NCUA LETTER TO CREDIT UNIONS

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

DATE: **August 2004** **LETTER NO.: 04-CU-10**

TO: **Federally Insured Credit Unions**

SUBJ: **Items to Consider When Underwriting Member Business Loans to the Self-Employed Borrower**

ENCL: **IRS Form 4506-T**

Dear Board of Directors:

During the five-year period ended December 31, 2003, the dollar amount in member business loans outstanding at federally insured credit unions doubled to more than $8.8 billion, or 2.4 percent of total loans. As member business lending continues to grow, credit unions need to remember the unique risks associated with underwriting loans to self-employed borrowers. The purpose of this letter is to provide you with best practice suggestions when lending to self-employed borrowers.

What is a self-employed borrower?

A self-employed borrower is an individual who has a 25 percent or greater ownership interest in a business. The business may be a sole proprietorship, partnership, or corporation. Self-employed borrowers present a unique underwriting risk because, in general, new small businesses have a high failure rate, the borrower's income typically fluctuates from year to year, and the borrower may be personally liable for the debts of his business.

What is IRS Form 4506-T?

Internal Revenue Service Form 4506-T allows you to request transcripts for the following tax returns: Form 1040 series, Form 1065, Form 1120, Form 1120A, Form 1120H, Form 1120L, and Form 1120S. The type of return varies by the business structure—sole proprietorship, partnership, or corporation. You can ask the borrower to sign an IRS Form 4506-T and enter your credit union's name, address, and telephone number on line 5. You should receive transcripts of the borrower’s tax returns within 10 business days of sending the completed Form 4506-T to the IRS. IRS offers this service free of charge.

One typical underwriting procedure associated with self-employed borrowers is to obtain copies of the borrower’s individual and business tax returns for the past two years. Consider comparing the IRS tax return transcripts to the tax returns submitted by the borrower either as a quality control check after loan closing or as part of the underwriting process.

In addition to tax returns, what are some additional best practices associated with underwriting member business loans to self-employed borrowers?

To mitigate the unique risks associated with granting a business loan to a self-employed borrower, loan underwriters need to consider both the individual borrower and the borrower’s business by reviewing the following:

- Existing borrowing relationships with the applicant,
- Size and type of business,
- Demand for the business’s service or product,
- Borrower’s level of experience in the business,
- Borrower’s cash flow available to service the debt, and
- Overall financial strength of the business.

Finally, underwriters should analyze the self-employed borrower’s business plan to assess the company’s strategic plans over the life of the loan.

As you strive to meet the small business loan needs of your members, we encourage you to evaluate your related policies and procedures to ensure you have established controls to mitigate the increased risk.

If you have any questions, please contact your NCUA Regional Office or State Supervisory Authority.

Sincerely,

/S/

JoAnn Johnson
Chairman

Enclosure