not all risk-based pricing programs involve granting credit to borrowers with higher risk of default.

Sub-prime lending can extend service to the underserved, and enable the credit union to reach out to more members. It can also be done profitably and with reasonable exposure to risk if the credit union implements sound policies, procedures, practices, and controls. In some credit unions, sub-prime lending may be standard due to characteristics of the field of membership (e.g., seasonal employment, underserved field of membership, cash economy without the usual credit references, etc.). The purpose of this questionnaire is to assist the examiner in determining whether a credit union is safely managing its sub-prime lending program.

For general lending guidance and instruction, refer to Chapter 10 of the Examiner's Guide, and for specific sub-prime lending guidance refer to FFIEC's Interagency Guidance on Sub-Prime Lending. The FFIEC guidance can be found via the internet at www.fdic.gov/news/news/financial/1999/FIL9920.html and www.fdic.gov/news/news/press/2001/pr0901.html.

Cell: A6

Comment: Planning/Evaluation #1

Implementing a sub-prime lending program should result from detailed analysis and thorough understanding of the risks associated with the activity. Risk assessment should incorporate operating, compliance and legal risks, as well as financial risks.

Implementation demands the board's approval because it can significantly impact the credit union's risk profile. If the board is conservative, sub-prime lending may not be suitable because delinquency ratios can exceed 10%, and losses can exceed 5%.

Without adequate planning, implementing a sub-prime lending program could quickly lead to adverse financial trends, including negative earnings and capital erosion.

Cell: A7

Comment: Planning/Evaluation #2

The board and senior management should develop specific targets for the sub-prime lending program. For example, member growth and improved profitability would be reasonable objectives. Reaching these objectives will depend upon the strength of credit union's control over the program.

It is important the credit union develop projections for profitability and capital accumulation based on plausible assumptions. If a credit union is new to sub-prime lending this may necessitate understanding industry performance factors.

Failure to meet objectives may occur due to excessive optimism, poor planning, or poor execution of plans. The credit union should be able to explain why objectives were not met, and what corrective action has been taken to resolve the problems.

Cell: A8

Comment: Planning/Evaluation #3

Sub-prime lending activities can expose the credit union's capital to increased risks due to increased loan losses and expenses. Initial and on-going evaluation of its capital should be implemented.

Cell: A9

Comment: Planning/Evaluation #4

Credit unions establishing a sub-prime lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

Cell: A10

Comment: Planning/Evaluation #5

In order to accurately assess the performance of the program and report the results to the board, the credit union must have a system in place that will capture required data. Inadequate monitoring and reporting can result in poor decisions by management and unexpected losses from the program.

Cell: A11

Comment: Planning/Evaluation #6

A credit union may be encouraged to enter into sub-prime lending when economic times are favorable. In such a climate, the performance of sub-prime loans will be significantly better than in times when a recession occurs and unemployment rises. It is these latter times that a credit union must prepare for when evaluating its sub-prime program. It must determine if it can profitably offer a program in weak economic times when delinquencies may be several times higher than they are currently, additional staff may be necessary to monitor borrowers, and collateral values may decline resulting in weaker recoveries. Even quality servicers in the sub-prime market have experienced delinquencies exceeding 10 percent and net charge-offs exceeding 5 percent.

Cell: A12

Comment: Planning/Evaluation #7

It is important the credit union evaluate these costs periodically because they will likely change with growth of the portfolio, the changing business cycle, and credit performance of the portfolio.

Cell: A13

Comment: Planning/Evaluation #8

After considering losses, staffing, overhead, capital improvements, the credit union should determine whether the program is meeting profitability goals. This analysis would be expected to be performed no less often than annually, and more frequently for new programs or programs that are material in relation to the credit union's assets and capital.

Cell: A14

Comment: Planning/Evaluation #9

To be successful, sub-prime lending requires experience in dealing with less creditworthy borrowers. Generally, most credit unions grant loans only to good quality borrowers. While marginal quality loans may also be granted, they are usually approved on an exception basis.

A credit union deciding to enter the sub-prime market should hire sub-prime experienced personnel instead of training existing loan officers. Experienced staff is more adept at understanding the administrative, operational, and capital expenditure demands required for managing a portfolio of sub-prime loans. For example, identifying good credit risks among credit-blemished applicants, contacting borrowers on a monthly, if not weekly basis (even if current), and initiating repossession actions within 45 days are practices that likely differ from those credit unions that primarily lend to good quality

borrowers.

Cell: A15

Comment: Planning/Evaluation #10

Pricing is an important function of a sub-prime lending program. Pricing too low will lead to unprofitable operations. Pricing too high may lead to lower loan volume and also member dissatisfaction. To perform this function properly, the credit union must have a thorough understanding of its cost structure and credit risk exposure.

A pricing evaluation should occur at least quarterly, if not more frequently, especially if the program is new.

Cell: A16

Comment: Planning/Evaluation #10(a)

The credit union should conduct its own yield analysis. When estimating the net return on investment, the credit union should recognize that accounting yields have key flaws that mask the true return on investment, such as ignoring the time value of money. Using a bond equivalent yield analysis will provide a more accurate assessment of the program.

Cell: A17

Comment: Planning/Evaluation #11

Credit unions should project the performance of their sub-prime loan pools under conservative "stress test" scenarios. Portfolio stress testing should include "shock" testing of basic assumptions such as delinquency rates, loss rates, and recovery rates on collateral. It should also consider other potentially adverse scenarios, such as: changing attrition or prepayment rates and changing in credit score distribution.

Whether stress tests are performed manually or through automated modeling techniques, credit unions should:

1. Clearly document the process;
2. Ensure inputs are reliable and relate directly to the subject portfolios;
3. Ensure assumptions are well documented and conservative; and
4. Determine any models are subject to a comprehensive validation process.

Cell: A18

Comment: Planning/Evaluation #12

Credit scoring provides a quick means for determining creditworthiness. However, to be effective, the underlying scoring attributes must be evaluated to determine that they are reasonable predictors of credit risks. Failure to review the scoring system can lead to increased credit risk, missed lending opportunities, and consumer compliance violations. For credit unions that obtain credit scores from outside firms, the credit union should inquire as to the steps the third party has taken to validate its system.

Cell: A19

Comment: Planning/Evaluation #13

The credit union should determine the sub-prime program complies with consumer regulations to prevent future legal suits by members. Of particular importance is that a credit union not discriminate against a protected class under the ECOA. It should also make sure the Finance Charge and APR are correctly reported (e.g., include prepaid finance charges such as loan fees in the APR).

Cell: A21

Comment: Policies & Procedures #1

Sub-prime lending involves significant risks, especially credit risk. Because the borrowers already represent weak credit risks, standard credit union lending and collection policies are generally not appropriate.

Cell: A22

Comment: Policies & Procedures #1(a)

The credit union should specify which loan types may be offered under the sub-prime lending guidelines. This prohibits the credit union from offering certain types of loans to sub-prime borrowers which the credit union determines carry excessive risk (e.g., real estate lending and large signature credit lines).

Cell: A23

Comment: Policies & Procedures #1(b)

The policy should clearly indicate the criteria for acceptable creditworthiness. Because sub-prime loans are often risk-priced, it is important to establish guidelines that are not arbitrary and capricious. Credit or risk grades should contain minimum and maximum criteria for each grade. The lowest grade should not be a catch-all that includes everything below the maximum criteria. Indefinite or vague criteria could lead violations of consumer compliance laws such as the ECOA, and also make it difficult for a credit union to determine which specific underwriting practices may be responsible for poor performance.

Cell: A24

Comment: Policies & Procedures #1(c)

The credit union should set forth guidelines for pricing each credit or risk grade to ensure consistent application and to avoid allegations of unfair treatment.

Cell: A25

Comment: Policies & Procedures #1(d)

Documentation may include income/employment verification, credit reports, a thoroughly completed loan application identifying past and present residences, names and addresses of relatives, and aliases; evidence of recent good credit history (if not evident on the credit report—this may include payments of utility bills or satisfaction of judgments); and purchase orders or other documentation of collateral value.

Cell: A26

Comment: Policies & Procedures #1(e)

The credit union should determine reasonable market values of collateral at the time of loan origination. This may include verifying purchase orders with dealer invoices or used car market guides. Sub-prime lenders want to be especially careful of auto dealers that may manipulate purchase prices or trade in values so a borrower will qualify for a loan.

Cell: A27

Comment: Policies & Procedures #1(f)

Authority should be restricted to those personnel that have sub-prime lending experience and training.

Cell: A28

Comment: Policies & Procedures #1(g)

It is important for a credit union to maintain tight controls over its sub-prime lending practices to reduce losses, maintain profitability, and guard against consumer compliance violations. For this reason, exceptions to loan policies should be subject to strict procedures and supervisory approval. Senior management, or the board, should be alerted to the approval of significant or repeated exceptions by a loan officer.

Cell: A29

Comment: Policies & Procedures #1(h)

Being successful at sub-prime lending is largely dependent upon the servicing and collections

procedures. Sub-prime borrowers require constant contact and reminders about their payment obligations. Further, when an account becomes delinquent, assertive action must be taken quickly to avert losses (e.g., within 1 to 2 days following a missed payment), including quick repossession of collateral. Failing to develop written policies and procedures can lead to inconsistent collection efforts and poor results.

Cell: A30

Comment: Policies & Procedures #1(i)

Setting forth reporting requirements ensures that senior management and the board are kept abreast of significant developments. Monthly reports should be provided. These reports should clearly define the level of activity, the performance of the portfolio, and the compliance with board imposed limits.

Cell: A32

Comment: Policies & Procedures #2(a)

Limits should be set so that the credit union does not put excessive capital at risk. Limits will be based on the board's risk tolerance, and the experience of the credit union in dealing with sub-prime borrowers. Lower limits should be set for credit unions that have recently implemented a sub-prime program to provide time to grow its experience level and ensure its controls are working properly.

Cell: A33

Comment: Policies & Procedures #2(b)

Sub-prime loans can be categorized by the degree of credit risk taken on by the credit union. There are no industry-standards, but general characterizations can be made.

"B" paper generally reflects those borrowers with weak credit histories, who are still making at least partial monthly payments to creditors. They may also secure the borrowing with good collateral. In contrast, "D" paper may reflect unsecured loans where the borrower has poor credit and has not demonstrated an ability to consistently make payments. "C" paper would represent middle ground.

It is important for a credit union to track and limit its exposure by classification so it can better understand the credit risk it has taken on.

Cell: A34

Comment: Policies & Procedures #2(c)

Collateral can improve the credit union's recoveries on charged-off loans. However, certain collateral may hold value better than other types, resulting in better recovery percentages. For example, a 3-year old auto would generally be seen as good collateral because the rate of depreciation slows after the first few years (assuming the collateral is in good condition to begin with). However, autos that are over 7 years old may be approaching the end of their useful lives leaving little value if repossessed.

Cell: A35

Comment: Policies & Procedures #3

Due to the higher credit risk, it is important the credit union institute controls to ensure sub-prime loans are properly classified as such. This promotes better oversight and recognition of risk exposure.

Cell: A36

Comment: Policies & Procedures #4

A credit union should beware of levying charges that could be construed as a finance charge. Combined with the interest rate on the note, this could exceed regulatory limits.

Refer to §701.21(c)(7) for maximum interest rates for federal credit unions.

Cell: A38

Comment: Monitoring #1

Sub-prime loan performance can deteriorate rapidly. A credit union must be able to identify adverse

trends quickly in order to take corrective action.

As the credit union decision makers, it is imperative that the senior management and board of directors receive timely reports so they can evaluate the success/failure of the sub-prime program. If reports are not provided timely, or do not convey adequate information to evaluate the sub-prime portfolio's performance, exceptions should be taken.

Cell: A39

Comment: Monitoring #1(a)

Instead of using delinquency and charge-off ratios as a percentage of total outstanding loans, "vintage" or "static pool" analysis uses ratios based on loans originated in a particular period or lending program. This type of monitoring is necessary as delinquency and charge-offs can be skewed when loan volume increases rapidly. The credit union could get into a program and grant a relatively large amount of poor loans. Increased delinquency and charge-offs would not be revealed initially when compared to the large increase in total loans. The ratios would remain deceptively low as long as the proportion of new loans exceeded the proportion of seasoned loans in the portfolio.

Cell: A41

Comment: Monitoring #2(a)

Understanding how loan performance is related to creditworthiness will assist the credit union in establishing reasonable pricing, making changes to underwriting and credit criteria, and alerting collectors to loans that may need more aggressive attention. For example, the credit union may track delinquency by debt ratio or credit score.

Cell: A42

Comment: Monitoring #2(b)

By segregating the portfolio by age, the credit union can observe how credit performance evolves over time. It also enables the credit union to observe how changing underwriting practices over time may have impacted the portfolio's performance.

Stratification by age is especially important for growing portfolios. New loans are not likely to evidence credit problems until after the first year. Therefore, delinquency ratios based on the aggregate portfolio, where new loans will represent a high proportion of total loans, will understate the true credit risk exposure. By stratifying loans by age, the credit union will have a better understanding of how the new loans are likely to perform once seasoned.

Cell: A43

Comment: Monitoring #2(c)

Borrowers with high LTV (loan to value) ratios have less invested in the collateral (those with LTVs in excess of 100 may have no money invested), and pose higher credit risks. By stratifying the loan performance by LTV, the credit union can assess if changes to the program are necessary (e.g., require lower LTV's, increase the interest rate charged on higher LTV loans).

Cell: A44

Comment: Monitoring #2(d)

Recognizing the collateral concentrations can alert the credit union to expectations of future collections should the portfolio performance deteriorate.

Cell: A45

Comment: Monitoring #2(e)

This permits the credit union to recognize where it has sub-prime concentrations by loan type, which may prompt restrictions or emphasis on growth as the circumstances warrant.

Cell: A46

Comment: Monitoring #3

As a benchmark, industry averages can provide a useful measure of performance. However, care must be taken to ensure the credit union's portfolio is commensurate with that used to develop the industry average. For example, if a credit union issues mostly "B" paper and compares it to an industry average based on "C" paper, the comparison's usefulness is muted. However, in this example, if the credit union's performance was worse than the performance of this industry average, it should alert the credit union to problems.

As an example, experienced sub-prime lenders/servicers have seen their sub-prime automobile delinquencies rise above 10 percent and net charge-offs exceed 5 percent over the past six year period ending 2001.

Cell: A47

Comment: Monitoring #4

"Cure" refers to efforts to refinance, extend, or otherwise bring a delinquent loan current. Because sub-prime borrowers are known credit risks, "cure" decisions should only be made on an exception basis. This necessitates management's approval.

Excessive exceptions indicate the credit union may be hiding delinquency.

Cell: A48

Comment: Monitoring #5

Once a loan is "cured" it should be closely monitored for it then represents a higher credit risk. Oversight of previously "cured" loans is facilitated by segregating, or flagging these loans.

Cell: A49

Comment: Monitoring #6

A prudent practice is to review non-performing loans to determine if the credit union's practices, policies, or procedures could be improved to prevent recurrences.

Cell: A51

Comment: Controls #1

Sub-prime loan files should be physically separated from other loans to promote easy access and review. The credit union's data processing system should be able to flag sub-prime loans so that they can be readily identified.

Cell: A52

Comment: Controls #2

It is prudent for a credit union to implement a quality control function to monitor compliance with standards. This prompts corrective action if errors or non-compliant practices are discovered.

Cell: A54

Comment: Controls #3(a)

Department supervisors should be notified to ensure corrective action is implemented. If the exception is material, the senior management and/or the board should be notified as well.

Cell: A55

Comment: Controls #3(b)

Tracking by source enables the credit union to determine if the source (e.g. loan officer) is a recurring problem that merits more oversight or training.

Cell: A56

Comment: Controls #4

The credit union's methodology for determining the adequacy of the Allowance for Loan and Lease Losses should be well-documented and in compliance with industry standards, including accounting

and regulatory guidance. (Reference IRPS 02-3 “Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions.”)

The credit union may need a separate pool for indirect loan portfolios to more accurately estimate probable losses for purposes of funding the Allowance for Loan and Lease Losses.

Cell: A57

Comment: Controls #5

It is prudent to have the supervisory committee, internal or external auditor perform periodic audits of the sub-prime lending program to ensure compliance with the credit union’s policies and procedures, and federal and state regulations. An annual audit is acceptable, unless the credit union is experiencing rapid growth or implementing a new sub-prime program—then the audit should be performed more timely.

Cell: A58

Comment: Controls #5(a)

The scope of the audit should cover the entire sub-prime lending process. If the credit union has outsourced a particular function, the audit should determine that it is handled properly and is in the best interests of the credit union.

Cell: A60

Comment: Servicing & Collections #1

Sub-prime servicing and collection practices are much more vigilant than for normal loans because sub-prime borrowers have already proven they are credit risks. Servicers and collectors should take a much more assertive role in contacting members, reminding them of their obligations, and if need be, repossessing collateral. To be successful, a credit union should employ experienced staff when implementing its program.

Cell: A61

Comment: Servicing & Collections #2

To keep staff abreast of recent sub-prime practices, techniques, compliance, and legal issues, training should be provided each year.

Cell: A62

Comment: Servicing & Collections #3

Centralized servicing promotes consistent application of policies and procedures. Decentralized operations require improved supervisory oversight and communications to be effective in achieving consistency.

If operations are decentralized, the credit union should have controls in place that track performance by individual service center.

Cell: A63

Comment: Servicing & Collections #4

Logs enable the credit union to monitor collection activity on borrowers, and document borrower promises to pay. This prompts improved collection efforts and also can be used should legal claims be pursued.

Cell: A64

Comment: Servicing & Collections #5

A common practice is for a lender to phone the borrower prior to the first payment to remind him of the obligation. This establishes a precedent that lets the borrower know the loan is being monitored, which could prompt timely payments.

Cell: A65

Comment: Servicing & Collections #6

Monthly statements serve as an effective means of payment reminder. It also serves as a means to verify that the credit union has a current address on file—returned statements indicate a change of address. This practice is preferred over issuing coupon books because coupon books do not require contact between the borrower and the credit union after the book is issued.

Cell: A66

Comment: Servicing & Collections #7

Direct deposits facilitate the timely and full collection of payments versus requiring the borrower to mail a check. Cancellations of direct deposit agreements should be monitored closely by the credit union and could signal future delinquency.

If payments are not set up with direct deposit, the payments should correspond to the borrower's pay period.

Cell: A67

Comment: Servicing & Collections #8

A common industry practice is to phone borrowers on a regular basis to maintain contact with them. The objective is not to harass borrowers, but to make the obligation appear more personal. This prompts timely and full payments. Unanswered phone calls can quickly identify members who have moved which may signal future delinquency.

Cell: A68

Comment: Servicing & Collections #9

Collection activity (notices, phone calls, legal action) must be initiated promptly with sub-prime borrowers. Generally, a notice or phone call will be issued within 1 to 2 days of a missed payment.

It is important for a lender to establish quick contact with a member because it is likely the member may be defaulting on other obligations as well. The lender must try to prioritize his claim with the borrower.

Cell: A69

Comment: Servicing & Collections #10

Sub-prime loans will become non-performing loans much quicker than loans to good credit risks. Therefore, charge-offs would be expected to be approved more aggressively (e.g., within 3-6 months delinquency).

Cell: A70

Comment: Servicing & Collections #11

Controls should be in place that restrict when a credit union may bring a delinquent account current (also known as "curing" a loan). These practices should require supervisory approval and should only be permitted for cases that warrant such treatment—cases where the borrower demonstrates an ability and willingness to repay (e.g., six months of consecutive full payments, significant principal payment, re-employment). Loan files should be documented to support decision to approve "cured" loans (e.g., verification of employment/income, payment histories, refreshed credit score/evaluation).

Cell: A71

Comment: Servicing & Collections #12

Once a loan becomes delinquent and collection actions begin, a borrower may lose incentive to maintain collateral in good condition. For this reason, repossession is typically ordered within 45-90 days of delinquency so as to protect the credit union's interest. State law may require a lender to provide certain notice requirements prior to repossessing collateral, so this time frame may be extended due to such requirements.

Cell: A72

Comment: Servicing & Collections #13

Many lenders rely on auction houses to dispose of collateral. While this method provides quick disposition, auctions may reap lower prices and incur fees. As an alternative, some credit unions may benefit from conducting private sales to increase recoveries. However, this necessitates additional staffing and expertise that may be best reserved for larger credit unions with greater resources.

Credit unions should maintain control over the sales of repossessed collateral to prevent abuses such as sales at non-competitive bids to insiders, or effectively curing a defaulted loan through refinancing a loan to the defaulted member.

Whichever method, the credit union should convert collateral to cash as quickly as reasonably possible.

Cell: A73

Comment: Servicing & Collections #14

Forced-placed insurance is a practice where a credit union purchases collision insurance policy on an automobile pledged as collateral and charges the premium to the member. This practice is followed when the borrower fails to show evidence the collateral is insured, or the credit union identified as lien holder, in accordance with the credit union's standards. The premium can be significant requiring the borrower to remit a higher payment or extend the loan term. This can lead to increased delinquencies due to the stresses of meeting this responsibility. If the loan is charged-off, the policy premiums may not be refundable, increasing the potential loss to the credit union. The credit union should, in addition, be certain that collateral protection insurance payments are amortized in accordance with applicable state laws and loan contracts.

Credit unions that employ this practice should ensure that a cost/benefit analysis is performed to determine that force-placing insurance is worth the risk of increased delinquencies.

Cell: A74

Comment: Servicing & Collections #15

Collateral protection insurance, also known as single interest auto insurance, is typically purchased as a blanket policy by the credit union. Premiums are not explicitly borne by the borrower, but the interest rate may reflect this additional cost to the credit union. Collateral protection insurance can cover losses associated with damage to the collateral, collateral that cannot be located, or unperfected liens. Policy coverage will vary depending upon the insurer and the premium paid.

Cell: A75

Comment: Servicing & Collections #16

A recent development in the sub-prime market, is loss protection insurance. Premiums are paid that will reimburse the credit union for losses arising from the difference between the loan balance and the proceeds from collateral sales. The specific terms of coverage are negotiated between the lender and the insurer.

Credit unions should obtain legal counsel's review to determine the actual coverage of a GAP policy, and cases where coverage is restricted. For example, a policy may reimburse the credit union for the difference between the loan balance and the wholesale value of the automobile in the NADA blue book. If the repossessed collateral sells for less than blue book values (due to excessive wear and tear, high mileage, inoperable equipment), the policy will not fully reimburse the credit union for its loss. The credit union must also consider how repossession, storage, disposition, and legal fees will affect the credit union's net recovery proceeds. Lastly, the credit union should understand if the insurer gives credit for options when determining blue book value.

The credit union should also review the financial standing and claims paying ability of the insurer. Failure of the insurer could render the policies worthless.