Chapter 10

LOANS

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Chapter 10 – Part 1

LOANS – GENERAL LOAN REVIEW

Examination Objectives

- Evaluate management's ability to identify and manage risk
- Evaluate the quality of the loan portfolio and the extent of related risks in lending activities
- Evaluate whether management has established adequate lending standards and maintains proper controls over the program
- Determine whether management adequately plans for all lending programs, committing the necessary resources in terms of technology and skilled personnel
- Assess whether the credit union has the financial capacity to conduct lending safely, without undue concentration of credit and without overextending capital resources
- Analyze the loan portfolio's performance, including profitability, delinquency, and losses
- Consider management's response to adverse performance trends, such as higher than expected delinquencies, charge-offs, and expenses
- Determine if the credit union's compliance program effectively manages the fair lending and consumer protection compliance risks
- Determine whether management has implemented an effective internal loan grading system (if applicable) to identify credit risk

Associated Risks

- Credit risk. Credit risk, which involves the ability of the member to repay the obligation, affects all types of loans. Loans with a guarantee (student, VA, SBA, FHA, NCUA purchase) contain a lesser degree of credit risk.

- Compliance risk. Each loan type has various degrees of compliance risk. Various NCUA regulations, state laws, and federal consumer compliance laws apply to both consumer loans and real estate loans. Failure to comply with these laws and regulations exposes the credit union to fines, civil money penalties, and diminished reputation.

- Interest rate risk. Interest rate risk increases as the terms of the loans extend. Monitoring this risk involves a large segment of a credit union's asset-liability management (ALM) program. Credit unions engaging in real estate lending should recognize that changes in interest rates affect the fair value of their balance sheet. Variable-rate loans also can experience interest rate risk since they may contain lifetime and periodic "caps" that limit the credit union's ability to increase (reprice) loan rates.

- Strategic risk. Strategic risk appears in the diversification of loans offered to members. Management's due diligence in the planning effort before implementing new loan programs will greatly affect the amount of this risk. A well-established program should have less risk than a proposed or newly instituted program.

- Transaction risk. Numerous transaction risks accompany lending. The strength of the credit union's internal controls will determine the extent of the risk. Management may demonstrate their control of transaction risk through reviewing internal reports such as Paid Ahead Loans, Non-Amortizing Loans, File Maintenance, Supervisory Override, Accrued Interest Greater than Payment, etc. Appendix 4B to the Internal Controls chapter of this Guide discusses other specific loan-related reports.

- Liquidity risk. The success of any lending program determines the level and type of liquidity risk involved. Credit unions engaging in real estate lending should evaluate and understand the variability of mortgage cash flows and the corresponding effect on its balance sheet. When interest rates fall, mortgage cash flows increase; conversely, when interest rates rise, mortgage cash flows decrease. This could result in a credit union having either too much or too little liquidity. To control liquidity risk, management must understand the interrelationships of interest rates, mortgage cash flows, prepayment risk, extension risk, and the effect on the fair value of its assets.

- Reputation risk. Lending and the types of loan programs offered greatly affect reputation risk. Collection efforts, or lack of them, influence the members' perception of the credit union, as do lending personnel and how they deal with the public. If the credit

union has an indirect dealer loan program, the reputation of the dealer can affect the reputation of the credit union and the program.

Overview

A credit union usually derives its primary source of income, as well as a major source of risk to its solvency, from its loan portfolio. Therefore, credit unions support this major asset account with sound business planning, policies, and internal controls.

Examination Guidelines

Examiners should try to obtain either an AIRES loan download or an ASCII formatted download file. Examiners should use their best judgment in considering whether, and to what extent, to review a particular portfolio. When examiners identify material concerns during the scope process, they should expand procedures to identify the cause of the problems, determine the severity of the noted problems, and devise plans for corrective action.

If examiners determine the analysis of the risk areas noted in the Scope Workbook warrants a loan review, they can use the AIRES Loan Review or a self-designed workpaper to document their review. The loan review may include any or all of the following, based on the examiner's judgment:

- Charged off loans. Examiners should scan the charged off list for unusual activity and review basic internal controls (board approval, proper accounting, assignment to a collection agency, etc.) They may expand their scope to review individual loans charged off to determine the extent of the problem and to develop plans for resolution. Examiners should encourage the credit union to perform an ongoing analysis of charged off loans to determine common characteristics, or loss trends by loan type for ALLL analysis.

- Delinquent loans. Examiners should scan the delinquent loan list for unusual activity and review basic internal controls (consistent and timely collection efforts and charge off.) Reviewing larger and more recently granted loans may prove beneficial in correlating underlying problems of the delinquent loans with those of the current loan portfolio. Examiners should consider reviewing loans

that were seriously delinquent at the previous examination to assess their disposition.

- Current loans. Examiners should select a random sample of current loans to review for adherence to policies and regulations, as well as documentation, and underwriting quality.

- Insider loans. Examiners may select a sample of loans made since the last examination to officials, credit union employees, and their immediate family members.

- Large loans and concentrations of credit. Examiners should select samples of large loans and concentrations of credit. In a credit union with numerous routine mortgage loans, examiners may review a sample of non-routine large loans.

- Member business loans and construction loans. Examiners should select samples of member business and construction loans. Examiners should document the status of the member business loan portfolio if the member business loans exceed the regulatory limits of §723.16 of the *NCUA Rules and Regulations*, the credit union has received an exception from these regulatory limits (§723.17), or the credit union has received a waiver for a category of loans (§723.10.)

- Other loan categories. Examiners may select a sample of loans from the following categories, if they exist:

New programs	Line of credit
Real estate	Home equity
Insured-Guaranteed	Credit card
Participation	Agricultural
Floor plan	Paid-ahead
Open end	SBA
Risk-based	Lease
Non-amortizing loans	Repossessions
Foreclosures	Paperless loan systems
Indirect dealer financing program	

With an AIRES download, examiners can use standard or customized loan queries to pull specific loans meeting defined characteristics.

Part 2 of this chapter discusses delinquent loan control. Appendix 10A discusses the various loan types. Appendix 10B contains a glossary of loan terms and Appendix 10C contains specific financial ratios to analyze member business loans. Appendix 10D contains sample Indirect Dealer Financing Program (IDFP) agreements. Appendix 10E contains a documentation checklist for real estate loans.

Loan Documents

Credit unions must require adequate loan documentation for all loans. Weak documentation practices could adversely affect the ability to successfully collect the loans in a litigation action, and could lower the value of loans in merging or liquidating credit unions.

Adequate loan documentation includes the following:

- A completed loan application along with documented approval;
- Documented creditworthiness analysis including:
    - Verification of income;
    - Credit reports; and,
    - Debt ratio or disposable income analysis;
- Evidence of collateral value (e.g., purchase invoice, appraisals);
- Loan officer worksheets and notes;
- A completed note or security agreement; and
- A perfected collateral lien and adequate insurance.

Loan Exceptions

Through a review of the individual loan files, the examiner identifies as loan exceptions (1) documentation deficiencies, (2) loan processing exceptions, (3) violations of the *FCU Act* or *NCUA Rules and Regulations,* (4) violations of the credit union's lending policies, (5) violations of consumer compliance regulations, and (6) deficient credit practices. Examiners may use AIRES Loan Exceptions, or a self-designed workpaper, to detail their exception comments on the loan review.

When loans are missing from the files, and staff cannot locate the documents, examiners should provide the supervisory committee with a list of missing loans. Examiners should obtain an agreement that the supervisory committee will promptly contact the borrowers to confirm the loan's authenticity.

Examiners should treat chronic loan documentation and loan quality problems (e.g., the lack of establishing the creditworthiness of borrowers, recording titles, liens, UCC filings, obtaining real estate appraisals, verifying income, etc.) as a major area of concern.

Impermissible Loans

Loans made in violation of the *FCU Act* or *NCUA Rules and Regulations* are impermissible. Examiners should document these violations as loan exceptions, provide guidance to the officials regarding their responsibilities in connection with the violations, and make appropriate recommendations for corrective action. When examiners review only a portion of the loans, they should instruct the officials to review all similar loans for possible violations.

If the credit union made intentional or material impermissible loan disbursements, the board of directors must notify surety and request assurance that bond coverage will continue. The credit union must call the impermissible loan disbursement, unless the credit union made the loan to a "good faith" borrower. Since credit unions cannot legally compel good faith borrowers to return the money in terms other than those found in the original loan agreement, the credit union must honor the terms of the loan. If the credit union does not renegotiate or correct the loan and a loss occurs, the credit union should file a bond claim with surety for the balance of the impermissible disbursement.

The supervisory committee should determine the board has taken appropriate action to address impermissible loans and to file a claim or protect the right to file a claim with the surety company. The examiner should make certain the committee members, as well as directors and appropriate employees, familiarize themselves with their exact duties regarding impermissible loans.

Loan Programs and Policies

Section 701.21(c)(2) of the *NCUA Rules and Regulations* and sound business practices require that credit unions develop written loan policies. The following financial considerations apply:

- Member needs. Each credit union serves a different field of membership with somewhat differing needs. Credit unions should consider this when developing their loan policies;

- Availability of funds. Credit unions should consider sources for their funding of loans;

- Competition. A credit union should price its loans competitively by remaining aware of the rates national and local lenders offer their members and customers;

- Cash flow. Credit unions must tie their loan policies into their overall funds management program and must provide for cash flow, as well as, profitable return. As such, they should carefully weigh single payment loans and balloon notes in terms of the likelihood of repayment and the negative effect on liquidity. Credit unions should also exercise care in establishing a real estate loan program in which repayment terms of 15 years or more can affect cash flow and income, particularly if real estate loans make up a large portion of the loan portfolio; and

- Pricing. Credit unions should establish and continuously monitor their loan rates to ensure an adequate spread for the cost of funds, operating expenses, reserve requirements, and profitability goals. Other pricing considerations include market competition, loan demand, and asset liability management strategies.

The following credit evaluation considerations apply:

- Adequate borrower information. Credit unions should obtain complete credit information on borrowers. A complete and accurate application enables the credit committee or loan officer to assess the applicant's willingness and ability to repay. This information also helps the collection staff, if needed.

- Completed loan application. The loan application should document the applicants' income source and stability, as well as their current obligations. Staff can better determine the applicant's "capacity to repay" by verifying the monthly obligations through credit reports, and reported income using one of the following:

  - A copy of a recent pay stub. This will verify employment, as well as income. The loan processor should review hourly

wages, salary, or year-to-date income, as stated on the pay stub. They should also alert themselves to any wage garnishments;

- A documented phone contact or written verification to the employer or credit union sponsor (the sponsor may have income information or pay scale based on position and length of service);

- A complete copy of the most recent signed tax return or independently prepared and audited financial statement, for self-employed borrowers. By obtaining two years' tax returns, the credit union can develop a trend analysis to better analyze self-employed borrowers' cash flows and income levels over time; and

- A copy of the lease or rental agreement, tax return, or pay stub, when the applicant lists "other income" (e.g., rental, investment, or second job.)

Many credit unions with stable fields of membership and one primary sponsor may know their borrowers' relative income levels and past payment histories. Examiners should consider such factors in conjunction with loan loss and delinquency levels when evaluating the issue of income verification. Many competing lenders do not verify income. Competition and member service could override documentation considerations in credit unions with good lending performance.

- Terms of repayment. Credit unions should base loan repayment terms on the purpose of the loan, the collateral, and policy constraints. The terms also must coincide with the provisions of the *FCU Act* and *NCUA Rules and Regulations*.

- Collateral. The principles regarding collateral and the actions required by the officials when accepting collateral for various types of loans include:

  - Sufficient equity in the collateral to diminish the applicants' willingness to lose their investment;

  - Repayment schedules that reduce the loan balance as the collateral depreciates;
  - Collateral that can readily convert to cash; and
  - Collateral that has a known value. For some types of collateral, such as vehicles, the credit union can determine the value from publications designed for that purpose. Other types of collateral, such as boats and real property, should have a written assessment or appraisal to document value.

- Extension agreements and refinanced loans. The principles of credit also apply to extension agreements and refinanced loans. Credit unions should not use them as devices to cover up delinquency problems. Generally, once a member with a previously unsatisfactory repayment history has demonstrated the ability to make three to six consecutive monthly scheduled payments without added collection work, the credit union may consider extending or refinancing that member's delinquent loan. The credit union should have a written extension policy and the ability to identify or track the performance of delinquent loans it extends or refinances.

- Chattel lien instruments. Management decides whether a credit union files chattel lien instruments or purchases chattel lien non-filing insurance. It is management's responsibility to protect the credit union and comply with the provisions of state and local laws.

Lending Practices

Examiners may evaluate lending practices by reviewing policies, board minutes, credit committee/loan officer minutes, and the loan files. When assessing practices, the examiner determines the following:

- The board establishes reasonable written policies to manage delinquency and loan losses;
- The credit committee or loan officers act within their written authority;
- The board establishes realistic loan limits and pricing, to the extent of available funds;
- The board establishes reasonable collateral requirements that provide adequate protection to the credit union; and

- The board establishes written policies implementing an internal loan review and grading system (if applicable) to identify credit risk in the loan portfolio.

Credit Report Analysis

Most credit unions use credit reports when evaluating a borrower's creditworthiness. Occasionally, small credit unions use oral credit reports but these can result in misinterpretation. Credit unions must keep documentation of the oral credit report in the borrower's loan file.

Credit reports help determine the applicant's "character" and verify outstanding debts. Credit unions should place a strong reliance on the credit report and the member's payment history. A poor repayment history and adverse credit report provide strong indications of whether the member will repay the credit union. In general, credit unions should pull a new credit report if the most recent credit report is more than twelve months old.

When reviewing credit reports, loan officers should determine that:

- Borrowers have listed all their debts on the application. Reconciling the credit report to the application can identify debts not listed. Credit reports do not include debts to institutions that do not report to the credit bureau (e.g., some small credit unions, sub-prime lenders.) To determine the member's "capacity to repay," staff should consider all the obligations including the new loan.

- The credit ratings indicate a good, slow, or poor past payment history. Some credit reporting agencies (Experian, Equifax, and Trans Union) quantify payment histories into risk scores. The risk scores indicate the probability of loan default and the member's probability of filing for bankruptcy in the future. If credit unions use a risk score rating system as part of their loan underwriting process, they should understand the system well enough to explain it.

- Excessive numbers of inquiries over the past year (which may indicate financial problems or excessive pending new credit) are explained.

The credit union should not automatically deny a loan because of a member's adverse credit history. A member having experienced a layoff or serious medical condition could have a poor prior record. If the credit union approves a loan to a member with an adverse credit history, the credit union should adequately document the reasons for the approval and show the member has resolved the reasons for the adverse ratings.

Members can have problems "below the surface" even if all ratings show positive. Many revolving lines of credit at or near the maximum limits can signal potential over extension or "pyramiding." Reviews of bankruptcies indicate many members were current prior to filing bankruptcy. Comparing past credit reports to present credit reports can identify pyramiding debt. Characteristics of pyramiding debt include:

- Using new credit to pay old debt, especially the use of unsecured credit to consolidate credit card debt;
- Escalating debt outpaces income; and
- Increasing numbers of recent credit report inquiries, which can indicate either lender denials or unreported new debt, as some lenders report inquiries but do not report new loans.

Capacity to Repay

A major consideration in granting loans is the analysis of the member's capacity to repay. Calculation of a debt ratio (monthly obligations to income) remains a standard method of analyzing the ability to repay.

Credit unions must also consider the member's level of income when making loan decisions. For example, members with higher levels of income can often handle higher debt ratios. This type of review, referred to as a Net Disposable Income Analysis, can help determine the members' capacity to repay. All loans granted to members with limited capacity to repay should have an overriding reason noted in the file.

Credit Scoring

Credit scoring systems attempt to statistically predict the likelihood of a member defaulting on a loan. Regulation B requires statistically derived and empirically sound credit scoring. Fair, Isaac and Company,

Incorporated, a financial service organization, pioneered credit scoring and provides many of today's credit scoring tools. Other sources of credit scoring include a credit union's custom model or a score obtained from one of several credit reporting agencies. Credit reporting agencies also offer preapproval screenings based on "canned" prescreens or individually developed queries. In general, credit unions outsource the development of a credit-scoring model to minimize costs, while taking advantage of the marketplace expertise.

Advantages of credit scoring include (1) quick loan turnaround, (2) consistency in lending, and (3) basis for risk pricing. Many credit unions use credit-scoring models to market loan products, such as pre-approved auto and credit card loans. Credit scoring allows these credit unions to send out pre-approved mass mailings to targeted groups. Credit unions use credit scoring as the basis either for loan decisions or as a loan officer's tool in a judgmental loan decision. Credit unions manage the volume of loans and level of risk assumed by setting credit score ranges loans must meet.

When a credit union uses credit scoring, loan policies and procedures must outline how the credit union will do the following:

- Apply them consistently;
- Validate them. At a minimum, the credit union should test and validate the credit scoring model at least every two years; and
- Track their results. For example, if unexpected delinquency results from credit scoring, the credit union should consider modifying the underlying parameters of the scoring model.

Some credit unions contract with third parties to perform credit scoring. The contract must set forth the responsibilities of the parties, including who assumes responsibility for ensuring that the credit scoring meets applicable regulations. The credit union should ensure that:

- Staff receive adequate training and understand the credit-scoring model. Loan officers should understand the system, its components, and its limitations;

- Management obtained a written legal opinion that states the credit union has met all applicable regulations and has adequately protected itself;
- Management tracks credit scored loans and recalibrates the credit scoring model when necessary; and
- Indirect lenders can only authorize approval for loans to members. The third party contract must exclude loans to non-members.

Paperless Lending

Credit unions constantly search for ways to deliver services more efficiently to members. Credit unions have systems to take loan applications via audio response systems, fax, and the Internet. Often, credit unions using these paperless systems order credit reports and compare the application information entered by the member with that on the credit report. Simple logic programs analyze the member's debt ratio, credit history, disposable income, etc., and either approve the loan request, or refer it to the staff for further action. Some systems may even complete and disburse the loan electronically.

Examiner Guidance

When reviewing a paperless loan system, the examiner should determine the credit union addressed the following areas:

- Data integrity. Credit unions must secure application information collected by the system, protect it from access by unauthorized parties, and provide it in a form that users can readily access;

- Regulatory compliance. The application should comply with applicable consumer regulations (e.g., give the member the opportunity to apply for the loan individually or jointly, properly address community property issues, and meet *Equal Credit Opportunity Act* (ECOA) criteria.) Further, the credit union should have an attorney's opinion stating that the paperless application constitutes a legal loan application;

- Collectibility. If the system completes and disburses the loan, the credit union should retain an attorney's opinion stating that the loan represents an enforceable debt or security interest and addresses the ECOA issues as to enforceability against co-applicants, co-makers, or guarantors;

- Internal Controls. The credit union must maintain a record of all loans approved or referred by the system. Loan officers (or the credit committee) must properly act upon system-approved and referred loans. The internal control manager, assigned staff person, or outside auditor, who has no involvement in lending, should review this record and management's documented inspection to affirm the credit union makes no unauthorized loans; and,

- Documentation. Examiners should review the adequacy of the documentation and disclosures the paperless loan system generates for the credit union and the member. Some systems may only generate an information summary showing the data entered by the member. Credit unions may compensate by taking a master application before allowing a member to use the "paperless loan" system, in order to meet application disclosure requirements.

Risk-Based Lending

NCUA Letter to Credit Unions 99-CU-5 and 174 address risk-based lending. Risk-based lending involves setting a tiered-pricing structure that assigns loan rates based on an individual's credit risk. Profitable risk-based lending requires the surcharge rates charged by the credit union cover the loan loss rates and overhead costs related to underwriting, servicing, and collecting these loans. Credit unions that cannot justify and support pricing differences based on risk will face heightened compliance and reputation risks if pricing decisions appear to result in disparate treatment under consumer protection regulations (e.g., ECOA.)

Credit unions that engage in risk-based lending should have in place:

- Strategic and business plans that acknowledge the additional inherent risks and provide for the necessary resources, including specialized management and staff expertise, to manage the risks;

- Policies and procedures approved by the board that define the parameters of the risks assumed and internal controls necessary to ensure acceptable portfolio quality;

- Information systems capable of providing monitoring information sufficient to analyze the results of underwriting, operations, and pricing decisions;

- Quality control systems that provide feedback on the adequacy of and adherence to underwriting, operating, pricing, and accounting guidelines;

- Compliance management programs that identify, monitor, and control consumer protection problems associated with risk-based lending; and,

- The level of net worth needed to support the additional risks incurred. Examiners may review the credit union's documentation of its method used to determine the amount of capital necessary, and may evaluate the overall capital adequacy on a case-by-case basis.

Large Loans and Concentrations

Examiners can often evaluate concentration risk by measuring concentrations as a percentage of total loans or total equity. (Smaller credit unions may find this more appropriate than larger credit unions.) Examiners may also find the pre-built queries in AIRES beneficial for identifying large loans and concentrations of credit. In both large and small credit unions, examiners may benefit from developing continuing workpapers for tracking large loans and concentrations of credit from one examination to the next.

AIRES

The AIRES Questionnaire workbook contains various loan questionnaires. These checklists further document the examiner's review of various loan types. Use of the questionnaires can also assist the examiner in reviewing unfamiliar loan types. Depending on the credit union's services offered, optional questionnaires may address controls in the following lending areas:

- Real Estate
- Line of Credit
- Leasing
- Indirect Lending

- Home Equity
- Credit Cards
- Construction
- Collections
- Adjustable Rate Mortgages
- Agricultural
- Member Business Loans

Workpapers and References

- AIRES Workpapers, Documents and Questionnaires
  - Review Considerations
    - Loan Analysis
    - Loan Exceptions Document
    - Loan Review
    - Key Ratios
    - Critical Loan Input
    - Real Estate Lending Controls
    - Adjustable Rate Mortgage Lending Controls
    - Construction Lending Controls
    - Business Lending Controls
    - Agricultural Lending Controls
    - Line of Credit Lending Controls
    - Credit Card Lending Controls
    - Automated Teller Machine Controls
    - Regulation M - Consumer Leasing
    - Regulation Z – Truth in Lending
    - Regulation Z – Variable Rate Loans
    - Allowance for Loan and Lease Losses Module
    - Manual Loan Classification

- References
  - *Federal Credit Union Act*
    - 107(5) – Authority to Make Loans
    - 107(11) – Statutory Liens
    - 107(13) – Purchase of Eligible Obligations
    - 114 – Credit Committee
  - *Federal Credit Union Bylaws*
    - Article IX – Credit Committee
    - Article XII – Loans to Members and Lines of Credit

- *NCUA Rules and Regulations*
  - 701.21 – Loans to Members and Lines of Credit to Members
  - 701.22 – Loan Participation
  - 701.23 – Purchase, Sale, and Pledge of Eligible Obligations
  - 702.402 – Full and Fair Disclosure Required
  - 722 – Appraisals
  - 723 – Member Business Loans
- *Accounting Manual for Federal Credit Unions*
- IRPS 83-3 – Financing Leases
- *Chartering and Field of Membership Manual*
- NCUA Letter No.119
- NCUA Letter No. 174
- NCUA Letter No.99-CU-5

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Chapter 10 – Part 2

LOANS – CREDIT RISK, DELINQUENCY, & CHARGE OFFS

Examination Objectives

- Determine the credit risk within the loan portfolio
- Determine if the credit union reports delinquency accurately and in a timely manner
- Determine if the credit union has appropriate and adequate collection policies and procedures
- Determine if the credit union makes appropriate and adequate collection efforts
- Determine if the credit union has implemented reasonable extension and refinancing policies and procedures
- Determine reasonableness of the charge-off policy

Associated Risks

- Credit risk occurs when the borrower cannot repay according to the terms of the loan;
- Liquidity risk occurs when the failure to collect problem loans affects available funding sources;
- Transaction risk occurs when delinquent loans are not properly aged; and
- Reputation risk occurs when delinquency or collection efforts (or lack thereof) affect the credit union's image.

Overview

Management's responsibility includes identifying and monitoring credit risk, delinquency, and charged-off loans on an ongoing basis.

Evaluating Credit Risk

There are two purposes for reviewing the loan portfolio:

- Assessing the level and direction of credit risk, and
- Determining the potential risk to the NCUSIF.

Adequate funding of the ALLL and/or low delinquency and loan loss ratios do not necessarily mean the credit union properly mitigates its credit risk. Credit unions should also have a quality control process by which they review the loan portfolio or components of the loan

portfolio to determine if risk factors exist that, if left unattended, could adversely affect the overall quality of the loan portfolio.

Examiners may review the credit union's quality control process. The goal is to ensure management can assess the risk in its portfolio and monitor potential future exposure. The credit union may prepare lists to monitor and assess delinquent loans, other problem credits, and special mention loans. The preparation and maintenance of these reports vary among credit unions and largely depend on the credit union's resources and sophistication. Tracking the information on these lists enables management to assess the performance of the loan portfolio and act to mitigate risk therein through changes in policies and/or procedures. If the credit union has an adequate process for evaluating credit risk, examiners need not perform a detailed review of the loan portfolio.

Other problem credits usually include past due loans, leases, and accounts receivable; however, they may also include non-delinquent loans of members experiencing a recent layoff, loans especially affected by a downturn in economic conditions, and loans that circumstances indicate may become delinquent in the near future.

Special mention loans usually include loans that require special monitoring by the credit union. These may include loans in new loan programs, loans the credit union officials chose to grant that fall outside the credit union's loan policy, loans for which the credit union has no prior experience, loans previously classified as problem credits, and any other loan that requires additional attention.

If the credit union does not have an adequate quality control review process, the examiner should review a sample of loans to assess the level and direction of credit risk. This may involve creating a list of loans that exhibit specific risk characteristics, to review from one examination to the next. The Query Report Loan Watch List in AIRES provides a tool that may assist examiners in tracking loans containing significant existing or potential risk. In addition, the examiner may review and track loans meeting certain criteria such as the following:

- Loans having weaknesses that jeopardize full collection of the debt, including the distinct possibility the credit union will sustain some loss if it does not correct the deficiencies;

- Loans where, even if collected, the credit union would incur collection costs, which could be substantial;

- Loans, both open-end and closed-end, past due 90 days from the contractual due date;

- Loans where it appears the credit union will not collect a substantial portion, even though the borrower makes partial or irregular payments;

- Loans with inadequate documentation;

- Loans that are current but represent potential losses to the credit union due to questionable security;

- Loans, that are current according to their terms, but represent potential losses because of the payment terms or past practices. This category might include single payment loans and "balloon" loans that the credit union has repeatedly refinanced or extended;

- Workout loans in which the credit union permanently amended the original terms of the note to lower payments or reduce interest rates. Workout loans generally allow the borrower to continue a reasonable payment stream thus avoiding default; and

- Any other loan as warranted.

Based on this review, the examiner may make recommendations to management that would enhance the quality of their loan portfolio. Examiners should direct their review toward determining the level and direction of credit risk and the potential risk to the NCUSIF.

Delinquency Control

Examiners should verify the credit union accurately reports delinquency each month for all loan types. Credit unions must report the total delinquent amount when reporting delinquency statistics,

including loans handled by a third party (e.g., bankruptcy loans, participation loans, student loans, credit card loans, and first mortgage real estate loans.) An accurate list of delinquent loans enables the examiner to evaluate collection policies and practices, and identify delinquent loans for possible charge off.

Examiners may test a sufficient number of loans to determine the reasonableness of the delinquent loan schedule. Examiners can perform manual calculations and testing using a calculator, or they can test electronically using AIRES or other computer programs (e.g., Excel.) If the loan sample tested reveals loans improperly categorized or omitted from the delinquent loan schedule, the examiner should design a workpaper to reflect the correct categories for these loans.

If no current, complete, or accurate delinquent loan schedule exists, the examiner should establish appropriate plans with officials to develop one. Examiners may retain a schedule of the delinquent loans in the field file for reference.

NCUA does not require a credit union to use a particular loan delinquency calculation method. Examiners may use one of the traditional methods (in AIRES) as a simple measure for comparison with a credit union's calculated delinquency estimate. However, examiners must understand the intent of these methods is to provide a "reasonableness test." Generally, credit unions must calculate loan delinquency consistent with loan contract terms, which can vary widely.

The delinquent loan schedule can serve as the basis for a loan review sample. For example, a review of recently granted delinquent loans might provide insight as to reasons for increasing delinquencies. The Loan Exceptions workpaper can aid officials in revising policies and practices to reverse an increasing delinquent loan trend.

During the delinquent loan review, the examiner may:

- Determine whether staff follows the collection policies and procedures;
- Identify weaknesses within the collection policy or process;

- Identify underwriting trends and weaknesses, and determine what changes in procedures could have prevented the delinquency;
- Determine if the credit union develops and properly monitors a watch list of loans that require special attention; and
- Review repossession, bankruptcy and foreclosure logs to evaluate credit union control.

Based on a review of the Scope Workbook, the credit union's 5300 risk parameters, and loan queries, examiners should determine the level of risk posed by delinquency. An initial review of loans may suggest understated delinquency and deserve a closer look.

Collection Procedures

Examiners should review the loan loss ratio and the delinquent loan ratio when evaluating collection procedures. These ratios show the credit union's past loss experience and its current potential loss position. The adequacy of the collection program and the credit union's level of compliance with it provide an indication of the future direction of delinquency. The composition of delinquency can also indicate whether problems are recent or older.

Each credit union should develop a collection program appropriate for its size, complexity, field of membership, and area. The program should have definite, measurable goals (e.g., follow up on missed promise to pay within 24 hours.) Collection programs usually share the following common characteristics:

- Prompt action. Early collection effort enhances the success rate of collecting delinquent loans (e.g., within a few days of the first missed payment, long before the loan appears on the monthly delinquent loan list);

- Repeated contacts. A collection effort should consist of a series of payment requests, beginning with a gentle reminder and ending with a firm demand for repayment. Collection staff should record all collection contacts, and the results of those contacts, on a collection card or computer system collection-working file;

- Varied action. A collection program that combines letters and personal telephone calls can prove quite effective. Collection staff

should determine the "intent" of the delinquent member as early as possible. If delinquent members cannot make full loan payments, they should reach agreement with the credit union to make regular, partial payments. As a minimum, the borrower should initiate and maintain regular contacts with the credit union. If the borrower does not establish "good faith" or "good intent," the credit union should take stronger collection action;

- Prompt follow up on failed promises. If borrowers do not follow through with their promise to pay, the credit union should follow up within a maximum of 48 hours;

- Follow through. If the credit union does not follow through with its threatened action, delinquent borrowers may believe they can ignore the credit union; and

- Proper paperwork. Although not considered part of a collection program, staff must properly complete paperwork to reduce the likelihood of legal action against the credit union.

Examiners should discuss deficiencies in the collection program, policies, or practices with the appropriate officials. When encountering weak collection procedures, examiners may document their review by completing the Collection Program questionnaire in AIRES.

Examiners may also review previously charged-off loans. Often, credit unions assign these loans to outside collectors. These outside collectors should issue periodic status reports to the credit union. If these reports indicate a lack of follow up, officials must take appropriate action.

An "inverted" delinquency (more delinquent loans in the 6 to 12 and 12 months and over range than in the 2 to 6 months range) may indicate a problem in the collection program. The examiner should review the reasons for the inversions and, if necessary, reach agreements with the board to improve the collection practices. Inversion can also indicate the credit union does not charge off loans in a timely manner.

In a "normal" delinquency condition, more loans exist in the 2 to 6 months range than in the 6 to 12 months and 12 months and over ranges. Examiners may analyze the loans 1 to 2 months past due to determine if a weakness in the collection program is beginning to surface.

Erratic trends in delinquency, such as increasing delinquency followed by a sudden decrease that does not relate to loan charge-offs, can indicate potential abuse (e.g., due date bumping or fictitious loans.) Examiners may expand the review if they note unusual trends.

Extension and Refinancing

Examiners may review extension and refinancing policies and procedures for reasonableness. At times, credit unions can effectively use extension agreements or refinancing of delinquent loans as collection tools; however, excessive extension agreements or refinancing can mask delinquency. Credit unions should use extension agreements or refinancing of delinquent loans only to help borrowers overcome temporary difficulties, and after the borrower demonstrates renewed willingness and ability to repay the loan.

Generally, credit unions grant extension agreements to delinquent borrowers who have demonstrated their commitment to repay their obligations by making substantial payments for at least three months prior to approval. (Examiners should note that delayed disability insurance payments for illness or circumstances such as recalls after a layoff may justify extension agreements without the member demonstrating three months of good faith payments.) The collection department can prepare extension agreements; however, a loan officer or credit committee must approve the transaction to assure segregation of duties and avoid a conflict of interest.

Credit unions should refinance delinquent loans only after the borrower has demonstrated a consistent effort and ability to repay. Refinancing of delinquent borrowers that do not make consistent payments could warn examiners of hidden delinquency.

As a general rule, credit unions should not extend or refinance a loan more than once within a twelve-month period, or two times within a five-year period. If the credit union has a history of frequently

extending or refinancing loans, the examiner should carefully review the underlying reasons.

Credit Card Collection Program

The examiner may need to review the credit union's in-house procedures for delinquent credit card loans to ensure proper aging and limited losses. Some processors only report delinquency up to 210 days, in which case the credit union must calculate and report the past due months over 210 days.

Examiners should consider the following items when analyzing the credit union's credit card collection program:

- Procedures for listing delinquent, over limit, lost, or stolen cards in a warning bulletin;
- Procedures for blocking cards;
- Procedures for reviewing over limit cards; and
- Adequacy of bond coverage and deductible for fraud losses.

Bankruptcy

Examiners should familiarize themselves with the basic terms and concepts of federal bankruptcy law (Title 11, U.S. Code) in order to make informed judgments concerning the likelihood of collection from bankrupt members or member businesses (called "debtors" under the bankruptcy law.) The following paragraphs present only an overview of bankruptcy.

Complex situations may arise where examiners need more in-depth consideration of the bankruptcy provisions that warrant consultation with the credit union's counsel, regional office, or Office of General Counsel. For the most part, however, knowledge of the following information, when coupled with review of credit file data and discussion with credit union management, should enable examiners to reach sound conclusions regarding the eventual repayment of the credit union's loans.

Forms of Bankruptcy Relief

Liquidation and reorganization comprise the two basic types of bankruptcy proceedings. Liquidation, pursued under Chapter 7 of the law, involves the bankruptcy trustee collecting all of the debtor's non-

exempt property, converting it into cash and distributing the proceeds among the debtor's creditors according to a priority prescribed by statute. In return, the debtor obtains a discharge of all debts outstanding at the filing of the petition, thus releasing the debtor from all liability for those pre-bankruptcy debts.

Chapter 11 or Chapter 13 of the law addresses reorganization and, in essence, provides satisfaction of the creditor's claims from the debtor's future earnings, rather than through liquidation of the debtor's assets. That is, debtors may retain their assets, but the court restructures their obligations and implements a plan to pay the creditors.

All debtors (whether individuals, corporations, or partnerships), may use Chapter 11 bankruptcy, regardless of the amount of their debts. On the other hand, only individuals with regular incomes and unsecured debts under $269,500 and secured debts less than $807,750 may use Chapter 13.

The Chapter 13 reorganization plan represents essentially a contract between the debtor and the creditors. Before confirming the plan, the bankruptcy court must find that it was proposed in good faith and that creditors will receive an amount at least equal to what they would have received in Chapter 7 liquidation.

In Chapter 11 reorganization, all creditors may vote on whether or not to accept the repayment plan. In Chapter 13 proceedings, creditors may object to the proposed repayment plan only on the following grounds: (1) they will not receive an amount at least equal to what they would have received in a straight liquidation (the "best interest of creditors" test); (2) the debtor is not required to pay all disposable income (i.e., income after payment of reasonable, current expenses) into the plan for at least three years (the "best efforts" test); or (3) the plan is not proposed in good faith (the "good faith" test.) The debtor may choose to convert a Chapter 13 bankruptcy to a Chapter 7 bankruptcy.

Most cases in bankruptcy courts involve Chapter 7 proceedings. From the creditor's point of view, Chapter 11 or 13 filings generally result in greater debt recovery than do liquidation situations under Chapter 7. The courts tailor reorganization plans to the facts and circumstances applicable to each debtor's situation, which mean they vary

considerably, and the amount that the creditor recovers may similarly fluctuate from nominal to virtually complete recovery.

Automatic Stay

Filing of the bankruptcy petition requires (with limited exceptions) creditors to cease or "stay" further action to collect their claims or enforce their liens or judgments (12 U.S.C. §362.) Once filed, the petition prohibits actions to accelerate, set-off, enforce a statutory lien (*NCUA Rules and Regulations* §701.39), or otherwise collect the debt. The petition also prohibits post-bankruptcy contacts with the debtor (i.e., "dunning" letters.) The stay remains in effect until the bankruptcy court releases the debtor's property from the estate, dismisses the bankruptcy case, approves a creditor's request for termination of the stay, or the debtor obtains or is denied a discharge. Two of the more important grounds applicable to secured creditors for seeking relief from the automatic "stay" follow:

- The debtor has no equity in the encumbered property and the property is not necessary to an effective reorganization plan; or

- The court is not adequately protecting the creditor's interest in the secured property.

In the latter case, the law provides three methods by which to adequately protect the creditor's interests: (1) the creditor may receive periodic payments equal to the decrease in value of the creditor's interest in the collateral; or (2) the creditor may obtain an additional or substitute lien on other property; or (3) the court arranges some other protection (e.g., a guarantee by a third party) to adequately safeguard the creditor's interests. If these alternatives result in adequate protection for the secured creditor, relief from the automatic stay will not be warranted. If the creditor obtains relief from the stay, creditors may resume pressing their claims upon the debtor's property free from interference by the debtor or the bankruptcy court.

Discharge – Objections and Exceptions

The discharge protects the debtor from further liability on the debts discharged. In some instances, however, bankruptcy does not discharge debtors at all (i.e., the creditor successfully obtains an "objection to discharge"), or discharges them only as regards a specific

creditor and a specific debt (an action known as "exception to discharge.") In general, most unsecured debt is dischargeable, while most secured debt survives bankruptcy as a charge on the property to which it attaches. The debtor obviously remains liable for all obligations not discharged, and creditors may use customary collection procedures to collect these obligations.

"Objections to Discharge." The grounds justifying an "objection to discharge" include any of the following actions of the bankrupt debtor (this list is not all-inclusive) occurring within twelve months preceding filing of the bankruptcy petition: (1) transfer, removal, destruction, mutilation, or concealment of property of the debtor or the estate, with intent to hinder, delay, or defraud; (2) concealment, destruction, mutilation, falsification, or unjustifiable failure to preserve records of debtor's financial condition and business transactions; (3) making a false oath or account, or presentation of a false claim to the bankruptcy estate; (4) withholding of books or records from the trustee; (5) failure to satisfactorily explain any loss or deficiency of assets; and (6) refusal to obey a lawful court order or to testify when legally required to do so. In addition, the debtor's receipt of a discharge in bankruptcy within six years preceding filing of the present bankruptcy petition is a valid ground for objection (11 U.S.C. §727(a)).

"Exceptions to Discharge." The grounds justifying an "exception to discharge" include: (1) pre-bankruptcy income taxes; (2) money, property, or services obtained through fraud, false pretenses, or false representation; (3) debts not scheduled on the bankruptcy petition and for which the creditor had no notice; (4) alimony or child support payments (only the debtor's spouse or children may assert this exception, property settlements are dischargeable); and (5) submission of false or incomplete financial statements.

If a credit union attempts to seek an exception on the basis of false financial information, it must prove (1) the written financial statement was materially false, (2) it reasonably relied on the statement, and (3) the debtor intended to deceive the credit union. The credit union may find these assertions difficult to prove. Corporations and partnerships cannot avail themselves of discharges; therefore, bankruptcy often causes corporations and partnerships to dissolve or become defunct.

Reaffirmation

Despite a bankruptcy discharge, debtors may sometimes promise their creditors they will repay a discharged debt. A common example involves an unsecured loan with the credit union that the borrower wants to reaffirm after discharge. This process of reaffirmation is voluntary, but judicially enforceable agreement (11 U.S.C. §524(c); Fed. R. Bankr. 4008.) The principal requirements for a reaffirmation agreement are:

- The agreement between the debtor and the creditor must be made (i.e., executed and dated) before the discharge is granted;
- The agreement must inform the debtor that there is no legal requirement to reaffirm (i.e., that reaffirmation is voluntary);
- The court must reiterate that reaffirmation is voluntary and explain the obligations imposed by the agreement and the legal consequences if the debtor defaults; and
- The agreement must give notice of the debtor's right to rescind the reaffirmation agreement at any time before the discharge is granted, or within 60 days after the agreement is filed in court, whichever is later.

Transfers Not Promptly Perfected or Recorded

Under most circumstances, a credit union that fails to promptly perfect its security interest runs great risk of losing its security. This is a complex area of the law, but prudence clearly dictates that the credit union properly obtain liens and promptly file them to eliminate the possibility of losing the protection provided by collateral.

Statutory Lien

Federal credit unions can take advantage of a statutory lien authorized by the *Federal Credit Union Act* §107(11) and interpreted by IRPS 82-5. Under this authority a federal credit union may (1) impress a lien when granting a loan, by noting the existence of the lien in its records at the same time it grants the loan, by stating in the loan documents that borrowers pledge their shares and dividends to satisfy the lien or to secure the loan, or by adopting a bylaw or board policy to the same effect; and (2) enforce the lien by applying the shares and dividends directly to the amount due on the loan (including the unpaid loan balance together with interest, fees, and other charges) without obtaining a court judgment, even if the credit union has allowed the

member to make withdrawals and even if state law requires a court judgment before enforcing a statutory lien.

Three exceptions apply:

1. Regulation Z generally prohibits a federal credit union from offsetting a borrower's indebtedness arising from a consumer credit transaction under a credit card plan against funds that the credit union holds (12 C.F.R. §226.12(d));

2. As concerns individual retirement accounts (IRAs), the Internal Revenue Code (26 U.S.C. §408(a)(4)) requires that the "interest of an individual in the balance in his account is nonforfeitable." NCUA takes the position that federal credit unions should not impress a statutory lien against an IRA without first obtaining advice of either a tax advisor or counsel; and

3. The automatic stay of a bankruptcy court can stay the use of the statutory lien, which, if impressed within the preference transfer reversion period, could be an illegal preference and thus voided.

Examiners should also note two caveats regarding the statutory lien:

1. The credit union may only impress the statutory lien against the debtor-member's accounts (e.g., in a tenancy-in-common account, deemed to be a 50-50 split in the absence of other evidence, a federal credit union could not place the lien against more than the debtor's 50 percent interest; it cannot impress the lien against a parent's account for debts of an emancipated minor); and

2. The statutory lien only applies in the loan context; a federal credit union must adopt a nonstandard bylaw amendment or bylaw resolution in order to debit a member's account for losses resulting from another account (e.g., unpaid fees or service charges or returned checks.)

Loan Loss Ratio (Net Charge-Offs To Average Loans)

The Financial Performance Report (FPR) computes an annual loss ratio termed net charge-offs to average loans, and provides a peer-group comparison (the amount of loss is shown per $1,000 of loans

outstanding.) It also provides a historical trend of the net charge-off ratio. The Key Ratios workpaper displays the loan loss ratio for prior periods and the current ratio. The examiner should use this information for both comparisons between credit unions and to supplement the trend analysis. However, this ratio can be misleading.

For example, a low loss ratio could result from a board's reluctance to recognize losses, which would be evidenced by a high delinquent loan ratio. The examiner should compare the loss ratios over the periods to detect trends. A high but declining ratio might indicate that the credit union is correcting past problems. On the other hand, a credit union might have a low but rapidly increasing loss ratio, which might indicate an emerging problem.

The examiner should determine whether the credit union has a reasonable and timely method of charging off loans. Moreover, the examiner must verify the accuracy of the information on the NCUA 5300 report.

Charge Off of Problem Credits

Credit unions should establish a policy for the regular charge off of uncollectible loans to avoid an intentional or unintentional misstatement of their net worth position. The Query Report Charge Offs in AIRES provides a tool that may assist examiners in identifying charge off loans, when necessary.

The board may adopt a policy that delegates to the manager the authority to charge off loans. The board should approve the extent of the delegation (i.e., the dollar amount and loan type), reflect the approval in board minutes, and note the parameters in the written collection policy or, more appropriately, written loan charge-off policy. The manager refers loans that do not meet the established criteria to the board. The policy should specifically prohibit the manager from charging off loans when such charge off may constitute a conflict of interest, such as loans to family members.

Management reports loans charged off under the delegated authority to the board of directors at the next regularly scheduled meeting. NCUA recommends that the board ratify all delegated charge offs.

The board of directors must periodically review compliance with the charge-off policy. This policy may require the manager to comply with IRS rules to report certain discharges of indebtedness.

When the credit union deems the loan a loss, it must charge off the loan to the ALLL account. Loans that exhibit the following characteristics present a high degree of credit risk, and the credit union should consider them for charge off:

- A non-performing loan more than six months past due without a payment of at least 75 percent of a regular monthly installment within the last 90 days. Transfers from shares and proceeds from the sale of collateral do not constitute "payments";
- A delinquent loan in the hands of an attorney or collection agency, unless there are extenuating circumstances to indicate the credit union will collect the loan;
- A "skip," where the credit union has had no contact for 90 days;
- An estimated loan loss, where the credit union has the repossessed, but not yet sold, collateral on hand;
- An account in bankruptcy, where the credit union has received notification of filing from the bankruptcy court (e.g., loans discharged in Chapter 7 bankruptcy within 60 days of receipt of notification of filing from the bankruptcy court);
- A loan under the protection of Chapters 11, 12, or 13 bankruptcy, where the credit union has received no payments for six consecutive months;
- A fraudulent loan, when the loss is determinable;
- A loan of a deceased person, when the loss is determinable;
- A loan, where the remaining balance is a deficiency balance after the sale of repossessed collateral and where the credit union has received no payment and has no apparent course of action; and

- A loan deemed uncollectible, where additional collection efforts are non-productive regardless of the number of months delinquent.

Note: In Chapter 11 and 13 bankruptcy proceedings, if the court lowers the amount that the borrower must pay, the credit union should immediately charge-off that portion of the debt, which the court has discharged. Examiners should note that the court frequently revises the amount and terms of the debtor's obligations. If the court changes the terms of the debtor's obligation, the credit union must also change the terms of the obligation on the records (e.g., if the court changes the interest rate from 12 percent to 9 percent, the credit union must lower the rate to 9 percent as determined by the court.)

If the credit union does not maintain the ALLL account balance at a sufficient level to permit the necessary charge offs, the credit union must re-evaluate its ALLL funding methodology. Determining the adequacy of the ALLL is not a by-product of the loan portfolio review. Please see the ALLL chapter for a detailed discussion.

Collateral in Process of Liquidation

When a credit union possesses loan collateral that is in the process of being sold, the examiner may evaluate the collateral for recoverable value. The examiner may document the evaluation on an examiner-designed workpaper or on the list of collection problem loans. Misuse of collateral in the process of liquidation can occur in credit unions. The supervisory committee, in carrying out its auditing function, should review this account and the collateral.

Other Real Estate Owned (OREO)

OREO (other real estate owned) consists of foreclosed property where ownership has passed to the credit union. A credit union often acquires OREO through loan foreclosure. Generally, the credit union intends to sell the real estate to partially or totally satisfy the loan obligation.

The following definitions refer to OREO:

- **Cost** - fair value at the date of foreclosure plus cash payments for capital additions and improvements to the asset and, if applicable, related capitalized interest subsequent to the date of foreclosure.

- **Fair value** - the amount that the creditor could reasonably expect to receive in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Market value (if an active market exists) determines the fair value of assets. If no active market exists for the assets transferred but exists for similar assets, the credit union may use the selling prices in that market in estimating the fair value of the assets transferred. If the credit union has no market price available, a forecast of expected cash flows, discounted at a rate commensurate with the risk involved, may aid in estimating the fair value of assets.

Accounting for OREO

Credit unions should account for and value foreclosed assets acquired by the credit union as OREO as follows:

- Presume OREO is "held-for-sale". The credit union should obtain appraisals or broker price opinions and onsite inspections as warranted to support the value of the property in question. (Note: generally, federal credit unions cannot hold OREO for the production of income. Therefore, this discussion of the accounting rules for OREO is limited to OREO-held-for-sale.)

- Record OREO at foreclosure at fair value less estimated cost to sell. After foreclosure, the credit union should account for OREO held-for-sale at the lower of fair value minus estimated costs to sell, or at cost. Credit unions should periodically evaluate the property for impairment and write down its carrying value if warranted. Often foreclosures need substantial refurbishments, such as new paint and carpeting, to make them marketable. Credit unions should factor estimated refurbishment costs into the carrying value.

- Report as a liability the principal amount of any debt to which the OREO is subject, and not deduct it from the carrying amount of the asset (e.g., tax lien, mechanic's lien.)

Workpapers and References

- AIRES Workpapers, Documents and Questionnaires
  - Supplementary Facts
  - Review Considerations
  - Loan Analysis
  - Loan Exceptions Document
  - Loan Review

  - Key Ratios
  - Critical Allowance for Loan and Lease Losses Input
  - Critical Loan Input
  - Collection Controls Questionnaire
  - Allowance for Loan and Lease Losses Module
  - Manual Loan Classification
- References
  - *Federal Credit Union Act*
    - 107(5) – Authority to Make Loans
    - 107(11) – Statutory Liens
    - 107(13) – Purchase of Eligible Obligations
    - 114 – Credit Committee
  - *Federal Credit Union Bylaws*
    - Article VIII – Credit Committee
    - Article XI – Loans to Members and Lines of Credit
  - *NCUA Rules and Regulations*
    - 701.21 – Loans to Members and Lines of Credit to Members
    - 701.22 – Loan Participation
    - 701.23 – Purchase, Sale, and Pledge of Eligible Obligations
    - 702.402 – Full and Fair Disclosure
    - 722 – Appraisals
    - 723 – Member Business Loans
  - *Accounting Manual for Federal Credit Unions*
  - IRPS 83-3 – Financing Leases
  - *Chartering and Field of Membership Manual*
  - NCUA Letter No. 119
  - NCUA Letter No. 174
  - NCUA Letter No. 99-CU-5

LOAN TYPES - APPENDIX 10A

The *FCU Act* and *NCUA Rules and Regulations* permit credit unions to grant many types of loans. This appendix details the various types of loans offered by credit unions.

Loans to Insiders

Insiders include officers, directors, committee members, employees, and members of their immediate families. Loans to insiders must comply with §107(5) of the *FCU Act*, §701.21 of the *NCUA Rules and Regulations*, the *FCU Bylaws*, and sound principles of internal control.

Review procedures for insider loans could include the following steps:

- Tracing loans to officials back to the approval in the board minutes;
- Ensuring insider loans comply with §701.21(d) regarding preferential treatment; and,
- Reviewing statements for:
  - Negative balance activity;
  - Consistent application of fees and charges (e.g., officials' fees should mirror those of the other members); and
  - Numerous or unusual transactions.

Co-makers and Co-signers

The terms co-maker, co-borrower, co-signer, guarantor, and joint applicant sometimes create a degree of confusion. In general, these terms refer to one of two possible parties, either a co-maker or a co-signer.

A co-maker shares equal responsibility with the borrower for payment of the loan and receives an equal benefit in the loan proceeds, or access to future advances in an open-end loan. Regulation B (202.7(d)(1)) identifies a co-maker as a joint applicant and the resulting loan as joint credit.

A co-signer takes on liability for the obligation of another person without receiving goods, services, or money in return or, in an open-

end credit obligation, without receiving the contractual right to obtain extensions of credit under the obligation. Credit unions request a co-signer's signature as a condition for granting a member credit or as a condition for forbearance on collection of a member's obligation in default. A spouse who must sign a credit obligation to perfect a security interest pursuant to state law may not serve as a co-signer (refer to §706.1(h) of *NCUA Rules and Regulations.*) §706.3(a)(2) requires that co-signers receive specific written disclosures before obligating themselves on a debt. Guarantor and endorser are terms that also identify a co-signer.

The *FCU Act* §107(5) requires that co-makers be credit union members (see legal opinion dated February 20, 1992.) The co-maker shares in the loan proceeds and bears joint liability for repayment. Thus, a credit union cannot make a loan to a nonmember co-maker. However, a credit union may permit a nonmember to sign a loan, provided the nonmember does so in the capacity of a guarantor (co-signer), rather than a loan recipient (co-maker.)

Policies and Procedures

Anyone of legal age (according to state law) to enter into a contract can assume the responsibility of a co-signer. The credit union's policy or practice cannot require the co-signer be a member of the credit union or a family member of the primary borrower (e.g., spouse or parent.)

The same credit principles used to determine an applicant's ability to repay also apply to co-signers and co-makers. For example, credit unions should obtain a co-signer's credit report and perform a debt ratio analysis that includes the new payment. Credit unions may not change loan terms or the security pledged without the co-signer's consent.

Effective collection programs include notification to both co-signers and co-makers upon initial default of the obligation. If the member cannot or will not pay, the credit union should pursue repayment from the co-signer or co-maker, just as if they had received the proceeds of the original loan.

Bankruptcy cases require different procedures. If the primary debtor files under Chapter 13, the credit union must cease all collection

efforts against both co-signers and co-makers. If the primary debtor filed Chapter 7, the credit union should continue collection efforts against both co-signers and co-makers.

Credit unions should remain aware of groups of members who co-sign each other's loans. This practice, called "round-robin" co-signing can quickly result in an unsafe and unsound situation. Some data processing systems track co-signer obligations, but many cannot. Credit unions should institute a tickler system to track the member's co-signer obligations.

Lines of Credit

A line of credit is a preapproved fixed amount a member may draw on and replenish by repayment of amounts previously drawn. The agreement specifies the amount the borrower may access and the conditions of the agreement. Cancellation may occur upon notice by either party.

Some ways to access a line of credit include:

- Check or cash disbursements. Many credit unions accept telephone or mail requests. The check used with these transactions should bear a restrictive endorsement similar to the following:

  > Endorsement of this check by member acknowledges receipt of proceeds resulting from the transaction and agreements set forth on the detachable portion of this check and constitutes acceptance of the conditions of the agreements, which are hereby incorporated by reference.

- Automated Teller Machines (ATM.) The ATM verifies the card and requests an advance amount. The machine processes the request and provides the funds, a receipt, and a record of the transaction.

- Share draft overdraft loans. The line of credit agreement is separate from the share draft agreement. The share draft agreement must specify the authorized amount and include authorization for the credit union to transfer the amount of loan advance to the share draft account.

- Loan drafts. The drafts are similar to a bank check. Encoding allows the draft to travel through the check clearing system to the credit union's bank for payment.

- Credit cards. A credit union either issues credit cards itself or enters into an agreement with a credit card processor to issue credit cards, such as "VISA" or "MasterCard" to its members for processing against the members' lines of credit.

Internal Controls for Plastic Cards

Failure to protect plastic card programs represents a significant safety and soundness concern. A credit union should assess the adequacy of the loss prevention measures in its plastic card programs. Loss prevention measures, such as the following, reduce or prevent fraud losses:

- Card Activation. Processors should send new plastic cards to legitimate cardholders in an inactive mode. Before using the card, legitimate cardholders activate the card by going through customer verification procedures. Card activation programs can significantly reduce the loss of plastic cards in the mail.

- CVV/CVC (Card Verification Value/Card Validation Code.) VISA's Card Verification Value (CVV) and MasterCard's Card Validation Code (CVC) combat counterfeit fraud by using numbers encoded on the magnetic stripe of credit and debit cards. When the merchant passes the card through the point of sale reader, the transaction will be rejected and not receive authorization if the special code on the card does not exist or does not match the code maintained by the processor. However, for CVV/CVC to work, a credit union must have its authorization mode set to decline the authorization. Credit unions should confirm:

  - Their processor implemented CVV/CVC coding;
  - The CVV/CVC is fully operational and being read on all cards; and
  - The settings on its authorization response codes will decline the authorization for all credit and debit transactions.

- Neural Network. Neural networks track spending patterns of both cardholders and typical fraud type transactions. Effective systems monitor transactions 24 hours a day, seven days a week.

Monitoring Lines of Credit

The credit union should periodically obtain information concerning the borrowers' current income and their repayment records on other debts. Industry norms require updated credit reports for lines of credit every two years. This review of a borrower's financial condition could help management determine whether to increase, decrease, or terminate a borrower's credit line.

Open-End Loans

An open-end loan is similar to a line of credit plan. The primary difference is that a line of credit plan has preapproved advances, whereas, each open-end loan advance must receive loan officer or credit committee approval.

A member applying for an open-end loan completes a personal and credit information sheet, similar to a loan application except it usually does not ask for an amount or purpose. The applicant also completes an "open-end" note combined with the consumer credit disclosure.

Request vouchers document loan advances, which include an amount, purpose, and terms of repayment. If the applicant's signature does not appear on the request voucher, the check must contain a restrictive endorsement, acknowledging the advance under the open-end loan plan. The credit union may request updated financial information or credit reports every few years to ensure the member's creditworthiness has not deteriorated.

Variable Rate Loans

Variable rate loans have interest rates tied to an index and margin. These loans pass some of the interest rate risk to the borrower. Movement in the index causes a change in the interest rate, which in turn causes a change in the monthly payment, the loan maturity, or a combination of these. While indices fluctuate over time, the margin (e.g., 100 basis points) remains fixed over the life of the loan. The index plus the margin equals the rate charged on the loan.

Following are some of the more common indices:

- Treasury Indices:
  - One-Year Constant Maturity U.S. Treasury (CMT) Securities (most common of the Treasury-based ARM indices);
  - Six-Month U.S. Treasury Bills; and,
  - Three-Year CMT Securities.

- London Interbank Offered Rate (LIBOR) indices:
  - Six-Month LIBOR as published in The Wall Street Journal; and,
  - Six-Month LIBOR as posted by Fannie Mae.

- Cost of Funds indices:
  - 11th District Cost of Funds index (COFi);
  - Federal Home Loan Bank Board (FHLBB) Monthly COFi;
  - National Monthly Median COF Ratio; and,
  - National Contract Rate.

- Prime Rate as published in The Wall Street Journal (most common index for Home Equity Lines of Credit.)

Laws governing Home Equity Lines of Credit (HELOCs) prohibit use of an internal cost of funds. Regulation Z also requires credit unions to prepare disclosures for variable rate loans showing the following:

- Circumstances under which the rate may increase;
- Any limitation on the increase;
- The effect of an increase, which refers to an increase in the number or amounts of payments or an increase in the final payment; and,
- An example of the payment terms that would result from an increase.

Variable rate loan review procedures include these additional steps:

- Determine the adequacy of policies, procedures, and internal controls for ensuring accurate rate change adjustments;
- Verify the credit union determined the borrower's ability to make the higher payment if interest rates increase;

- Review the variable rate log book or the computer program to verify the credit union has made accurate changes;
- Review the rate change notification sent to the member to verify the notification conformed to the terms of the note;
- Determine whether internal or external auditors or other staff periodically test the loan servicing system for accuracy; and,
- Determine the accuracy of the rate change adjustments.

Guaranteed Student Loans

Credit unions may offer guaranteed student loans that are part of the Federal Family Education Loan Program (FFELP.) Credit unions must receive approval to participate in FFELP and have strict monitoring procedures in place to maintain the program. Under FFELP, administered by the Department of Education (DOE), private lenders provide the loan principal and the federal government guarantees through a state agency the loan's principal and interest up to 98 percent. If the student or parent borrower defaults on the loan, the government reimburses the lender.

Granting and processing student loans differs from most other types of loans. Student loans are normally granted to nonworking students who attend school at least half time. The borrower's current ability to repay does not serve as the basis for the granting of student loans. This type of loan requires less credit risk analysis.

Most credit unions offering student loans accept and process the application, disburse the funds, and portfolio the loan while the student is in school. When the student graduates, the credit union may sell the loan on the secondary market. Credit unions may receive interest from the guarantor while the student is in school, then they may transfer the time consuming and extensive due diligence process to another entity when the student graduates.

Due Diligence on Student Loans

The credit union must perform due diligence on outstanding student loans. On subsidized student loans, the credit union must complete and send a billing report to DOE quarterly to receive interest due. The credit union also must update the status of the student borrowers at least annually (normally through a mailing) to obtain current school information and addresses.

Maintaining federal insurance on student loans requires that credit unions comply with all due diligence requirements, especially during the repayment process. Credit unions must make specific minimum telephone and written contacts to meet DOE's due diligence regulations. Violations occur when a credit union misses a contact or does not comply with the regulations. Violations of the DOE's regulations can result in loss of the government guarantee. Numerous violations may result in loss of the guarantee on the entire portfolio. The DOE may also levy fines for noncompliance. In addition, each state involved in the student loan process has its own required regulations and procedures. Credit unions often sell the student loan servicing to avoid the extensive due diligence requirements.

If the credit union appears to have significant risks associated with the student loan portfolio, examiners should determine the credit union has the following:

- Documented, comprehensive policies and procedures that adequately address the requirements of DOE, the secondary market, the guarantor, and the servicer;
- Adequate tracking methods for student loans;
- Delinquent loan list that includes delinquent student loans (even though they are guaranteed);
- Timely interest claims;
- Adequate training for management and employees that includes familiarity with DOE regulations;
- Well-documented and complete loan files;
- Adherence to the 50-50 rule (i.e., the credit union cannot have more than 50 percent of total loans in student loans); and,
- Additions to the collection policy that address specific requirements of DOE.

Real Estate Loans

NCUA Rules and Regulations §701.21 addresses real estate lending. Well-planned and well-executed mortgage lending can offer advantages to the credit union including member loyalty, opportunity for cross-selling, good return and dependable cash flow. Credit unions should underwrite loans to ensure their eligibility for sale in the secondary market, unless they fit a specific exception created in the credit union's real estate policies.

Review procedures for these loans could determine the existence of the following potential higher risk loans:

- Loans over $50,000 which meet the requirements of §723.1 are considered member business loans; and,
- Loans made to a "blind trust" (a trust whose beneficiaries' identities are hidden) are high risk and can cause significant losses when members use these trusts to avoid restrictions on concentrations of loans.

Real estate loan review procedures could include these additional steps:

- Assess interest rate and liquidity risks associated with the terms and rates offered;
- Determine if policies and procedures address credit and collateral risk;
- Determine sufficiency of controls to ensure compliance with internal policies and minimum documentation requirements;
- Ensure the mortgage program is part of a well-planned and well-executed strategic plan;
- Evaluate reputation risk involving service to members and dealings with outside vendors; and,
- Ascertain compliance with the *NCUA Rules and Regulations*, individual state statutes, and other applicable consumer compliance laws and regulations.

The Secondary Market

After originating mortgages in the primary market, buying and selling of mortgages take place in the secondary market. The two biggest purchasers of mortgages are the Federal National Mortgage Association (FNMA or "Fannie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac.") Using their experience in the mortgage market, FNMA and FHLMC have determined an appropriate level of credit risk and established standards to control this risk.

NCUA Letter to Credit Unions Nos. 124 (June 1991) and 99-CU-12 (August 1999) provided credit unions with real estate lending guidelines. Credit unions should originate their loans in conformity

with secondary market standards; however, not all of a credit union's loans must necessarily meet this standard. Credit unions should also account for real estate loans, especially first mortgages, based on industry standards of 30-day month/360-day year, with a 15-day grace period and explicitly defined penalties. Departure from industry standards incurs additional risk.

Appraisals

Lenders use appraisals to determine the value of the collateral. Part 722 of the *NCUA Rules and Regulations* specifies the following:

- Identifies which real estate-related financial transactions require the services of an appraiser;
- Prescribes which categories of federally related transactions a state-certified appraiser shall appraise and which a state-licensed appraiser shall appraise; and,
- Prescribes minimum standards for the performance of real estate appraisals.

Appraisers normally use various valuation approaches. The valuation section of the appraisal provides the appraiser's support for the market value based on the cost approach, the sales comparison approach (market data approach), and the income approach. The appraiser usually places more weight on the sales comparison approach in the case of owner-occupied homes. The appraiser must report a minimum of three comparable sales as part of this approach.

FNMA and FHLMC have established guidelines for net and gross percentage adjustments. Generally, the dollar amount of net adjustments for each comparable sale should not exceed 15 percent of the comparable's sales price. The dollar amount of the gross adjustments, without regard to the positive and negative signs, for each comparable should not exceed 25 percent of the comparable's sales price. The appraiser should also use comparable sales settled or closed within the last 12 months. When the adjustments fall outside the 15/25 guidelines, comparable sales are more than six months old, or comparables are not in close proximity to the subject property, the appraiser should provide a written explanation. Ultimately, credit unions must accept sole accountability for the appraisal's accuracy.

Loans meeting the following criteria may not require a full appraisal:

- The loan is under $250,000;
- The loan is for less than 50 percent of the property's value;
- The loan was planned to fit a specific exception created in the credit union's real estate policies; therefore, the credit union does not plan to sell the loan in the secondary market; and,
- The loan does not meet the requirements for an appraisal in Part 722 of the *NCUA Rules and Regulations*.

In these restricted circumstances, §722.3(d) requires the credit union to obtain a written estimate of market value, "performed by an individual having no direct or indirect interest in the property, and qualified to perform such estimates of value for the type and amount of credit being considered."

Evaluating Appraisers

When selecting an appraiser, credit unions must follow the specific requirements and restrictions outlined in Part 722 of the *NCUA Rules and Regulations.* In addition, the credit union should consider the following standards for selecting an appraiser:

- A minimum of two years of appraisal practice;
- A license or certification from the appropriate state; and,
- Insurance for errors and omissions.

Holding versus Selling Loans

Theoretically, lenders can sell any loan or portion of a loan. However, poorly documented or poorly underwritten loans may sell at reduced prices. Once a borrower has established a payment history (i.e., the loan is "seasoned"), buyers may relax documentation and underwriting requirements. Sometimes the credit union may find it advantageous to hold loans and sell them later as "seasoned" loans.

Credit unions may sell loans with or without recourse. The credit union must repurchase loans sold with recourse if the borrower defaults, even if it meets standard representations and warranties.

Servicing Mortgage Loans

Servicing constitutes all actions necessary to ensure proper handling of mortgage loans from the time of disbursement until finalization, by payoff, or charge-off. Servicing mortgages carries a significant amount of transaction risk. Credit unions must have all related practices in writing and follow them carefully. The required procedures include the following:

- Escrow accounts for the payment of taxes and insurance;
- Calculation of changes in payment for adjustable rate loans; and,
- Collection efforts regarding delinquent loans.

Servicing Rights: Sell or Keep

When a credit union sells a loan, it has three servicing options: (1) perform servicing itself, (2) sell its servicing rights to a second party, or (3) contract for servicing activities from a second party while maintaining control and ownership of those rights. Credit unions that sell or contract their servicing duties must ensure they deal with a reputable servicer.

Loan servicing can generate profit. Annual income may range up to one-half of one percent of the outstanding balance of the payments collected. At the same time, credit unions considering servicing loans must understand the labor-intensive nature of this activity and the importance of economies of scale. Credit unions that do not generate a large volume of loans may find it expensive. Generally, a servicing portfolio requires $50 million or more to breakeven.

Selling of Servicing Rights

If the credit union sells the servicing rights, it must ensure the servicer can meet the standards for servicing required by the secondary market. The following list, while not all inclusive, addresses the most important items:

- The purchaser/servicer is reputable. The credit union should investigate the financial soundness and business history of the servicer.

- The credit union has a contract with the purchaser/servicer that addresses the following:

- Timeframes for remittance of payments. The member sends the required monthly payment to the servicer. The contract should determine when and under what conditions the servicer remits the principal and interest portion to the credit union;

- Information system. The servicer must have adequate information system processing capability to maintain accurate accounting and mortgage payment records. The credit union should maintain the right, by contract, to examine the records pertaining to the mortgages the servicer handles;

- Delinquency control. The servicer must perform collection activities mandated by the secondary market, including counseling procedures used with the borrower when trying to avoid or cure delinquency;

- Collection needs. The servicer should have established collection policies and procedures. Policies should address:

  i. Actions taken by the servicer if the property requires repairs and the owner either cannot, or will not, pay for them;

  ii. Procedures to control and monitor bankruptcy proceedings; and

  iii. Guidelines addressing when to use an attorney and who will pay attorney's fees and associated costs;

- Foreclosure responsibilities. Servicer must familiarize themselves with the local and state requirements for all loans in its possession. In addition, some secondary market investors and insurers have specific foreclosure requirements;

- Filing of IRS forms. An important servicer responsibility involves timely filing of all IRS forms;

- Submission of periodic financial information. Credit union officials should periodically review the servicer's financial condition to ensure it operates safely and soundly;

- Servicer's insurance and bond protection requirements. Insurance policies must indemnify the servicer against losses resulting from dishonesty or fraudulent acts committed by the servicer's personnel and employees of outside firms that provide information systems and technology services for the servicer. Servicers must also have an errors and omissions policy to protect them against negligence, errors, and omissions in meeting the legal paperwork requirements;

- Accounting Records. Accounting records must identify the application of payments received on all loans. The servicer should provide the loan owner a monthly breakdown of the payment applications, based on the distribution of funds received;

- Onsite inspection requirements. The need and frequency of onsite inspections vary with the loan type, the payment history of the borrower, and the requirements of secondary market purchasers;

- ARM adjustment calculation. The agreement should provide a description of conditions governing when the servicer will calculate and notify the borrower of adjustments to the loan and payments per the contractual agreements of the note;

- Repurchase of rights. Written documentation should exist describing the terms and conditions with which the credit union can cancel or buy back the servicing rights;

- Resale of rights to a third party. If the credit union sells loans to a secondary market investor, the contract will contain a provision of approval for the sale of servicing rights to a third party. This protects the credit union's interest in the loan from involvement by inadequate servicers; and

- Penalty provisions for noncompliance. Noncompliance with any of the above provisions should trigger penalties outlined in the servicing agreement.

Escrow Accounts

Escrow accounts accumulate funds to pay taxes, assessments, insurance premiums, and other charges that could affect the credit union's first lien position. The servicer's responsibility involves maintaining escrow accounts and adequate records to document (1) each account, its activity and current balance, (2) the prompt payment of bills, and (3) required reporting to appropriate government and non-government agencies. Regulation Z contains specific guidelines for escrow accounts.

Foreclosures

Once the credit union determines the member either cannot or will not bring the loan current and make the required payments, it should consider foreclosure. Servicers' policies should comply with secondary market requirements. Policies and procedures should consider provisions of the mortgage, applicable state or local laws, requirements of a loan insurer, and the best interests of the credit union.

Policies and procedures should address the following:

- Onsite inspections. Property location, crime rate in the area, occupancy status, and loan owner requirements determine the frequency and extent of onsite inspections;

- Property maintenance. The policies and procedures should ensure the property physically remains in salable condition. This can include lawn mowing, trash removal, snow removal, winterizing, etc.;

- Acceptable timeframes for foreclosure action. Legal counsel should address this issue. Generally, servicers should start foreclosure promptly after three full payments are past due on a first mortgage and after two full payments are past due on a second mortgage. They should immediately start foreclosure of abandoned or empty property;

- Insurance. Filing of needed claims with a mortgage insurer, if appropriate (e.g., PMI) and ensuring the credit union obtains insurance on foreclosed property; and,

- Pursuing deficiency judgments. The credit union must consider local laws restricting such action, the costs involved, potential delay in foreclosure procedures, collectibility of judgment, and the requirements of the secondary market.

A credit union foreclosing on secured contaminated property should determine if a liability exists under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA.) CERCLA facilitates the cleanup of hazardous waste sites. The mere threat of a hazardous substance release can invoke liability under CERCLA, which covers environmental hazards in the air, water, and soil. Legal guidance should help them determine the appropriate course of action.

Once the credit union completes foreclosure, it should account for the property as other real estate owned (OREOs) in accordance with generally accepted accounting principles (GAAP.)

Internal Controls, Segregation of Duties

A major purpose of internal controls is to avoid fraud and embezzlement. Separation of duties in the three phases of the mortgage lending process (taking the application, processing, and underwriting) decreases the risk of fraud. If the credit union cannot provide for adequate segregation of duties using its own staff, it should consider contracting out enough of the activities so that proper separation of duties occurs. A contractor can perform any or all of the three phases.

Independent Quality Control

A quality control program uses a sample of loans selected randomly by the quality control department. The quality control department audits the sample to determine proper collateralization according to the policies and procedures of the credit union and the regulatory authorities. Servicers must correct deficiencies uncovered during these reviews. Credit unions that sell loans to the secondary market must ensure their quality control program meets secondary market requirements.

Asset/Liability Management

The asset/liability management (ALM) program must address liquidity and ALM to maximize the gross spread and control interest rate risk

(IRR.) The Asset/Liability Management chapter provides additional information.

Adjustable Rate Real Estate Loans

Credit unions can reduce interest rate risk associated with mortgage lending by offering adjustable rate loans. However, adjustable rate loans carry their own problems, including:

- Lower yields, caused by market rates materially lower than those of fixed rate mortgages;
- Low "teaser" rates to attract borrowers (caution: the secondary market will not accept rates discounted more than 300 basis points below market);
- Index adjustments too far apart. The longer the adjustment period, the greater the lag;
- Adjustment caps too low. A low cap may keep the rate too low for the market, and too low to cover the credit union's costs;
- No floor rate. The credit union should establish a floor rate that will cover their costs;
- Use of an inappropriate index. Nonstandard indices affect salability and may result in poorer performance;
- Default among borrowers when rates adjust upward. Inability of borrowers to afford the higher payments may lead to more defaults; and,
- Penalties. Mistakes in calculating adjustments to rates may result in penalties.

Subordinate (Second) Mortgages

Subordinate, often second, mortgages allow borrowers to use a portion of the equity in their homes to secure borrowed funds. The *NCUA Rules and Regulations* do not prohibit third or fourth mortgages, but credit unions must carefully evaluate these for increased risk.

Tax laws allow borrowers to deduct interest on loans secured by their homes under certain conditions, so obtaining a mortgage loan often offers a tax advantage over a consumer loan.

Second mortgages, also marketed as "Home Equity Loans," include the following types:

- Open-end/closed-end. An open-end loan is either a line of credit (in which the credit union pre-approves advances at the time of application) or a loan where each additional advance requires reapplication and approval. Closed-end refers to the common type of standard second mortgage with set principal and term.

- Fixed rate/adjustable rate. Either open-end or closed-end second mortgages can have a fixed or an adjustable interest rate. Adjustable rate second mortgage loans can have all the features of an adjustable rate first mortgage: index, premium above index (e.g., "index plus two percentage points"), annual and lifetime caps, floors, etc.

A well-established market for second mortgages exists, so credit unions should use the standard documentation and practices in setting their own requirements.

Home Equity Lines of Credit

A Home Equity Line of Credit (HELOC) is a mortgage that does not require reapplication and approval for each advance. A HELOC carries an adjustable interest rate, usually adjustable monthly (with Prime Rate changes) or quarterly (per contract terms.)

In general, credit unions process and underwrite HELOCs in the same way as second or subordinate mortgages, with the following differences:

- Note and mortgage. Credit unions use special note and mortgage instruments for HELOCs. Standard secondary market documents for applicable parts of a HELOC loan file (e.g., mortgage, deed, title opinions) are recommended.

- Consumer regulations. The credit union must comply with all applicable consumer regulations. See the Consumer Compliance chapter for further information.

- Legal considerations. Legal opinions specifying the documents used to comply with applicable state and federal regulations should remain on file in the credit union.

- Creditworthiness. Credit union staff must analyze the borrower's creditworthiness periodically throughout the life of the loan.

- Loan-to-value (LTV) ratio limits. Credit unions should establish LTV limits. For conventional loans, the maximum LTV permissible should not exceed 80 percent of the lower of the appraised value or sales price unless the borrower obtained private mortgage insurance (PMI.) Credit unions should require borrowers to obtain the PMI from a company acceptable to the credit union and to established secondary markets. The LTV for government insured loans may not exceed the applicable FHA or VA guidelines. In declining real estate value markets, credit unions may require periodic appraisals for some properties. Ideally, credit unions should have the ability to trace property value statistics. Falling market values may require a reassessment of loan limits and the invoking of "Escape Clauses" allowed by the Federal Reserve Board to reduce the line of credit.

- Title insurance. As with other second mortgages, if the borrower can demonstrate title insurance outstanding, the credit union may choose to waive title insurance. However, without evidence of first mortgage title insurance, credit unions should require title insurance on home equity loans (assuming a sufficient loan amount.) The home equity loan should have a higher priority lien than an existing line of credit.

- Cash advances. The credit union's internal control programs should include tests of abuses of the equity line of credit. Equity lines of credit should not pay other in-house obligations. Establishing cash advance minimums discourages borrowers from using the line of credit for daily living expenses.

- Interest rate index. Credit unions must use publicly disclosed indices to establish the borrowing rate, not an internal cost of funds index. The index should be specific, such as the Prime Rate as published in the Wall Street Journal on a specific day.

Loans Secured by Mobile Homes and Real Estate

Mobile home loans secured by property may qualify as a real estate or consumer loan, according to each state's laws. Credit unions should familiarize themselves with their applicable state laws. In many cases, title insurance companies will not include the value of the mobile home in their policy unless the borrower removes the wheels and tongue and places it on a permanent foundation. Also, some states require the same to qualify for homeowner's insurance.

Insured - Guaranteed Loans

§701.21(e) of the *NCUA Rules and Regulations* permits credit unions to grant loans secured by the insurance or guarantee of, or with an advance commitment to purchase the loan by, the federal government, a state government, or any agency of either. The law, regulations, or program under which the insurance, guarantee, or commitment is provided specifies the maturity, the terms, and conditions, including rate of interest, for making these loans.

Loans insured by the Federal Housing Administration (FHA) and loans guaranteed by the Veterans Administration (VA) are the most common types of loans that credit unions grant under this authority. Both types of loans help reduce the credit risk.

Only credit unions designated as "FHA-approved mortgagors" may originate loans under an FHA insurance program, and those functioning as "supervised lenders" may originate VA loans. Most credit unions should qualify.

These programs usually allow a borrower to purchase a home with little or no down payment. While the insurance or guarantee does not prevent a loss to the credit union, it usually provides the same protection that a large down payment from the borrower provides.

FHA/VA loans are more liquid than conventional mortgages, since both real estate and the government insurance or guarantee contract secure the loans. Additionally, credit unions may pool FHA and VA loans into Government National Mortgage Association (GNMA) pass-through securities. This pooling ability helps lower potential liquidity risk.

Auto-Equity Loans

Changes in the tax laws severely restricted the deductibility of consumer loan interest paid by taxpayers. Lenders responded to these changes by creating "auto-equity" loans. Credit unions offering these consumer-purpose loans (generally for automobile purchases) take title to the automobile and place a lien on the member's real property. This action may make the loan interest tax deductible for the member (credit unions should provide members with a notice to consult a tax professional regarding deductibility of interest paid on the loan.)

Most credit unions underwrite these loans using consumer loan guidelines, rates, and terms. Credit unions take the real property lien purely as an abundance of caution and to possibly make the interest paid on the loan tax deductible for the members. The credit unions must comply with the applicable disclosure requirements for real estate loans, including recision requirements.

Construction Loans

Construction loans are high-risk loans that require sophisticated underwriting and administration. Construction loan policies should establish limits compatible with the credit union's size. The limits should integrate construction lending into the overall ALM plan. Credit unions should hire or contract with loan processors and underwriters trained and experienced in construction lending. NCUA Letter to Credit Unions No. 124 (June 1991) provides credit unions with real estate lending guidelines, which included information on residential construction loans. Generally, there are four types of construction loans:

- Loans to a developer to complete a commercial building such as a shopping center, office building, hotel, or apartment building;
- Loans to a developer to finance residential construction made on a speculative or "spec" basis (i.e., homes built to sell later in the general market);
- Loans to a general contractor to finance single homes to persons who may or may not have obtained prearranged permanent financing; and,
- Loans to an owner for financing the construction of the owner's primary residence (whether or not the owner acts as the general contractor.)

The first three loan types are member business loans if they exceed $50,000. When owners act as general contractor, the credit unions must have tight controls to ensure construction progresses as planned. The major concerns involved in construction lending are:

- Failure of the builder to produce the anticipated product as contracted;
- Threat of prior or intervening liens placed on the mortgaged property;
- Unreliable market analysis resulting in either an unmarketable or difficult-to-market project; and,
- Inadequate funding for completing construction.

The following are possible unsafe and unsound operating practices:

- Disbursing funds in advance of construction progress. This could result in the credit union not having sufficient undisbursed funds to ensure project completion;

- Approving loan agreements, which do not include precautionary measures, to avoid the filing of mechanics' liens or stop notices. Mechanics' liens precede mortgage liens and stop notices can cause costly delays in construction;

- Approving loans for speculative or investment projects without (1) evaluating and approving feasibility studies, or (2) obtaining an independent appraisal of land value;

- Approving loans to investment borrowers without considering (1) their past performance records on similar projects, and (2) the proposed marketing program for the planned project;

- Approving loan agreements that do not include provisions for inspecting the construction's progress. Credit unions should disburse funds for labor and material according to progress of the project;

- Approving construction loans without prior review of builder's cost estimates to determine the accuracy and reasonableness of the estimates;

- Disbursing construction funds without supporting inspection reports;
- Approving loan agreements that do not require prior approval for changes in plans and specifications;
- Failing to segregate construction loan appraisal, inspection, and disbursement functions; and
- Granting loans to builders or developers with insufficient equity in the project. §723.3(b) of the *NCUA Rules and Regulations* requires 35 percent equity.

Land Loans

Loans collateralized by either raw acreage or improved property (having sewers, utilities, curbs, etc.) often contain high risk because of volatile land values and limited marketability compared to other real estate. Land loans usually require the following additional documents:

- Appraisal, Survey, and Zoning Requirements. When determining the soundness of the loan, the appraisal should consider the size of the property, the zoning requirements, the stated highest and best use of the land, access to highways, etc. A credit union should limit the LTV to no more than 60 - 70 percent of the appraised value of the land. Some experts limit the LTV to 50 percent. This will depend on the quality of the land, planned use of the land, and how soon owners plan to develop it;
- Agreement that parties require credit union approval before making any improvements to the property; and,
- Title search and insurance. Credit unions should periodically inspect unimproved property to ensure the borrower does not make changes without the credit union's knowledge.

Member Business Loans

A member business loan includes any loan, line of credit, or letter of credit (including any unfunded commitments) where the borrower uses the proceeds for a commercial, corporate, other business investment

property or venture, or agricultural purpose. *NCUA Rules and Regulations* §723.1(b) lists the exceptions to this general rule.

Credit unions must separately identify member business loans in their records and in the aggregate on their financial reports and 5300 Call Report. Many credit unions do not properly identify their member business loans. A review of the loan collateral and purpose codes can help identify potential member business loans. Reviewing reports on amortization, new funds advanced, extensions and loans granted in excess of $50,000 may also assist in identifying these loans.

Policies and Procedures

Member business lending requires special skills in underwriting, servicing, and collecting. Credit unions engaged in member business lending must use the services of an individual with at least two years experience in business lending. Credit unions must have the expertise to monitor the financial condition of member-borrowers through periodic receipt and analysis of financial data, when appropriate and necessary (e.g., open-end member business loans.)

Member business lending programs often affect liquidity and interest rate risk. Credit unions involved in this type of lending must have adequate ALM policies and procedures before the credit union starts making these loans. The commitment to the borrower may involve a long-term business relationship, even though the actual loan term is short. For example, an agricultural operating loan generally involves a long-term commitment to fund the annual operations, while the individual loan may mature in one year or less.

To adequately address transaction and compliance risks, credit unions must document internal controls, policies, practices, and procedures. This documentation should include the types of loans granted, copies of forms used, and any other pertinent information.

Underwriting

The underwriting process should include an evaluation of the character and integrity of the borrower, including the borrower's ability to manage the business, repay debt, and accumulate capital in the business. The credit union should also assess the condition of the

industry in which the borrower operates, particularly as it affects the ability to repay.

The emphasis in underwriting member business loans shifts from the individual to the financial soundness of both the business and the member requesting the loan. To support their analysis of businesses, credit unions can use (1) commercial credit reports (e.g., Dun and Bradstreet), (2) individual credit reports, (3) balance sheet and income and expense statements, (4) cash flow statements, and (5) ratio analysis. Whenever a credit union requires a personal guarantee on a loan, it must evaluate the guarantor's financial strength. Some tools for the analysis include:

- Cash flow analysis. A credit union should only make the loan if the borrower has cash flow projections based on actual cash flow data. Many small businesses have trouble obtaining adequate and reliable cash flow information. Credit unions should not accept cash flow assumptions without data to show they are realistic. Borrowers must provide evidence they have sufficient funds available to service the debt.

  The credit union should obtain tax returns and financial schedules of both the member and the business to properly analyze the cash flow statement. A quick test for cash flow is to add back to the profit-and-loss data of the business (net income) any non-cash expenditures (such as depreciation, adjustments to accounts receivable, etc.) and relate a positive resulting figure to the member's ability to cover loan payments.

- Net worth analysis. In addition to reviewing cash flow, the credit union should evaluate the strength of the business. One method of measuring profitability is to divide net profit by net worth, which results in the owner's return on investment.

  Net worth is the equity or retained earnings of the business and represents the borrower's cushion before bankruptcy or insolvency occurs. Borrowers can distort net worth by overstating assets or understating liabilities. While borrowers often overvalue their assets, they can also understate liabilities both on their personal

and business financial statements. A borrower must supply supportable financial data to the credit union.

- Collateral analysis. The underwriting process must include a determination of the value, liquidity, and lien status of the collateral. Prudent lending requires the borrower to have equity in the assets securing the loan. The credit union's member business loan policy must establish guidelines for the maximum LTV the credit union permits for various types of collateral, while meeting the minimum regulatory requirements. When establishing these values, the credit union must keep in mind the forced sale of collateral generally brings a minimal return in relation to the value of the assets of a viable business.

  Considering the high percentage of new businesses that fail, the credit union must carefully analyze collateral and cash flow. If the borrower uses inventory as collateral, all the procedures discussed later in this chapter concerning floor plan loans apply. However, the forced sale value of inventory in process may cover only a fraction of the value of the finished product.

- Financial analysis ratios. Credit unions should analyze at least three years worth of data from financial statements before granting a loan. They should perform ongoing analysis after granting the loan. Forward, as well as historical projections are critical to sound financial analysis. Examples of basic capital and liquidity ratios can be found in Appendix 10C - Member Business Loan Financial Ratios. Credit unions should use these ratios and, if necessary, establish additional ratios to analyze loans.

  Credit unions may use published ratios relating to various industries as a standard for comparison (e.g., the Robert Morris ratios.) The credit union should maintain copies of the particular industry's standard ratios.

Documentation

Documentation for a member business loan also must include proper signatures from the parties to the transaction (those individuals permitted to borrow under the *FCU Act*, *FCU Bylaws*, and the *NCUA Rules and Regulations*.) §723.7 of the Regulations require the credit

union not grant member business loans without the personal liability and guarantee of the principals, except where the borrower is a not-for-profit organization, as defined by the IRS (26 U.S.C. 501.)

Lien filings often require the use of UCC documents. The credit union must file the necessary documents with appropriate local or state agencies, perform and document their search for prior liens, and keep their liens current, as required by their local or state agencies. Business assets also require proper insurance with appropriate loss payable clauses to the credit union.

Loan covenants documenting specific conditions of the loan are part of the member business loan note. Examples of loan covenants include (1) frequency of providing financial reports, (2) insurance renewal periods, (3) working capital requirements, (4) limits on owner draws, (5) permission for periodic onsite business inspections, and (6) call options, if the financial performance of the business deteriorates. An attorney experienced in loan covenants should prepare the loan agreement. Credit unions willing to take the risk of making a member business loan must recognize they need to pay for the expertise needed to document the loan agreements.

The credit union should know that too many covenants can expose the credit union to possible "lender liability", if the borrower defaults. Lender liability can also occur when a borrower becomes dependent on a lender for a constant supply of funds.

Environmental Protection Agency (EPA) Concerns

A credit union foreclosing on secured contaminated property should determine if a liability exists under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA.) CERCLA facilitates the cleanup of hazardous waste sites. The mere threat of a hazardous substance release can invoke liability under CERCLA, which covers environmental hazards in the air, water, and soil.

Technically, when the credit union forecloses on the collateral, it becomes the "owner" of the property and the EPA can hold lenders liable for hazardous waste cleanup. However, CERCLA can exempt parties that hold ownership primarily to protect their security interest,

even when foreclosure leads to actual ownership. Legal guidance should help them determine the appropriate course of action.

Types of Member Business Loans

Examples of member business loans include investment property loans, working capital advances, term business loans, agricultural credit, and loans to individuals for business purposes. Some credit unions also grant letters of credit, which examiners may find particularly difficult to identify since they are an off-balance sheet contingent liability.

Rental Property Loans

The most common type of business loan is for rental property where the member obtains a credit union loan secured by an apartment building or a house, which the member then rents out. While real estate securing a member business loan may meet the requirements for exclusion from Part 723 of the *NCUA Rules and Regulations*, the examiner should treat the loan as a member business loan for review purposes.

When credit unions use rental income to qualify a borrower for a loan, the credit union should include the gross rental income as part of the borrower's gross income (after factoring in a reasonable vacancy rate), and the borrower's debt should include expenses related to the property.

Credit unions should support credit-granting decisions for rental property by determining the property's cash flow. For example, adding back depreciation to net rental income provides a good estimate of cash flow from rental property. Loan officers making rental property loans should have sufficient expertise in the rental property area, including a full understanding of Schedule E of the member's tax return.

Working Capital Loans

Working capital is the difference between current assets and current liabilities. This type of loan provides temporary capital in excess of normal needs. Working capital loans provide short-term funds that borrowers repay at the end of the cycle by converting inventory and accounts receivable into cash. Businesses engaged in manufacturing,

distribution, retailing, and service-oriented operations use short-term working capital loans.

Regulatory requirements and sound business practices govern the collateral securing this type of loan. Usually, the credit union takes the borrower's accounts receivable or inventory as collateral. If the credit union takes inventory as collateral, the lien should include the phrase "and proceeds thereof" since inventory converts to cash or accounts receivable, as it is sold.

Since this type of loan is high-risk, a credit union must set financing limits. For example, since accounts receivable collateral will rarely bring 100 cents on the dollar in a forced sale, the credit union should limit the loan to an amount less than the book value (e.g., 50 percent.) In addition, credit unions should review the accounts receivable discount terms and aging records to determine collection activity of the business.

If the credit union takes accounts receivable as security, the loan covenants should require the borrower to regularly check the credit rating of the major debtors on the receivable list. The credit union should receive a monthly aging of the accounts receivable past due and make periodic onsite inspections to determine the accuracy of the borrower's aging and reporting records. The credit union should also determine if the borrower has pledged inventory against another loan (e.g., a UCC filing search.)

When taking inventory as collateral, the credit union must perform periodic onsite inspections to ensure the borrower maintains a reliable inventory control system. The credit union should perform test checks on the inventory control system to ensure the accuracy of the total amount of reported inventory.

In all cases, credit unions should obtain quarterly profit and loss statements (including past statements, preferably for two or more years) from the borrower to evaluate the continued viability of the business.

Term Business Loans

Normally, members use term business loans to acquire capital assets such as plant and equipment. Regulatory requirements govern the collateral securing this type of loan. Due to the extended loan period, term loans contain more interest rate risk than do short-term advances. Because of the greater risk, credit unions should require amortization payments. Loan agreements will also contain restrictive covenants (conditions agreed to by the borrower) for the life of the loan.

Agricultural Loans

Agricultural loans range from mortgages on real estate to equipment, livestock, growing crops, operating loans, or personal loans. A credit union making farm real estate loans must take into account various factors that may not occur in other real estate loans. For example, credit unions making farm loans should (1) value not only acreage, but the productivity of those acres; (2) consider erosion and wastage along with fertility, since repayment may occur over an extended amount of time; and (3) look to the farm's productivity over a series of years as the source of repayment. Changes in price levels affect net worth.

To ensure repayment of the loan, credit unions should determine the agricultural operation earns sufficient income to pay taxes, personal living expenses (if applicable), operating expenses (including crop and herd insurance, if required), and reasonable allowances to maintain the productivity of the land and income flows. A farmer or rancher must demonstrate managerial efficiency by maintaining operating costs consistent with the productive unit type the borrower offers as security. Some owners, or farm or ranch managers, operate farms or ranches inefficiently because they economize too much in the use of labor-saving machinery, while others invest in more mechanization than the farm income can support.

If the amount of agriculture loans represents a significant risk to the credit union examiners can use the following questions as guidelines when evaluating internal controls for agriculture loans:

- Livestock loans:
  - Does the credit union require inspections at the time it makes livestock loans? Does the credit union require the borrower to provide proof of ownership at that time?

- Does the credit union require inspectors to properly date and sign the inspection report?
- Does the inspection report note the condition of the animals?
- Does the credit union require periodic inspections when appropriate for the type of livestock loan?
- Has the credit union made proper notification to and reviewed with appropriate brand inspection or recording offices to ensure the borrower has proper title to the livestock?
- Is the brand registered with the appropriate local or state agencies?
- Is the brand registered in the borrower's name?
- Has the credit union established a tickler file to ensure the borrower reregisters the brand every nth year as required by local or state agencies?
- Does the credit union file security agreements with appropriate local and state authorities?
- Does the credit union require assignment of milk check agreements on dairy loans?

- Crop loans:

  - Does the credit union require inspections of growing crops before it advances funds?
  - Does the credit union require borrowers to obtain crop insurance, where appropriate?
  - Does the credit union closely monitor disbursements to ensure the borrower channels loan proceeds into the farm operation and uses the proceeds as intended?
  - Are disbursement checks made out jointly to the borrower and vendor?

Letters of Credit

A letter of credit substitutes the creditworthiness of the credit union for that of the individual or corporation. Credit unions may earn a fee for issuing a letter of credit. Most credit unions do not offer them.

Credit unions disclose letters of credit, which are off-balance sheet contingent liabilities, using footnotes to the financial statements. When credit unions fail to disclose letters of credit, examiners may detect them through fee income spikes occurring in a single month.

Although the credit union disburses no funds when it approves a letter of credit, sound internal controls for member business loans require lenders to treat a letter of credit like a funded loan (i.e., if the member cannot service the debt, the collateral must be liquid.)

Two types of letters of credit are (1) the commercial letter of credit, and (2) the standby letter of credit. Often, a commercial letter of credit finances the sale of goods between a buyer and seller. The seller ships the goods to the buyer and submits an invoice. To avoid risk of nonpayment for the goods, the seller may require the buyer to obtain a letter of credit. Commercial letters of credit, secured by cash deposits, pose little risk to an institution as long as the credit union receives proper documentation from the beneficiary (seller.)

A standby letter of credit represents an irrevocable commitment to pay if the member defaults on an obligation. When issuing standby letters of credit, credit unions should determine that adequate collateral secures these letters of credit. Application forms should automatically convert to collateralized notes when members draw upon their letters of credit. Standby letters of credit have many uses. A request for a demand for payment of a standby letter usually signals something is wrong. Nonperformance or default that triggers payment of a standby letter of credit signals financial weakness, whereas payment under a commercial letter of credit suggests a normal business transaction.

Floor Plan Loans

Floor plan lending, a form of wholesale or inventory financing, finances items for dealers, including automobiles, mobile homes, boats, large home appliances, furniture, television, and stereo equipment. Under a written contract between the credit union and the dealer, a specific piece of equipment collateralizes each loan advanced. As the dealer sells a piece of collateral, the contract requires the dealer to repay those funds advanced for that collateral sold. A common policy requires dealers to invest 10 to 20 percent of their own funds.

Credit unions rarely engage in floor plan lending, which is specialized lending with above-normal risks. Loan officers working in the area of floor plan lending require special expertise.

This type of financing usually involves the use of a trust receipt. The written contract between the credit union and the dealer specifies the credit union will release to the dealer title to a specific piece of collateral sold with the stipulation the credit union will hold title to such collateral in trust until time of sale. The contract usually gives the dealer the right to sell the inventory, but normally at not less than the "release price." The credit union should request the dealer to authorize the credit union to periodically inspect the inventory, examine the dealer's records, and upon any default by the dealer to declare a forfeiture of the dealer's interest in the inventory. The credit union can verify inventory for reasonableness against tax forms.

To reduce the risk involved in this type of financing, the credit union should ensure prompt repayment by frequently inspecting the dealer's inventory (to determine exactly which units the dealer has sold), record inspection dates, the name of the inspector, and an itemized list of collateral.

Floor plan financing contracts should also provide for partial repayments on unsold inventory. For example, contracts frequently require the dealer to pay down the invoice price by 10 percent after 90 days and then make a 5 percent partial payment each month thereafter. Under such a plan, the credit union would require the dealer pay in full the note financing any units not sold after one year. This plan encourages inventory turnover and helps the credit union avoid financing out-of-date inventory.

Credit unions should require periodic financial statements from the dealers, monitor the dealers' financial position, and address any over-leveraging that may occur. Problems result when a dealer floor plans inventory with several lenders and uses the proceeds from the sale of the inventory for purposes other than to repay the floor plan loan.

Examination Guidance

The review of the member business loan portfolio could document the credit unions compliance with:

- Member business loan requirements of Part 723; and,
- Loan maturity limits of §701.21(c)(4).

Examiners may complete the Business Loan questionnaire, which documents (1) whether the credit union complies with the *NCUA Rules and Regulations*, and (2) whether safety and soundness concerns exist in the credit union's member business lending practices. Examiners may also benefit from developing continuing workpapers for tracking member business loans from one examination to the next.

Examiners should report on the status of member business lending in credit unions whose member business loans exceed regulatory limits specified in §723.16 (the aggregate of member business loans plus unfunded commitments equal the lesser of 1.75 times the credit union's net worth or 12.25 percent of the credit union's total assets.)

SBA Loans

The Small Business Administration (SBA), an independent agency of the federal government, guarantees up to 90 percent of the principal and interest on loans made by credit unions to small businesses meeting prescribed eligibility standards. In determining the $50,000 member business loan threshold, credit unions should consider only the amount of the loan not guaranteed by SBA.

Participation Loans

Federal credit unions may participate with others in loans to credit union members, subject to the provisions of §701.22 of the *NCUA Rules and Regulations*. Participation loans may provide additional security to an investor, since the credit union would share in a portion of any loss.

The contract between the investor and the credit union may require the credit union to assume the majority of the risks in the event of a default. Such a contract may affect the adequacy of the Allowance for Loan and Lease Losses account. Sometimes credit unions enter into such transactions to avoid booking losses on a sale. If a third party with whom the credit union participates receives a higher rate of return on its investment than the credit union, examiners should carefully review the transaction to determine the credit union properly accounts for the transaction.

Following are possible unsafe and unsound operating policies and practices in loan participations:

- Purchase of loans without investigation of borrowers' credit positions, the condition of security properties, and the adequacy of appraisal reports;
- Purchase of unacceptably high risk loans to obtain purchase discounts or net yields above current market averages;
- Sales of high-yield loans and replacement of these loans with lower-yield loans;
- Sales of loans at a time when no current or projected demand for loanable funds exists; and,
- Participation sales only for creating income from a yield differential, a particularly risky practice under the condition described immediately above.

Purchase, Sale and Pledge of Eligible Obligations

Credit unions may purchase, sell, or pledge, in whole or in part, eligible obligations and loans in accordance with §701.23 of the *NCUA Rules and Regulations*.

Review procedures could include these additional steps:

- Conformance with all applicable parts and established limits of §701.23;
- Conformance of accounting procedures with GAAP, as applicable;
- Adequacy of reporting and collection practices and procedures;
- Existence and proper endorsement of notes and collateral documents; and
- Soundness of the loans' value.

Stock Secured Loans

Credit unions sometimes offer loans collateralized by stock, often in conjunction with a sponsor company, to facilitate sponsor-employee stock programs. Securities listed on the New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or NASDAQ usually have a ready market. In most instances, credit unions should not make loans secured by stocks not listed on a national exchange, since these

loans can substantially increase credit, transactional, liquidity, and reputation risk.

The Federal Reserve Board's Regulation U (12 C.F.R. §221.2) provides an in-depth definition of a margin stock. In general, a margin stock is an equity security. Credit unions must adhere to both the margin and reporting requirements set by Regulation U. Credit unions that make loans to purchase securities (purpose loans) or make loans secured by securities must familiarize themselves with the requirements of Regulation U. Credit unions must also advise members about Regulation X, which requires borrowers in securities transactions to comply with margin regulations. These regulations help curb excessive credit in the securities market.

Regulation U stipulates, in part, that if a credit union extends credit of $200,000 or more during a quarter (or has total credit outstanding at any time during the quarter of $500,000 or more), secured by collateral that includes any margin security (regardless of the purpose of such loans), it must register by filing Federal Reserve Form FR G-1 with the district federal reserve bank. Regulation U also requires all registrants file an annual summary recap, FR G-4. The Federal Reserve forms are located at the FRB website:

www.federalreserve.gov/boarddocs/reportforms/

A currently registered credit union that has not extended any credit secured by margin securities during any six month period and that does not have more than $200,000 of such credit outstanding during that period is eligible for deregistration (using form FR G-2, Deregistration Request.)

Loan Policy and Procedure

Credit unions should cover the following areas in their stock secured loan policy:

- Types of acceptable stocks the credit union will accept for collateral (e.g., stock in the sponsoring company only, or stock listed on one or all of the major exchanges);

- Evaluation of the stock price, at the date of the loan disbursement, as well as periodic evaluations of the stock value;

- Loan to value limitations (margin.) Since stock values can fluctuate, credit unions should allow some margin in case of a reduction in stock value (e.g., 60 percent of current value); and,

- Stop loss provisions. The credit union should adopt procedures to liquidate the stock to satisfy the loan in the event the value of the underlying stock declines below an established loan-to-value ratio.

Required Documents

Credit unions making stock secured loans should have the following documentation:

- Note and security agreement. Consumer loan documents generally do not suffice for perfecting stock security interest. Credit unions often use a special note and security agreement designed for stock secured loans. If applicable, the co-owner of the stock must sign a third-party pledge agreement when the pledge is not part of the security agreement;

- Stock assignment forms. A stock assignment form giving the credit union the right to sell the stock, if necessary, must identify the name as it appears on the stock certificate and the stock certificate number. A credit union employee must witness the assignment. Sound internal controls require that stocks and assignments remain under dual control;

- Purpose statement, Form FR G-3. Credit unions must execute this form on all loans secured by margin securities extended after the credit union becomes subject to the registration requirements. The form, which the borrower and credit union must sign, prevents borrowers from using a false purpose statement to obtain funds for purchasing margin securities. The credit union must retain the form for at least three years after the borrower pays off the loan;

- Collateral tracking. The credit union must document and verify the number of shares and, as applicable, certificate numbers for stock received. Credit unions must implement an audit procedure to

periodically audit stock loans, their current balance, and the adequacy of the collateral's value as follows:

- Safekeeping receipts. Credit unions should issue a safekeeping receipt to the member to document receipt of the actual stock certificates. If the stock is in two names, the credit union should issue only one receipt to prevent one party from claiming the certificate without the knowledge of the other;

- Book-entry stock registration. In some cases, the member may not physically possess the stock, but a trustee may hold the stock in book-entry electronic format. Procedures must state what documentation the trustee must maintain to identify the stocks pledged as collateral for a loan; and

- Stock ownership. The credit union must assure the physical stock certificates exist in the member's name, not some other or street name. However, book entry stock registrations are held in street name;

- Default sale. Credit unions must adopt procedures to specify the conditions that would result in liquidation of stock collateral (e.g., default for past due payments or when the stock value declines.) When the value of stock falls below an established loan to value, the credit union must contact the member in writing and inform the member of the options available to address the collateral deficiency (e.g., paying down the loan or providing more collateral.)

NCUA Guaranteed Loans

Some credit unions purchase loans from liquidating credit unions under the terms of a contract with the NCUA Board on behalf of the National Credit Union Share Insurance Fund (NCUSIF.) Some contracts state the share insurance fund will repurchase a specified amount of loans within a specified time if the credit union cannot recover from the borrowers. The examiner should review the terms of the contract to determine the credit union complies with those terms, giving special attention to the credit union's accounting for payments received on the loans since contract provisions often differ.

The examiner also may need to evaluate the loans for the feasibility of an early settlement of the loan guaranty when both NCUA and the credit union would benefit from an early settlement (e.g., in cases of poor performing loans where the credit union needs more flexibility to develop a specific workout strategy.)

Indirect Dealer Financing Programs

Indirect Dealer Financing Programs (IDFPs) allow borrowers to make a purchase and obtain financing at the same location. IDFPs often apply to new and late model automobile loans; however, the concepts discussed apply to all types of indirect financing or point of sale lending.

A credit union should evaluate the stability of the dealership before entering into an IDFP business relationship. A credit union should investigate dealerships by (1) obtaining a Dun and Bradstreet report on the dealership, (2) contacting the applicable department of motor vehicles and the Better Business Bureau, and (3) analyzing the dealership's audited financial statements. Even after establishing the program, the credit union should cautiously select dealers and continue to review dealer selection.

In an IDFP, the automobile dealership realizes additional profit by charging a flat fee for referring loans to the credit union, or by charging the buyer-borrower an interest rate higher than the credit union's lobby rate (rate differential.) Rate differentials in excess of three percent indicate the dealership may be taking advantage of the credit union's members.

While the dealer initially determines the existence of credit union membership or eligibility for membership for a prospective borrower, responsibility for membership eligibility is the credit union's first consideration before beginning the loan approval process.

Before initiating an IDFP, the credit union should have in place:

- A written business plan that incorporates the aspects of the IDFP into appropriate areas of the credit union's operation;
- A sound overall lending program;

- Documentation of management's due diligence, including a formal cost/benefit analysis, for the proposed IDFP;
- An asset-liability management strategy that includes specific provisions for the IDFP;
- Detailed IDFP lending policies and procedures;
- Experienced IDFP lending management and staff;
- A comprehensive "dealership agreement" that delineates the rights, duties, and obligations of both the dealer and the credit union;
- A legal opinion on file that addresses the IDFP in general and specifically (1) the legality of the dealership agreement and loan documentation, and (2) applicable state and federal consumer compliance laws (Truth in Lending Act, Credit Practices Rule, Fair Credit Reporting Act, etc.);
- A strong internal control program that safeguards against contracts that may take advantage of members. The rapid growth and competitive pace of IDFPs may result in dealers using undue pressure tactics; and,
- A strong collection department with expertise in repossessing and disposing of vehicles.

Policies and Procedures

Formal IDFP policies and procedures should, at a minimum, address:

- Membership eligibility;
- Definition of terms;
- Lending requirements, including:
  - Obtaining legal opinions on loan documents and applicable consumer laws;
  - Qualifications for the lending staff; and
  - Limitations on aggregate amounts loaned through the IDFP;

- Dependable line of credit to avoid discontinuing the program during times of tight liquidity;

- Qualifications of dealerships (e.g., financial, experience, longevity, and ongoing analysis of dealer profitability);

- Limitations on dealers and dealerships;

- Internal controls;

- Monitoring procedures, to review by dealer:

  - Number of applications processed;
  - Number and amount of loans approved, conditioned, and rejected;
  - Number and amount of loans booked; and
  - Delinquency, repossessions, and charge offs;

- Method of determining rate differential or flat fee (credit unions should amortize rate differentials over the life of the loan or when the loan is paid off, whichever is sooner);

- Dealer contracts, including a legal opinion on such contracts;

- Auditing procedures for the dealer's reserve accounts and payouts; and,

- Marketing strategies aimed at maintaining a good relationship with the dealers.

Potential Problems

The following are a few of the problems credit unions may encounter in an IDFP:

- Unless the credit union has a competitive rate differential (or flat fee) structure, dealers may only forward high-risk loans, thereby increasing credit and transaction risk;

- Without adequate preparation and control, the increased loan volume could overrun the loan department resulting in unsound

underwriting decisions, again increasing credit risk and possibly liquidity risk;

- The increase in automobile loans could overtax the collection department with increased delinquencies and repossessions, thus increasing transaction and credit risks;

- The dealer's involvement may increase the credit union's potential for making a loan to a non-member or ineligible member, thus increasing reputation risk;

- The Holder-in-Due-Course provision, which creates a contingent liability to the credit union, applies due to the business relationship between the credit union and dealership. Since the degree of risk to the credit union depends on the financial stability and business reputation of the dealers involved, the credit union should ensure that the dealership agreement includes a recourse (or indemnification) agreement, which limits the credit union's losses in the event of a claim under the Holder-in-Due-Course provision;

- The dealer's buy rate or the flat fee paid to the dealer diminishes the credit union's profit margin. Constant monitoring of the cost/benefit relationship provides the board with important information for determining the IDFP's viability;

- Credit unions may lose fee income when the dealer sells loan protection, disability, and other types of insurance to members. The cost/benefit analysis should include the effect of lost opportunity fees;

- Credit unions with IDFPs that take members or business away from other area credit unions may experience strained relations with those credit unions, affecting reputation risk;

- Some members may become disgruntled to learn they are paying higher interest rates or insurance prices through an IDFP than other members pay who deal directly with the credit union. The credit union's marketing program should keep the membership informed of current lobby rates; and,

- The endeavor could result in a loss to the credit union if a substantial number of IDFPs fail; however, the credit union can minimize the risk of loss or failure if it takes appropriate initial steps before getting involved in an IDFP.

Warning Signs

The following items may evidence the credit union's lack of control over the program:

- The credit union approves more than 75 percent of the loans processed;
- The credit union places full reliance on the dealer to obtain credit checks and credit reports;
- The dealer, not the credit union, accepts the borrower's loan payments;
- The dealer makes payments on behalf of the borrower, a practice that could potentially disguise past due accounts;
- The member-borrower may apply for the title, which could result in an improperly recorded lien;
- The dealer finances the down payment (through dealer incentive, inflated or fraudulent trade-in, or purchase price, etc.) resulting in the member having no equity in the collateral;
- The credit union initiates or permits continuous overdrafts in the dealer reserve or holdback accounts;
- The IDFP operates outside of the credit union's normal trade area; or,
- The credit union does a majority of their business with one dealership or one finance and insurance (F&I) person.

Regulatory Issues

Federal credit unions may participate in IDFPs under both the authority to make loans to members (see §107(5) of the *FCU Act* and §701.21 of

the *NCUA Rules and Regulations*) and the authority to purchase eligible obligations of members (see §107(13) of the *FCU Act* and §701.23 of *NCUA Rules and Regulations.*) Participation under the loan authority requires the following:

- The federal credit union must make the final underwriting decision. That is, before the dealer and member sign the sales contract, the credit union must actually review the application and other documents and determine that the transaction conforms to its lending policies (federal credit unions may not delegate their lending authority to a third party); and

- The dealer must assign the sales contract to the federal credit union very soon after the member and dealer sign it. An indirect loan is a loan to a member (within the meaning of §107(5) of the *FCU Act* and §701.21 of the *NCUA Rules and Regulations*) only if the formation of a sales contract, the assignment of the loan to the credit union, the transmittal of funds to the dealer, and the establishment of a debtor-creditor relationship between the credit union and the member occur in a very short time frame.

When dealers do not assign contracts within a short time frame or when the credit union does not review the application and other documents prior to agreeing to fund them, NCUA considers them to be purchases of eligible obligations and, as such, limits them to five percent of the credit union's unimpaired capital and surplus.

Direct versus Indirect Point of Sale Programs

Many credit unions, through arrangements with local retailers (auto dealerships, appliances and electronic equipment stores, etc.), have direct dealer financing programs (DDFP.) While the majority of the items pertaining to IDFPs can apply to DDFPs, the major differences between the two programs are as follows:

- In most cases, DDFPs do not involve signing up new members (i.e., borrowers must already belong to the credit union);

- Credit unions write loans with the same rates and terms for all members, leaving no room for the dealer to negotiate terms;

- Credit unions do not process non-member loans when dealers mistakenly submit them;

- Credit unions have the right of first refusal of their members' loans (i.e., the dealer does not shop the sales contract until the credit union rejects the loan); and

- Credit unions issue the "adverse action notice" if they do not grant the loan.

Leasing

Part 714 of the *NCUA Rules and Regulations* addresses permissible leasing activities for credit unions. Credit unions may engage in:

- Direct leasing, whereby the credit union purchases the property and leases it back to the member;

- Indirect leasing, whereby the member has a lease and the credit union purchases the lease from a third party (subject to §714.3);

- Open-end leasing, where the member assumes the risk for any difference in the estimated residual value and actual value at lease end; and

- Closed-end leasing, where the credit union assumes the risk for any difference in the estimated residual value and actual value at lease end.

Part 714 further specifies:

- Credit unions can only finance leases to their members;

- Credit unions may only offer a net, full payout lease. In a net lease, the member assumes all the burdens of ownership (maintenance, repair, licensing, registration, taxes, and insurance.) In a full payout lease, the credit union expects to recoup its entire investment in the leased property (amount financed), plus the cost of financing;

- The amount of the estimated residual value cannot exceed 25 percent of the original cost of the leased property (unless the excess is guaranteed);

- Credit unions must retain salvage powers over the leased property. The credit union must retain the power to take action to protect the value of the property if there is a change in conditions that threatens their financial position (such as failing to maintain insurance); and

- Credit unions must maintain a contingent liability insurance policy with an endorsement for leasing (or be named a co-insurer for indirect leasing) from an insurance company rated B+ or better.

Residual Value Insurance

Most automobile lease arrangements use residual value insurance coverage. Industry experts publish price guides showing residual values (e.g., Automobile Leasing Guide or Black Book.) Residual value insurance protects the credit union from errors in value estimation.

The credit union must determine the financial strength and reputation of the insurance company before purchasing residual value insurance coverage. The insurance company will only pay a claim for losses due to excessive devaluation of a vehicle at the end of the lease term. If, for any reason, the lease terminates early, this insurance does not apply.

Auto Insurance

Every member must carry normal liability and property insurance on the leased property. The member must name the credit union as an additional insured on the liability insurance policy and as the loss payee on the property insurance policy.

Regulation "M"

Regulation M implements the consumer leasing portions of the Truth in Lending Act to assure member-lessees receive accurate disclosures that allow members to compare various lease terms. The regulation also places limits on the size of balloon payments and specifies some advertising requirements. The credit union need not disclose "interest"

rates to the member, and usury laws do not apply. Lease contracts refer to fees rather than interest.

The regulation applies to leases that have the following characteristics:

- Term longer than four months;
- Leased property valued at no more than $25,000;
- Purchases personal property for personal, family, or household use; and
- Natural person lessee.

Following are the required disclosures for Regulation M:

- Description of the leased property;
- Amount due at lease signing;
- Payment schedule and total amount of periodic payments;
- Other charges (i.e., the amount of any liability the lease imposes upon the lessee at the end of the lease term);
- Total of payments;
- Payment calculation:
  - Gross capitalized cost;
  - Capitalized cost reduction;
  - Adjusted capitalized cost;
  - Residual value;
  - Depreciation and any amortized amounts;
  - Rent charges;
  - Total of base periodic payments;
  - Lease term;
  - Base periodic payment;
  - Itemization of other charges; and
  - Total periodic payment;
- Early termination:
  - Conditions and disclosure of charges; and
  - Early-termination notice;
- Maintenance responsibilities:
  - Statement of responsibilities;
  - Wear and use standard; and
  - Notice of wear and use standard;
- Purchase option:
  - End of lease term; and

  - During lease term;
- Statement referencing nonsegregated disclosures;
- Liability between residual and realized values;
- Right of appraisal;
- Liability at end of lease term:
  - Rent and other charges;,
  - Excess liability; and
  - Mutually agreeable final adjustment;
- Fees and taxes;
- Insurance:
  - Through the lessor; or
  - Through a third party;
- Warranties or guarantees;
- Penalties and other charges for delinquency;
- Security interest; and
- Limitations on rate information.

Failure to comply with the Consumer Leasing Act increases compliance risk and may result in criminal and civil penalties. Lessors must retain evidence (paper copies are not required) documenting their compliance with the Consumer Leasing Act regarding actions they performed and the required disclosures they made. The lessor must retain, for at least two years, enough information to reconstruct the required disclosures or other records. The Compliance chapter discusses Regulation M in more detail.

Income on Leases

Lease contracts refer to income on leases as "fee income" rather than "interest income". Therefore, lease contracts do not disclose an "interest rate" to the member. The credit union must know the costs of the lease and their overhead costs in order to determine the lease program's profitability. A well-managed lease program should identify the profit margin on leases.

Because a portion of each lease payment contains some principal return to the credit union, the credit union should use an effective interest method of recording income consistent with GAAP. This "interest rate" must be consistent with the "fees" disclosed in the lease agreement, but the credit union need not disclose the rate itself to the member, although some credit unions voluntarily disclose this rate.

Leasing Program Problems

The credit union should implement internal controls to mitigate the following problems posed by a leasing program:

- The credit union bears responsibility for credit risk. Residual value insurance does not benefit the credit union if a lease becomes delinquent. The member does not own the vehicle, usually makes no down payment on it, and therefore, does not have a vested interest in the vehicle. If the member defaults on payments and if the credit union repossesses the vehicle, the credit union would have to dispose of it and bear the depreciation expense. Credit unions must not view all of the insurance policies associated with auto lease programs as a substitute for quality underwriting procedures. Credit unions should take prompt action to limit losses on leases.

- Intense competition in the leasing area may tempt credit unions to offer lower lease payments by increasing the residual values. Manipulating and inflating residual values can result in significant losses to the credit union.

- Vehicles depreciate rapidly when they are new and gap insurance may not cover losses due to theft of the vehicle. Members will not continue paying on a wrecked or stolen vehicle, and the insurance company probably will not give the credit union book value (per the credit union's books) for the vehicle.

- If the credit union is the owner of the vehicle, a contingent liability may exist relative to the operation of the automobile.

- Although the member must properly maintain the vehicle, the incentive to maintain it lessens if the member intends to turn it in at the conclusion of the contract term. Poor or no maintenance may decrease the value of the vehicle at the conclusion of the lease. The credit union can penalize the member for a breach of the contract and impose a fee. However, the credit union may have difficulty collecting those fees the member feels are unwarranted.

- In closed-end leasing, losses resulting from depreciation and the credit union's inability to sell the vehicle for the loan balance at the end of the lease contract are the sole liability of the credit union,

unless it obtains appropriate insurance coverage. Closed-end leasing contains a level of risk that the credit union should understand and carefully evaluate.

- Using an outside party presents some risks. The benefits of using the services of a CUSO or leasing company include minimizing the credit union's administrative burdens and liability. However, if a credit union invests in or lends to a CUSO, and the CUSO fails, it can lose its investment in the CUSO, its loan to the CUSO, and the services that the leasing company CUSO provide. Since the credit union relies on the services of the CUSO, it should monitor the CUSO's financial condition and operations. Further, if the CUSO or leasing company files bankruptcy, the credit union may encounter difficulty obtaining title to the vehicles if the titles are in the name of the CUSO or leasing company at the time of bankruptcy. A participating credit union must monitor the financial condition of CUSOs or leasing companies.

- The credit union should have on file an attorney's opinion acknowledging that, in the event of bankruptcy, the leased vehicles are the credit union's assets, not assets of the CUSO or leasing company.

- Additional burdens could fall on the credit union if, at the end of the lease term, members return the vehicles to the credit union. The credit union must have written agreements for vehicle disposition at the time of lease termination to reduce the possibility of its becoming a used auto sales company. It should enter into written automobile disposal agreements with the residual value insurance company or local used auto dealers or auctions to reduce the potential of incurring a loss on the value of the vehicle. If a credit union uses a CUSO for leasing, this normally becomes the CUSO's responsibility.

- The potential for fraud exists in any program. Credit unions should check with their surety company and determine whether they need special bond coverage for lease financing.

- Interest rate risk exists with auto leasing as with any "loan" portfolio. When analyzing the profitability of a leasing portfolio,

the credit union must consider several factors, including the cost of CUSO service, the cost of insurance (usually included in the fee to the CUSO), the cost of credit risk, and the opportunity cost of the money invested.

- The credit union must consider service to members. Longer-term leases usually generate more profit to the credit union than short-term leases. Short-term leases may generate less profit than conventional loans. Some leases have marginal income spreads. If so, examiners should ensure that the credit union understands this condition and determine the profitability of the overall portfolio.

Balloon Notes

Balloon loans are loans with large final payments. The following inherent risks exist:

- The credit union may not contact the borrower frequently enough to learn of new financial problems of the borrower;
- The contracted balloon payment may exceed the borrower's ability to pay (borrower's expectations failed to materialize);
- The borrower may be unable to make final payment or obtain affordable financing elsewhere, when the contracted balloon payment comes due. When collateral depreciates faster than the loan balance amortizes, the collateral may no longer adequately secure the loan; and,
- The credit union may have liquidity problems due to a lack of cash flow.

Balloon notes present significant problems to management in establishing a sound asset-liability management (ALM) program. The credit union's ALM policies must clearly address how the credit union manages the risks inherent in balloon loans. Ideally, credit unions should match balloon note assets with equal maturity liabilities.

Boat Loans

Boats come in multiple shapes and sizes with costs ranging from less than $500 to over $1 million. There are two recognized categories of

boats based on displacement size, each with different requirements for perfection of liens.

- Boats with net displacement under five tons. This category contains mostly mass-manufactured recreational boats. While displacement differs for various hull types and shapes, generally boats under 32 feet fall into this category. Credit unions can determine the value of boats in this category from NADA (see nada.com) and Blue Book publications; similar to the way they determine the value of automobiles. Lenders can request independent appraisals if they cannot determine the value of a specific craft or its condition. In general, well-maintained boats hold their values much longer than automobiles or other recreational equipment.

  Requirements for perfecting lien interests in small boats vary from one state to another. Most states title boats the same way they title automobiles. In some states, lien perfection requires filing a UCC-1. The credit union should familiarize itself with the requirements of the applicable states.

- Boats with net displacements over five tons. The U.S. Coast Guard regulates boats in this category, which generally operate in the open ocean, Great Lakes, and other large bodies of water (often as commercial fishing vessels.) Thus, loans for this type of boat may require business loan documentation. Credit unions should use caution when granting loans where the payments depend on income from a commercial fishing venture, since the cash flow is often seasonal (e.g., the limited Alaskan halibut season.) With the limited number of prospective buyers, high deficiency balances can result from defaults.

  Many boats in this category have a mass manufactured hull, but the remainder of the boat is often custom built for an individual buyer. Equipment and quality of fit and finish vary widely. Before extending credit on boats in this category, credit unions should obtain a marine survey and an appraisal, especially important when the credit union grants a loan on a used vessel. A marine survey is a detailed report on the boat, its equipment, condition, seaworthiness, and compliance with Coast Guard fire and safety

regulations. Appraisers often require the completed survey before providing a firm value.

Perfection of a lien on a boat in this category requires a preferred marine mortgage filed with the U.S. Coast Guard.

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GLOSSARY OF LOAN TERMS - APPENDIX 10B

Glossary of Auto Leasing Terms

Capitalized Cost: the amount financed or the final capitalized cost (cap cost) to the lessee.

Closed-End Lease: most consumer leases are closed-end leases. In a closed-end lease, the credit union assumes responsibility for any deficit between the agreed upon residual value and the vehicle's actual value at the end of the lease. This type of lease is often referred to as a "walk-away" lease.

Direct Lease: a lease where the credit union becomes the owner of the property at the request of the member and leases the property to the member.

Excess Mileage: the residual value is based on the leased vehicle having an exact number of contracted miles over the term of the lease. This mileage criteria is a major consideration in establishing the residual value. If the lessee anticipates additional miles at the beginning of the lease, the residual value can be lowered to account for the usage. If the mileage at lease end exceeds the amount contracted for, the excess mileage is billed at a predetermined cost per mile.

GAP Insurance: at any time during a loan's life, a payoff can be requested to determine the balance if paid in full before the scheduled end of the loan. This is often referred to as the net payoff. When a vehicle is stolen or considered a total collision loss, the insurance company negotiates a final settlement for the insured. In many cases, the settlement amount is less than the net payoff leaving a deficiency for which the borrower is still liable. GAP insurance pays the difference between the net payoff and the insurance settlement less the insurance deductible, thus eliminating the loss or deficiency.

Indirect Lease: a lease where the credit union purchases the lease and the leased property (or is assigned the lease and has a lien on the leased property) after the lease has been executed between a leasing company and the member.

IRPS 83-3: the NCUA's Interpretive Ruling and Policy Statement (IRPS) 83-3 authorizes federal credit unions to become involved in either direct or indirect, and in either open-end or closed-end financing of leased property. The personal property financed must secure the loan. All requirements and limitations established in the Federal Credit Union Act, the NCUA Rules and Regulations (particularly Sections 701.21 and 701.23), Regulations B and M, and local state laws must be followed.

Lessee: the party who actually uses the vehicle. The credit union member is the lessee.

Lessor: the party that enters into the lease with the credit union member. This may be the credit union, leasing company, or CUSO.

Open-End Lease: in an open-end lease agreement, the credit union member would take responsibility for any deficit between the agreed upon residual value of the property and its actual value at the end of the lease. This type of lease would be rare because the residual value would have to be less than 25 percent of the price of the vehicle and the member would have to accept this depreciation risk. These factors would make a lease agreement very unattractive to the member.

Residual Value: the projected future value of the leased vehicle. The value will vary based on the term of the lease, type of vehicle, and contracted mileage. Residual value is usually expressed as a percentage of the vehicle's MSRP (manufacturer's suggested retail price).

Glossary of Indirect Dealer Finance Paper (IDFP) Terms

Buy Down Rate: a lower rate than the dealer's "buy rate." The dealer will pay the credit union the difference in the amount of the finance charges between the dealer's buy rate and buy down rate. This provides a lower rate to the dealer's customer (lower payments) allowing the dealer to complete the sale.

Conditional Sales Contract: agreement between the dealer and purchaser describing the merchandise with add-ons, agreed upon price, etc.

Captive Financiers: General Motors Acceptance Corporation, Toyota Motor Credit, Ford Motor Credit, etc.

Dealer's Buy Rate: the loan rate charged the dealer by the credit union. The rate offered to the dealer is usually between 0.25 and 1.00 percent less than the rate offered to members (lobby rate).

Dealer's Invoice: factory invoice describing the vehicle and the amount the dealer paid for the vehicle.

Dealer's Reserve: general ledger account balance owed to the dealer. It may represent an amount that must be retained in the dealer's reserve under the control of the credit union to assist in refunding interest on prepaid contracts, and to offset losses on contracts for which the dealer is obligated but has not performed.

F&I: an automobile dealership's Finance and Insurance Department.

Hold-Back Reserve: similar to dealer's reserve account, but usually represents a stipulated portion of the rate differential on a contract that the credit union believes represents a greater risk than normally accepted from the dealer.

Holder-in-Due Course: a liability situation created for the lender when the lender establishes a business relationship (e.g., IDFP) with the seller of a product (dealer). This area should be addressed in the Dealership Agreement to limit the loss exposure to the credit union.

Indirect Dealer Financing: financing arrangement whereby the dealer facilitates loans made by the credit union to members. The credit union is responsible for making the underwriting decision and the loan is assigned to the credit union immediately after being made.

Lobby Rate: rate charged members for direct financing with the credit union.

Post Purchase Audit: a detailed review of the paper submitted by the dealer to ensure the faxed application and sales contract agrees with the final paperwork submitted by the dealer, and the merchandise, add-ons, and insurances are appropriately priced. Usually performed for all new dealerships and periodically through the business relationship.

Quality Rating System: any number of loan rating methods designed to determine the risk assigned to a particular loan. (If the credit union is using some type of quality rating system, the amount and maturity of the hold back reserve should be adjusted in relation to the risk involved.)

Rate Differential: difference between the dealer's buy rate and the rate charged the customer. The higher the rate the customer will pay the more the dealer's profit on the financing.

Recourse Agreements: affects the lender's ultimate collectibility should the loan become delinquent. There are three types of recourse: 1) under "full recourse" the dealer must purchase the loan at the credit union's demand; 2) "limited recourse" would require the dealer to buy back the loan or repossess the goods if the credit union fulfills certain obligations; and 3) with "no recourse" (the most common), the dealer has no obligation on the loan unless fraud or misrepresentation was involved.

Retail Verification: also referred to as "after-purchase survey," this process serves as an internal control and quality control function (and, incidentally, presents an opportunity for the credit union to cross sell other loans and services.) An individual, other than the loan officer, calls the borrower after the loan is processed to ensure the dealer did not misrepresent the deal to the credit union or the member (APR, trade-in, out of pocket down-payment, accessories, insurance, etc.) This process should be completed for all new dealerships and F&I persons for the first 25 deals and then randomly thereafter (20 percent to eventually 10 percent of deals) as the relationship matures. The credit union considers a newly hired F&I person a new relationship.

Glossary of Real Estate Lending Terms

Actual/Actual Remittance Type: a method of sending monthly mortgage payments to the loan owner that requires the lender (servicer) to remit only the interest and principal payment it actually receives from mortgagors.

Adjustable-Rate Mortgage Loan (ARM): a mortgage that allows the lender to adjust the interest rate periodically based on the movement of a specified index.

ALTA - American Land Title Association: a national association of title insurance companies, abstractors, and attorneys specializing in real property law. The association establishes standard procedures and title policy forms.

Amenity: an aspect of a property that enhances its value, e.g., off-street parking, availability of good public transportation, tennis courts, or a swimming pool.

Amortization: gradual reduction of the debt through periodic payments scheduled over the mortgage (debt) term. A loan payment schedule characterized by equal periodic payments calculated to meet current interest payments and retire the principal at the end of a fixed period.

Appraisal: a written report by a qualified person that sets forth an estimate or opinion of value. The term also refers to the process by which this estimate is obtained.

Arms-Length Transaction: a transaction between a willing buyer and a willing seller with no undue influence imposed on either party, and where there is no relationship between the parties except that of the specific transaction.

Assumption: a method of selling real estate wherein the property purchaser agrees to take over the primary liability for payment of an existing mortgage.

Balloon Mortgage: a mortgage that has level monthly payments that would fully amortize it over a stated term, but which provides for a balloon payment to be due at the end of an earlier specified time, e.g., 30-year amortization, with balloon payment due in five years.

Balloon Payment: the remaining balance of a mortgage that must be paid in a lump sum at the end of the mortgage term. The amount represents more than a monthly payment and is generally substantial, e.g., the balloon payment on a $50,000 mortgage with a five-year term and 30-year amortization at 8.75 percent is scheduled to be $47,800.

Bankruptcy: a proceeding in a federal court in which debtors who owe more than their assets can relieve the debts by transferring their assets to a trustee. This affects the borrower's personal liability for a mortgage debt but not the lien of the mortgage.

Basis Point: 1/100 of one percent.

Biweekly Mortgage: a mortgage that requires payments to reduce the debt every two weeks.

Blanket Lien: a lien on more than one parcel or unit of land, frequently incurred by subdividers or developers who have purchased a single tract of land for the purpose of dividing it into smaller parcels for sale or development.

Bridge Loan: a temporary loan generally made to borrowers who need financing between the purchase of a new home and the sale of an old home. Also called a "swing loan."

Cash-out Refinance: a refinance transaction in which the amount of money received from the new loan exceeds the total of the money needed to repay the existing first mortgage, closing costs, points, and the amount required to satisfy any outstanding subordinate mortgage liens.

Closing: the completion of a real estate transaction that transfers rights of ownership to the buyer. Also called "settlement."

Closing Costs: money paid by the borrower to enact the closing of a mortgage loan. This normally includes an origination fee, title insurance, survey, attorney's fees, and such prepaid items as taxes and insurance escrow payments.

Common Areas: those portions of a building, land and amenities owned by a Planned Unit Development (PUD) or condominium project's owners' association (or a cooperative project's cooperative corporation) that are used by all of the unit owners. Common areas could include swimming pools, tennis courts, and other recreational facilities, as well as common corridors of buildings, parking areas, etc.

Common Area Assessments: levies against individual unit owners in a condominium or PUD project for additional capital to defray the owner's association's costs and expenses to repair, replace, maintain, improve or operate the common areas of the project.

Comparables: in appraising, properties of reasonably the same size and location with similar amenities as the subject property. These are properties that have been sold recently, thereby indicating the approximate fair market value of the subject property.

Completion Bond: an insurance policy taken out for the lender that assures completion of the construction project if the builder or contractor cannot complete it.

Condominium: a real estate project where each unit owner has title to a unit, an undivided interest in the common areas of the project, and sometimes the exclusive use of certain limited common areas. Fannie Mae does not purchase condominium projects, but does purchase mortgages on individual units in the project.

Conforming Loan: a loan, the amount of which is less than or equal to the FNMA or FHLMC maximum loan limit (with the exception of loans securing property in Alaska or Hawaii which have higher limits).

Conventional Mortgage: a mortgage that is not insured or guaranteed by the federal government.

Cooperative Mortgages: mortgages related to a cooperative project. They may be multi-family mortgages covering the entire project or single-family mortgages covering individual units (share loans).

Cooperative Project: a multi-family residential building that has multiple ownership wherein a corporation holds title to the property and conveys units to individuals by issuing shares of stock and occupancy agreements.

Cost Approach to Value: a method of measuring the value of a property based on the cost of producing a substitute residence that has the same use and features as the property being appraised.

Covenant: refers to the various conditions (both positive and negative) associated with business loan and condominium promissory notes that the borrower or lender must meet during the life of the contract.

Credit Report: a report from an independent agency that verifies (last reported/known) a loan applicant's current employment and income, and provides information on previous debts and liabilities.

Credit Risk: the risk that a borrower will default (often associated with mortgage loans in view of their long-term nature.)

Credit Union Conforming Mortgage: a FNMA product that allows simplified documentation (credit reporting, income and employment verification, and application requirements) to facilitate FNMA's purchase of credit union-originated loans.

Deed in Lieu: a deed given by a borrower to a lender to satisfy a debt and avoid foreclosure.

Deed of Trust: in some states the document used in place of a mortgage; a type of security instrument conveying title in trust to a third party covering a particular piece of property; used to secure the payment of a note; a conveyance of the title land to a

trustee as collateral security for the payment of a debt with the condition that the trustee shall re-convey the title upon the payment of the debt, and with power of the trustee to sell the land and pay the debt in the event of a default on the part of the debtor.

Default: the failure of a borrower to make a mortgage payment when due. A delinquent loan is said to be in default.

Delinquency Advance: the deposit of a servicer's corporate funds into its custodial account to assure that the full monthly remittance due the secondary market will be available on the remittance due date, even though the servicer has not collected the actual funds from a delinquent borrower. A servicer may reimburse himself for delinquency advances from subsequent collections.

Discount: the amount by which the face value of a mortgage exceeds its selling price.

Discount Point: A percentage (usually one percent) of the loan amount (not the purchase price) of the property. Discount points paid by the borrower or seller when a loan is originated in order to increase the lender's actual yield.

Documentation: the use of FNMA/FHLMC Uniform Instruments ensures that the documentation associated with mortgage loans is complete and consistent with secondary market standards.

Due-on-sale Provision: a covenant in a conventional mortgage that allows the lender to call the mortgage due and payable if ownership of the mortgaged property is transferred without their permission.

Endorsement: additional coverage added to title insurance.

Errors and Omissions Coverage: a type of indirect loss insurance used to cover losses that occur because of error or neglect on the part of an employee to whom a specific responsibility has been assigned.

Escrow Account: the account holding that portion of the mortgagor's monthly payment, held by the lender, used for the payment of taxes, hazard insurance, mortgage insurance, and any other specified items as they become due.

Federal National Mortgage Association (Fannie Mae or FNMA): a major purchaser of mortgage loans on the secondary market. A privately owned corporation created by Congress to support the mortgage industry. It purchases and sells residential mortgages insured by FHA or guaranteed by VA as well as conventional home mortgages.

Federal Housing Administration (FHA): part of HUD whose main activity is to insure residential mortgage loans made by private lenders. It sets standards for construction and underwriting, but does not lend money or plan construction directly.

Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC): a private corporation authorized by Congress to provide secondary mortgage market support for conventional mortgages.

Fee Simple: the basic form of ownership, which conveys the largest bundle of ownership rights, including air rights above and mineral rights below the property.

Fee Simple Estate: an unconditional, unlimited estate of inheritance that represents the greatest estate and most extensive interest in land that can be enjoyed. It is of perpetual duration. In a condominium, the owner owns only his/her unit in fee simple and is an owner in common with respect to the land and other common portions of the property.

FHA Mortgage: a mortgage insured by the Federal Housing Administration; may be referred to as a "government" mortgage.

First Mortgage: a real estate loan that is the first lien against a property. First refers to the order in time that the lien is filed.

First Right of Refusal: lien that allows a prospective buyer the chance to buy the property before it goes on the market.

Fixed-rate Mortgage: a mortgage that provides for only one interest rate for the entire term of the mortgage. If the interest rate changes because of enforcement of the due-on-sale provision, the mortgage is still considered a fixed-rate mortgage.

Foreclosure: the legal process by which a borrower in default under a mortgage is deprived of his or her interest in the mortgaged property. This usually involves a forced sale of the property at public auction with the proceeds of the sale applied to the mortgage debt.

Ginnie Mae (GNMA), Government National Mortgage Association: a government-owned corporation within the US Department of Housing and Urban Development (HUD) that issues mortgage-backed securities in exchange for FHA/VA mortgages.

Hazard Insurance: insurance coverage that compensates for physical damage to the property (e.g., by fire, wind, or other natural disasters).

Home-Equity-Line-of-Credit (HELOC) Loan: a mortgage loan, usually in a junior lien position, that allows the borrower to obtain multiple advances of the loan proceeds at his or her discretion, up to a stated amount that represents a specified percentage of the borrower's equity in a property.

Home Mortgage: a residential mortgage on a one-to-four-family property.

HUD, Department of Housing and Urban Development: department responsible for the implementation and administration of government housing and urban development programs, including community planning and development, housing production and mortgage credit, and equal opportunity in housing.

Improvements: those additions to raw land that normally increase its value, e.g., buildings, streets, and sewers. Off-site improvements are improvements outside the boundaries of a property, e.g., sidewalks, curbs and gutters. On-site improvements include construction of buildings or other improvements within the property's boundaries.

Income Approach-to-Value: a method of measuring the value of a property, which is based on market rent or income that the property can be expected to earn.

Index Rate: a number that determines interest rate changes on adjustable-rate mortgages, e.g., LIBOR, 11 COFI.

Installment Debt: borrowed money that is repaid in several successive payments, usually at regular intervals, for a specific amount and term, e.g., automobile or furniture loan.

Insured Closing: settlement performed at the title company, not the credit union.

Interest Rate Risk: the risk that interest rates could increase or decrease significantly from the rates on loans held in a loan portfolio.

Junior Lien: any lien that is filed after the claims of the holder of a prior (senior) lien.

Lease: a written agreement between the property owner and tenant that stipulates the conditions under which the tenant may possess the real estate for a specified period of time and rent.

Leasehold Estate: a way of holding title to a property wherein the mortgagor does not actually own the property but rather has recorded a long-term lease on it.

Letter of Credit: a letter addressed by a financial institution, on behalf of a borrower, to a third party, authorizing the third party to draw drafts up to a stipulated amount under specified terms.

Lien: a legal hold or claim of one person on the property of another as security for a debt or charge.

Liquidity Risk: the risk of having inadequate cash on hand to meet member needs. A credit union in this position would be forced to borrow money or sell assets on what may be unfavorable terms to raise cash.

Loan-to-Value (LTV) Ratio: the relationship between the unpaid principal balance of the mortgage and the property's appraised value (or the sales price, whichever is lower).

Market Conditions: lending in any area requires a thorough knowledge of the local market, laws, customs and pricing.

Margin: a fixed-rate added to an index for determining the overall interest rate that will be charged on adjustable-rate loans. The margin is usually stated in terms of basis points, such as 100 BP, or as an interest rate, such as one percent.

Monthly Fixed Installment: that portion of the total monthly payment that is applied toward principal and interest.

Mortgage: conveyance of an interest in real property given as security for the payment of a debt. The deed by which such a transaction is effected. Collectively, the security instrument, the note, the title evidence, and all other documents and papers that evidence a lien on property as security for payment of a debt.

Mortgagee: a person or company to whom property is mortgaged.

Mortgagor (also Mortgager): a person who mortgages property (borrower, homeowner).

Negative Amortization: a gradual increase in the mortgage debt that occurs when the monthly installment is insufficient to cover interest. The interest shortage is added to the unpaid principal balance to create negative amortization - an increase in the principal amount owed.

Net Worth: the value of all assets, including cash, less total liabilities; often used to indicate creditworthiness and financial strength.

No Cash-Out Refinance: a refinance transaction in which the mortgage amount is limited to the sum of the unpaid principal balance of the existing first mortgage, closing costs (including prepaid items), points, the amount required to satisfy any liens that are more than one-year old (if the borrower chooses to satisfy them), and cash to the borrower of up to one percent of the loan amount.

Non-assumption Agreement: a provision whereby if the loan is sold the buyer cannot assume the debt.

Nonconforming Loan: a loan that FNMA or FHLMC will not buy because it exceeds their maximum loan limits (with the exception of loans securing property in Alaska or Hawaii which have higher limits.)

Nonstandard Loan: either a conforming or nonconforming loan supported by nonstandard documentation, e.g., a TRW credit report rather than a Residential Mortgage Credit Report.

Notice of Default: rider attached to title insurance for credit unions in a second lien position. Requires the first lienholder to notify the second lienholder before foreclosure.

Occupancy Status: Fannie Mae uses three definitions of ownership to determine conventional mortgage eligibility:

- Principal Residence - the borrower's primary residence. At least one borrower must occupy and take title to the property and execute the note and mortgage.
- Second Home - a single family property that the borrower occupies in addition to the principal residence (a two- to four-family residence is not eligible for second home status). When the property is classified as a second home, rental income may not be used to qualify the borrower.
- Investment Property - a property that the borrower does not occupy. This definition is used whether or not the property produces revenue.

Origination Fees: the fees charged by a lender to prepare loan documents, make credit checks, inspect, and sometimes to appraise a property. The fees usually are computed as a percentage of the face value of the loan.

Operating Loan: a current liability. It funds the operations of the business/farm for the cycle or period is due and payable within the operating cycle. Generally, used for the acquisition and financing of inputs for the production cycle.

P & I (Principal and Interest): that portion of a homebuyer's monthly payments to the lender that composes the debt service on the mortgage.

Power of Attorney: transfer right (interest) in property to another person to act in owner's behalf.

Private Mortgage Insurance (PMI): insurance written by a private company, protecting the lender against loss resulting from a mortgage default.

Promissory Note: borrower's promise to repay a loan; used in all types of borrowing. Contains the terms and conditions of the loan, including covenants necessary in commercial lending. All promissory notes contain the amount borrowed and the agreed upon interest rate - either fixed or variable.

Planned Unit Development (PUD): a real estate project in which each unit owner has title to a residential lot and building and a nonexclusive easement on the common areas of the project. The owner may have an exclusive easement over some parts of the common areas (e.g., a parking space). Fannie Mae does not purchase PUD projects but does purchase individual units in such projects.

Purchase-Money Transaction: the borrower obtains the mortgage to purchase the property.

Quality Control: development of regular loan monitoring that addresses the credit, collateral, and interest rate risk within a real estate loan portfolio. A system of safeguards and checkpoints to ensure that all loans are originated, processed, underwritten, closed, and serviced according to the lender's and/or secondary market's requirements.

Quit Claim Deed: transfers a portion or all interest to another.

Reconveyance: to transfer lien back to previous position or owner

Recourse: a financial institution's acceptance, assumption, or retention of some or all risk of loss generally associated with ownership of an asset, whether or not the institution owns or has ever owned the asset.

Red Lining: making home mortgage loans only in specified areas of towns or municipalities.

Refinance Transaction: the repayment of a debt from the proceeds of a new loan using the same property as security. Fannie Mae also considers the current owner's placement of financing on a property not financed as a refinance transaction.

RMCR, Residential Mortgage Credit Report: a detailed account of the credit, employment, and residential history (as well as public records information) of a borrower.

Sales Comparison Approach-to-Value: a method of measuring the value of a property based on an analysis of comparable sales, contract offerings, and listings of properties that are the most comparable to the property being appraised. (Also called "market data approach".)

Scheduled/Actual Remittance Type: a method of sending monthly mortgage payments which requires the lender to remit the scheduled interest due (whether or not it is collected from mortgagors) and the actual principal payments that it collects from mortgagors.

Scheduled/Scheduled Remittance Type: a method of sending monthly mortgage payments that requires the lender to remit the scheduled interest due and the scheduled principal due (whether or not payments are collected from mortgagors.)

Second Mortgage: a mortgage that has a lien position subordinate to the first mortgage because it was recorded later.

Secondary Market Lending Standards: participation in the secondary market requires strict adherence to established industry mortgage lending standards.

Secondary Mortgage Market: the market in which existing mortgages and mortgage-backed securities are bought and sold.

Servicing: the tasks performed to protect the mortgage investment including collecting the monthly payments, managing the escrow accounts, monitoring and dealing with delinquencies, and overseeing foreclosures and payoffs.

Servicing Compensation: the income that a servicer receives for the collection of payments and management of operational procedures related to a mortgage, e.g., base servicing fee, plus late fees charged for special services, yield differential adjustments or excess yield, and, sometimes, a share in prepayment charges.

Servicing Released: sale of a mortgage loan along with the rights to service that loan when the loan is sold in the secondary market.

Servicing Retained: retention of the rights to service a loan when the loan is sold in the secondary market.

Subordinate Financing: any mortgage or other lien that has priority lower than that of the first mortgage.

Subservicer: party under contract to the original lender to perform the on-going servicing activities for the mortgage or pool. A qualified party acceptable to the purchaser must service loans sold on the secondary market.

Subservicing Arrangement: an arrangement wherein the contractually responsible servicer of a mortgage or pool of mortgages hires another servicer to perform its servicing functions.

T & I (Taxes and Insurance): that portion of a home buyer's monthly payments to the lender transferred into an escrow fund to pay property taxes, the homeowner's insurance premiums, and mortgage insurance, if applicable.

Title Insurance: insures against defects in title that were not listed in the title report or abstract.

Trade Area: the area, as defined by the credit union's policies, where a stated type of loan will be considered. The area must be such that the credit union will be able to perform adequate monitoring of market conditions and of loans granted.

UCC, (Uniform Commercial Code): a comprehensive codification and modernization of commercial law (excluding law dealing with real property). Each state has adopted its own provisions to this codification.

VA Mortgage: a mortgage that is guaranteed by the Department of Veterans Affairs; may be referred to as "government" mortgage.

Warranty Deed: contains a covenant of warranty whereby the coventor will defend against the claims of all persons.

Wraparound Mortgage: a mortgage that includes the remaining balance on an existing first mortgage plus an additional amount requested by the mortgagor. Full payment of both mortgages is made to the wraparound mortgagee, who then forwards the payments on the first mortgage to the first mortgagee.

Glossary of Student Loan Terms

Deferment: time interval of postponement of principal payments on a Stafford Loan during which the federal government makes the interest payments (excluding unsubsidized). Lender/servicer determines the deferments, which are authorized for borrowers who meet the following criteria:

- Study at least half-time at an eligible school;
- Study in an eligible graduate fellowship program;
- Are seeking but are unable to find full-time employment;
- Will suffer economic hardship from repayment (as determined by the lender using Department of Education regulations);
- Serve in an eligible internship program

Federal Family Education Loan Program (FFELP): formerly called the Guaranteed Student Loan (GSL) program. Loans granted under this program are insured. Qualified students and parents can borrow money for education. This program includes Federal Stafford Loans (subsidized and unsubsidized), Federal Parent Loans for Students (PLUS), and Federal Consolidation loans.

Federal PLUS Loans: unsubsidized loans to parents who are assisting their dependent student. The parent is responsible for the loan repayment. Interest accrues from the date of origination and is the responsibility of the parent borrower. The loans have no grace period and repayment begins while the student is still in school.

Grace Period: the period of time between when a student ceases to attend school at least halftime and when the loan repayment must begin (usually 6 months).

Guarantee Agencies: agencies designated by the US Department of Education to guarantee loans made under the FFELP. The guarantee agency will reimburse the lender for an eligible loan in case of default, borrower's death, bankruptcy, or total and permanent disability. Each state has its own guarantee agency.

Insurance Premium: a fee, usually a percentage of the loan amount (up to 3 percent), deducted from the loan proceeds by the lender and transferred to the guarantor agency. The guarantee agency establishes the premium amount.

Interest Benefits: payments made by the Department of Education to lenders. The lender receives the full amount of the actual interest as long as the borrower remains eligible.

Secondary Market: purchases student loans from lenders and is the holder of the loan after purchase. Includes institutions such as SLMA (Sallie Mae - Student Loan Marketing Association) and CHELA/USA (California Higher Education Loan Authority).

Servicers: companies (e.g., EduServe and Academic Financial Services Association) that provide day-to-day management of student loans. The level of service can be negotiated with the individual companies (e.g., payment processing and collections).

Special Allowance: payments made by the Department of Education to the lender allowing lenders to offer FFELP loans at a reduced interest rate. Based on a mathematical formula established by the Department of Education, the special allowance depends on the average 91-day T-Bill rate, interest rate on the student loan, and a "special allowance factor" set by law. The special allowance compensates the lenders for what they could be earning if the funds were in consumer loans rather than student loans.

Subsidized Federal Stafford Loans: loans to undergraduate, graduate, vocational, or professional students who meet specific financial need and income criteria. These loans require no repayment when borrower is in school at least half time and during grace and deferment periods, at which times the government subsidizes these loans by paying interest to the lender. Monthly payments begin 6 months after the student graduates, drops below half-time status, or withdraws from school. The maximum payback period is 10 years from the date of the first payment.

Unsubsidized Federal Stafford Loans: loans to undergraduate, graduate, vocational, or professional students who do not meet specific financial need and income criteria. Interest payments begin immediately after the loan is disbursed. The interest can either be paid by the borrower or capitalized and added to the principal. The government does not subsidize these loans and therefore does not pay interest. Monthly payments begin 6 months after the student graduates, drops below half-time status, or withdraws from school.

MEMBER BUSINESS LOAN FINANCIAL RATIOS - APPENDIX 10C

Member Business Loan Ratios

Credit unions should establish specific ratios to analyze their member business loans. The following are intended to aid examiners in understanding the information presented during the loan review.

- **Acid Test Ratio (or Quick Assets):**

$$\frac{\text{Cash + Cash Equivalents + Accounts Receivable}}{\text{Current Liabilities}}$$

Tests the company's short-term debt paying abilities. Only the current assets that are readily converted into cash are used. Highlights potential liquidity problems attributable to an inadequate mix of current assets.

- **Current Ratio:**

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Most common indicator of a firm's short-run liquidity. Shows the relationship between current resources and short-term debt. Puts the dollar amount of the Working Capital calculation into ratio format for comparison purposes.

- **Days Sales in Accounts Receivable (Collection Period):**

$$\frac{\text{Accounts Receivable (Year-End)}}{\text{(Credit Sales / 360)}}$$

- **Earnings Per Share:**

$$\frac{\text{Net Income}}{\text{Average Common Stock Outstanding}}$$

Shows the amount of earnings attributable to each share of common stock held by the stockholders (owners).

- **Earnings Yield:**

$$\frac{\text{Earnings Per Share}}{\text{Market Price}}$$

- **Gross Margin Ratio:**

$$\frac{\text{Gross Profit}}{\text{Sales}}$$

- **Interest Burden:**

  Interest Expense / Total Assets

- **Inventory Turnover:**

  Cost of Goods Sold / Average Inventory

Indicates the number of times the firm's inventory is turned over or sold during a period. Generally, the higher the inventory turnover, the more effective the firm is in its operations, the lesser the amount that must be tied up in inventories, and the shorter the operating cycle necessary to replenish cash. Too high a ratio may indicate lost sales as a result of insufficient inventory on hand.

- **Long-Term Debt to Equity Capital:**

  Long-Term Liabilities / Equity Capital

- **Net Income to Sales, or Profit Margin:**

  Net Income / Sales

The relationship of net income to sales can evaluate the company's efficiency in controlling costs and expenses in relation to sales. Does not, however, consider the owner's investment necessary to generate the sales and income. A return on investment ratio will overcome this.

- **Operating Margin:**

  Operating Income - Depreciation / Sales

- **Operating Profits to Sales:**

  Operating Profit / Sales

- **Pretax Income to Sales:**

  Pretax Income / Sales

- **Receivables Turnover:**

$$\frac{\text{Net Credit Sales}}{\text{Average Net Receivables}}$$

Indicates how many times receivables are turned over or collected each period. Shows the efficiency with which the firm collects its receivables and converts them to cash.

Generally, the higher the turnover, the better, as the firm will have fewer resources tied up in receivables, collects at a faster pace, and usually will have fewer uncollectible accounts. Receivable turnover is often divided into the number of days in the business year to show the average collection period in days. Comparing the company's average collection period to the days in its typical credit terms gives an indication of how aggressively the company's credit department collects overdue accounts.

- **Return on Equity Capital or Return on Stockholders' Equity:**

$$\frac{\text{Net Income}}{\text{Average Equity Capital}}$$

Reflects the residual return on the owners' equity.

- **Return on Total Assets:**

$$\frac{\text{Net Income + Interest Expense (Net of Tax)}}{\text{Average Total Assets}}$$

The amount of net income earned in relation to total assets; an indicator of a firm's efficiency in the use of its economic resources. The ratio can be mildly distorted depending on the age of the company and its assets. Average assets (beginning period assets plus ending period assets divided by 2) are used as net income is earned over the time period.

- **Sales to Cash:**

$$\frac{\text{Sales}}{\text{Cash}}$$

- **Sales to Accounts Receivable:**

$$\frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

Accounts receivable turnover ratio.

- **Sales to Inventory:**

  $$\frac{\text{Sales}}{\text{Inventory}}$$

- **Sales to Working Capital:**

  $$\frac{\text{Sales}}{\text{Working Capital}}$$

- **Sales to Fixed Assets:**

  $$\frac{\text{Sales}}{\text{Fixed Assets}}$$

- **Sales to Total Assets:**

  $$\frac{\text{Sales}}{\text{Total Assets}}$$

The ability of the company to minimize the level of assets (current and fixed) to support its level of sales.

- **Times Interest Earned:**

  $$\frac{\text{Operating Income Before Interest and Taxes}}{\text{Interest Expense}}$$

An indicator of the firm's ability to cover its interest obligation through its annual earnings. It is a measure of the safety of the creditors' (particularly long-term) investments in the firm.

- **Total Debt to Total Capital (Debt Ratio):**

  $$\frac{\text{Current Liabilities and Long-Term Liabilities}}{\text{Equity Capital and Total Liabilities}}$$

  or

  $$\frac{\text{Total Liabilities}}{\text{Total Assets}}$$

Indicates the percentage of total assets contributed by creditors. Subtracting the ratio from 100 is the percentage of total assets (or equity ratio) contributed by stockholders (owners).

- **Working Capital Calculation:**

  Current Assets - Current Liabilities

Shows the dollar amount by which current assets exceed current liabilities. Changes in the amount from one period to another is a useful indicator of the businesses' short-term debt-paying ability.

Simplified Cash Flow Analysis

Net Income		XX
Add: Depreciation		XX
Increase (decrease) deferred tax		XX
Increase (decrease) working capital (see below)	XX	
Cash from operations		
Increase (decrease) from investing activities (i.e., fixed asset purchase)		XX
Increase (decrease) from financing activities (i.e., notes payable, long-term debt)		XX
Net Increase (decrease) to cash		XX

* * * * * * * * * * * * * *

Increase (Decrease) to Working Capital

Add:

Increase (decrease) to receivables
Increase (decrease) to inventory
(Increase) decrease to accounts payable
(Increase) decrease to interest payable

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SAMPLE IDFP AGREEMENTS - APPENDIX 10D

Sample Dealer Purchase Agreement

This sample agreement is intended for use as a training aid for NCUA examiners and should not be considered an all inclusive legal document to be shared with, copied, or used by any other person or entity in whole or in part.

The XYZ Federal Credit Union ("Credit Union") agrees to purchase and the undersigned Dealer ("Dealer") agrees to sell, from time to time, loans entered into by Dealer and Dealer's customers ("Buyer"), pursuant to the terms of this agreement.

1. All loans offered by Dealer to Credit Union for purchase shall be secured by a first lien on the vehicles sold by Dealer to Buyer (hereafter the "Collateral").

2. All loans offered by Dealer to Credit Union for purchase shall be documented by standard form installment agreement, together with documentation necessary to perfect a first lien in the Collateral to secure the indebtedness (said documentation collectively to be known as "Dealer Paper").

3. Dealer may provide Credit Union with a copy of Buyer's loan application via facsimile transmission and obtain an approval of the loan and the terms that are acceptable to Credit Union, or a disapproval of the loan. In the event Dealer tenders Dealer Paper relating to a pre-approved application, Credit Union shall use all efforts to promptly review said Dealer Paper and verify it complies with the terms and conditions of the pre-approved application, before purchasing said Dealer Paper. Credit Union is under no obligation to purchase any Dealer Paper which does not comply with the terms of this Agreement as well as the terms provided by Credit Union when pre-approving a loan.

4. All Dealer Paper tendered by Dealer to Credit Union shall be completed by Dealer in a form acceptable to Credit Union and shall include, but not be limited to:

   a. Original Loan Application;
   b. Original Sales Contract;
   c. Original Dealer's Invoice;
   d. Note and Disclosure;
   e. Title Work;
   f. Insurance Verification; and
   g. Income Verification.

5. Dealer shall assign to Credit Union all Dealer Paper purchased by the Credit Union and shall notify the appropriate authorities (including, but not limited to, the Department of Transportation) of the assignment of the lien securing the indebtedness to the Credit Union.

6. Credit Union has the option but not the obligation of purchasing any loan tendered by Dealer, except Credit Union shall purchase any loan from Dealer that complies with the terms of a pre-approved application.

7. For each loan purchased from Dealer, Credit Union shall promptly pay Dealer (after receiving all required documentation) the amount of the loan (which may include the cost of life and/or disability insurance and/or extended warranties sold to Buyer), together with an incentive fee as set forth on a schedule provided to Dealer by Credit Union from time to time.

8. As to all loans purchased by Credit Union, Dealer warrants:

(a) Dealer is authorized to sell said Dealer Paper; and

(b) The Dealer Paper is genuine and legally enforceable according to its terms; and

(c) No buyer was a minor or incompetent when the Dealer Paper was executed; and

(d) All statements contained in the Dealer Paper are true; Dealer has no notice of any matters not disclosed to Credit Union which might impair the credit of buyers; the disclosed cash down payment and trade-in were actually received by Dealer; Dealer has not made and will not make any advance to Buyer; and Dealer has no agreement with Buyer to separately finance or impose finance charges on Buyer or defer payment of a portion of the down payment; and

(e) Within ten (10) days of delivery of the vehicle sold to Buyer, Dealer perfected or will perfect a first security interest in the vehicle, time being of the essence; and

(f) The Dealer Paper and the transactions out of which it arose comply with all applicable laws and regulation; and

(g) Dealer has performed or will perform all of its obligations to Buyer, and no Buyer has asserted any defense, set-off, or counterclaim to Buyer's liability under the Dealer Paper; and

(h) At the time of sale, Dealer had authority to sell the goods to Buyer free of any security interest or other encumbrance and the goods have been delivered to and accepted by the Buyer within ten (10) days of the date of the Dealer Paper.

9. Dealer shall provide Credit Union with at least one bank reference and authorizes Credit Union to investigate Dealer's financial position from time to time as determined in Credit Union's sole discretion. Upon request, Dealer agrees to provide Credit Union with sworn current financial statements.

10. Dealer agrees, with respect to any Dealer Paper sold to Credit Union, that:

(a) If Dealer places insurance on the Collateral or obtains credit life or credit disability insurance for the Buyer, Dealer shall promptly pay to Buyer any premium refunds or other amounts it receives regarding such insurance to which the Buyer is entitled; and

(b) Dealer shall indemnify, defend, and hold Credit Union harmless from any loss, liability, penalty, claim, damage, or expense claimed or incurred due to any act or omission or commission of Dealer with respect to the Dealer Paper or the Collateral (including, but not limited to, violation of any applicable Federal or State

law or the breach of any of the provisions of this Agreement) which indemnification shall include any costs and attorneys' fees of credit union.

11. Credit Union may, without notice and without impairing Credit Union's rights against Dealer, in the name of Dealer or otherwise, take all actions and legal proceedings deemed advisable by Credit Union with respect to the Dealer Paper or the Collateral including, without limitation, modifying, extending, or compromising any terms, discharging or releasing any person liable, or releasing any security; Credit Union has no duty to perfect any security interest in the Collateral, to enforce any rights of Dealer, or to preserve rights under this agreement against prior parties.

12. If any warranties or covenants of Dealer shall be false or breached with respect to certain Dealer Paper, Dealer shall, upon request, repurchase the Dealer Paper from Credit Union for the full amount unpaid thereon (less credit union's unearned interest) plus expenses incurred by Credit Union in endeavoring to collect or enforce the Dealer Paper. Upon repurchase of the Dealer Paper, Credit Union will assign it to Dealer without any recourse or warranties whatever.

13. Dealer covenants that it has performed and will continue to perform in a timely manner all of its obligations to the Buyer, including its obligations which arise by virtue of the contract and all agreements between the Buyer and Dealer and all obligations which may arise by operation of law or otherwise. Dealer will advise Credit Union in writing within ten (10) days if the Buyer notifies Dealer that Buyer intends to assert any claim or defense against the Credit Union which arises out of the relationship between Buyer and Dealer. In such case, Dealer shall within thirty (30) days of receiving notice from the Buyer use its best efforts to resolve the claim to the mutual satisfaction of the Credit Union and Dealer. If the Credit Union receives notice from the Buyer of a claim or defense to be asserted against it, the Dealer shall within thirty (30) days of receiving written notice of the claim from the Credit Union use its best efforts to resolve the claim to the mutual satisfaction of the Credit Union and Dealer. In the event Dealer cannot satisfactorily resolve the issue within the 30-day period, Credit Union may demand Dealer to repurchase the Dealer Paper for said loan, which Dealer shall purchase. The purchase price shall be the amount of principal remaining due on said loan, together with any unpaid accrued interest due as of the date of the sale by Credit Union to Dealer. Said sale shall be without recourse to Credit Union.

14. This agreement is to be interpreted under the laws of the State of _________.

15. Upon execution, this Agreement shall bind the parties and their successors and assigns. This Agreement shall continue to be in effect for one year unless terminated by either party upon at least 60 days prior written notice. Unless so terminated, this Agreement shall automatically renew itself on its anniversary date. Any termination of this Agreement shall not affect the rights and duties of the parties regarding any Dealer Paper sold to Credit Union by Dealer prior to the effective date of the termination of this Agreement.

Dated this ______________ day of ______________________, 19____________.

DEALER:	XYZ FEDERAL CREDIT UNION:
By:____________________________	By:__________________________

Sample Dealer Reserve Agreement

This sample agreement is intended for use as a training aid for NCUA examiners and should not be considered an all inclusive legal document to be shared with, copied, or used by any other person or entity in whole or in part.

AGREEMENT between ABC Credit Union (credit union) and XYZ Rolls Royce Inc. (Dealer).

FOR CONSIDERATION, and intending to be legally bound, the Credit Union and Dealer Agree:

1. Definitions.

(a) "Amount Financed" means the amount financed as stated in a Contract.

(b) "Buy Rate" means the minimum annual interest rate which the Credit Union is willing to accept from time to time, as determined by the Credit Union in its sole discretion. The Credit Union shall quote its current Buy Rate to Dealer at any time upon request.

(c) "Buyer" means a person who purchases a product from Dealer.

(d) "Collateral" means a product sold by Dealer to a Buyer under a Contract.

(e) "Contract" means an installment sale and security agreement evidencing the sale of Collateral from Dealer to Buyer.

(f) "Contract Interest Rate" means the interest rate specified to apply under a Contract before default. The Contract Interest Rate shall not exceed maximum rates quoted by the Credit Union to Dealer from time to time. In no event shall the Contract Interest Rate exceed the rate allowed by applicable law.

(g) "Paper" means one or more of Dealer's Contracts.

(h) "Reserve" for each Contract means the excess of (i) the total interest payable in accordance with the terms of the Contract calculated at the Contract Interest Rate, over (ii) the total interest payable in accordance with the terms of the Contract calculated at the Buy Rate in effect at the time the Credit Union purchases the Contract.

2. Purchase. Dealer will from time to time offer to sell Paper to the Credit Union under the terms of this Agreement. The Credit Union may refuse to purchase any Paper offered by Dealer.

3. Purchase Price. The purchase price for a Contract shall be the Amount Financed stated in the Contract plus the Reserve for the Contract. If Contract is prepaid before scheduled full term, the Credit Union shall have the right to keep or be compensated for part of the Reserve, as provided in paragraph 5.

4. Reserve. At the time of each purchase of a Contract, the Credit Union shall compute the Reserve for the Contract and deposit the amount of the Reserve, together with the Amount Financed, into the Dealer's share draft account. Dealer agrees to make an initial minimum deposit into an interest bearing share savings account. Dealer may withdraw from the share savings account from time to time, but not below a minimum balance determined by the Credit Union taking into account the volume of the Credit Union's purchases of Paper from Dealer and the Credit Union's experience with that Paper. The initial minimum balance required is $500. Dealer grants the Credit Union a security interest and lien in any credit balance in that

account or in any other money or subsequently owed Dealer by the Credit Union. In addition to all other remedies, the Credit Union may at any time, without notice or demand, set off against any such credit balance or other money owed the Credit Union by Dealer. Upon full payment or other liquidation of all Paper purchased by the Credit Union from Dealer, and Dealer's full payment of all amounts owed the Credit Union, the Credit Union shall pay the balance of the account to Dealer.

5. The Credit Union's Right to Reserve. If a Buyer prepays a Contract, if Buyer defaults and collateral is repossessed, or if Dealer repurchases a Contract, Dealer shall pay Credit Union a fractional portion of the Reserve for the Contract. The numerator of the fraction shall be the excess of the scheduled term of the Contract in months over the time in months the Contract was held by the Credit Union. (In the case of repossession, the numerator shall be equal to the number of unpaid full monthly payments remaining to fulfill the contract's original term.) The denominator shall be the scheduled term of the Contract in months. In determining months for this purpose, partial months of 14 days or less shall be ignored, and partial months of 15 days or more shall be counted as one full month. For example, two months and ten days shall be counted as two months; and two months and fifteen days shall be counted as three months.

6. Term: Additional Terms. Upon the Credit Union's acceptance, this document shall constitute an agreement between parties which shall inure to and bind the parties, successors and assigns. It shall continue in effect until terminated by either party upon at least 60 days prior written notice to the other. In addition, the Credit Union may terminate this agreement immediately upon notice to Dealer if Dealer defaults or becomes the subject of bankruptcy or other insolvency proceedings. Termination shall not effect the respective rights and obligations of the parties as to Paper purchased prior to the effective date of termination. Waiver of any default shall not constitute a waiver of any other default. This agreement shall be construed according to the laws of the State of _________.

7. Notice. Any notices given in connection with this agreement shall be in writing and shall be either personally delivered or mailed in the first class United States mail, postage prepaid, addressed to the last known address of the recipient. Notice by mail shall be effective one day after such mailing.

Date________________________________, 19________

DEALER____________________________________

BY:____
(Authorized Signature and Title)

____
(Type of Organization, Corporation, Partnership or Proprietorship)

____
(Street Address)

____
(City, State, Zip Code)

Dealer's personnel authorized to sign Contracts and drafts in connection with this agreement are:

(Name and Title)	(Sample Signature)
(Name and Title)	(Sample Signature)
(Name and Title)	(Sample Signature)
(Name and Title)	(Sample Signature)

Accepted______________________, 19______

ABC Credit Union
By__________________
(Authorized Signature)

REAL ESTATE DOCUMENTATION CHECKLIST - APPENDIX 10E

Real Estate Loans - General

- Loan Application
- Contract of Sale
- Verification of Employment
- Verification of Deposits
- Residential Mortgage Credit Report
- Uniform Residential Appraisals Report
  - Property Survey
  - Zoning Requirements
- Flood Insurance Statement/Coverage
- Debt Ratio Computation Page
- Title Insurance
- Title Binder/Title Policy
- FNMA/FHLMC Mortgage or Deed of Trust
- FNMA/FHLMC Note
- FNMA/FHLMC Deed
- Private Mortgage Insurance, if applicable
- RESPA Settlement Statement
- Current Hazard Insurance
- Notice of Recision, if nonpurchase mortgage on residence
- Termite Inspection, if applicable
- General Home Inspection, if applicable
- Radon Inspection, if applicable
- Adjustable Rate/Variable Rate Rider
- Loan to Value Ratio Computation
- Verification of the Balance of the First Trust Deed
- Other Documents, as necessary

Real Estate with Mobile Home

Add to General list:

- Deed to Real Estate with Title to Mobile Home
- Documentation Whether Wheels Have Been Removed
- Purchase Order or NADA Value
- Sewage Permits or System, as needed
- Water Availability
- UCC Lien for Tongue and Wheels

Construction Loans

Add to General list:

- Title Insurance Binder, with
  - Periodic Insurance
  - Adjustments/Notifications
- Take-Out Commitment
- Construction Loan Agreement
- Identification of Contractor
- Borrower's Risk Insurance on Builder
- Architect's Plans
- Builder's Cost Estimates and Line Item Budget
- Completion Bond, if required
- Periodic Inspection Reports Based on Phase Completions
- Photos of Inspection Phases and the Completed Project
- Schedule of Disbursements
- Building Permits
- Environmental Considerations
- Sewage Permits or System, as needed
- Feasibility Study
- Change Order Documentation

Unimproved Property

- Agreement that Improvements Cannot be Made to the Property without Credit Union Consent