

NCUA LETTER TO CREDIT UNIONS

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

DATE: September 2004 **LETTER NO.:** 04-CU-13

TO: Federally Insured Credit Unions

SUBJ: Specialized Lending Activities

ENCL: [AIRES Questionnaires:](#)
(1) Sub-Prime Lending Controls
(2) Indirect Lending Controls
(3) Outsourced Lending Relationships

Dear Board of Directors:

The March 31, 2004 financial trends show that while the total volume of loans is increasing, shares are increasing at a faster rate causing the loan to share ratio to decline. As credit unions search for more lending opportunities, they may choose alternative lending arrangements.

As credit unions increasingly turn to alternative lending arrangements to meet their strategic objectives, safety and soundness concerns increase along with risks. As a result, NCUA has reviewed and updated the guidance provided to examiners to ensure it adequately explores pertinent issues and concerns.

This letter focuses on three higher risk lending activities – sub-prime lending, indirect lending, and outsourced lending relationships. Each of these lending activities can make good strategic business sense for credit unions when done with proper care. However, engaging in any of these lending activities exposes a credit union to a range of risks including credit, interest rate, liquidity, transaction, compliance, strategic, and reputation. It takes proper planning, experienced staff, and adequate controls and monitoring to make these profitable and productive activities for serving members.

Sub-prime Lending. Sub-prime lending is the practice of extending credit to borrowers who have weak credit histories (e.g., delinquent payments, charge-offs, judgments, bankruptcies), or reduced payment capacity (e.g., high debt ratios or low credit scores). A sub-prime portfolio will likely display significantly

higher delinquency and/or loss rates than prime portfolios. Typically, higher interest rates and fees are charged to sub-prime borrowers to compensate for the higher risk. Sub-prime portfolios generally require more intense and specialized collection efforts increasing a credit union's expenses in this area.

The term "sub-prime" is often misused to refer to certain "predatory" or "abusive" lending practices since a greater proportion of these practices occurs against sub-prime borrowers. Sub-prime lending that is appropriately underwritten, priced, and administered can serve to increase access to credit for borrowers with special credit needs and is not predatory by design. NCUA views as unsafe and unsound loans to borrowers who do not demonstrate the capacity to repay the loan as structured and where reliance for repayment is placed on the collateral pledged.

While sub-prime lending involves higher levels of risk and skill, properly managed, it can be a sound book of business. Sound underwriting practices, effective control and monitoring systems, and sufficient capital levels are key components to a well-managed program.

Indirect Lending. Indirect lending is an arrangement where a credit union contracts with a merchant to originate loans at the point of sale (e.g., an auto dealer). Generally, indirect lending is associated with auto loans. An indirect lending program can lead to rapid growth, changing the structure and risk profile of a credit union's balance sheet quickly. In addition to credit risk, on-going evaluation of both a credit union's liquidity and interest rate risk is essential.

A credit union should periodically review its approved dealers to ensure they meet certain standards including reputation, experience, and financial condition. Periodic review of approved dealers will ensure the dealer is not using excessive sales pressure on the borrower to increase its sales volume which could result in lower credit quality for the loans presented to the credit union. On-going review and monitoring of individual dealer loan statistics ensures the dealer's compliance with credit union credit criteria.

Written contracts should be in place addressing, at a minimum, dealer compensation, credit criteria, documentation standards, and dealer reserves. A dealer reserve account is controlled by the credit union and provides for charging back non-performing loans to the dealer under certain conditions.

Increased loan volume is a tangible benefit of indirect lending. Indirect lending can also provide a source of new members. However, a credit union needs to properly plan for and understand the risks of the program.

Outsourced Lending Relationships. Outsourced lending relationships can provide a credit union with greater flexibility in offering loans to members. Typically, a credit union will contract with a third party to originate or service

loans. NCUA Letter to Credit Unions No. 01-CU-20 addresses “Due Diligence Over Third Party Service Providers” and provides useful guidance for credit unions dealing with outsourced lending relationships. The letter highlights planning, background checks, legal review, financial review, return on investment, and controls such as policies and procedures, staff oversight, and reporting.

Outsourcing functions can be a profitable venture; however, a credit union must ensure proper controls and monitoring are in place.

Summary. When a credit union engages in any higher risk activity, it should be compatible with a credit union’s risk tolerance, administrative capabilities, and strategic goals. The projected and realized impact on a credit union’s financial performance should be analyzed regularly. Reasonable program limits should be established as well as on-going program monitoring and analysis.

Examiners will assess whether a credit union involved in specialized higher-risk lending activities has adequately planned for, and is monitoring and controlling those activities. Management will be adversely rated for failure to manage and control such programs.

To increase awareness and understanding of NCUA’s approach to specialized lending programs, we are enclosing the revised examiner questionnaires used to evaluate programs. We encourage you to review these, compare them to your existing and/or planned activities, and then be in a position to effectively respond to and address questions that may arise.

Should you have any questions, please do not hesitate to contact your district examiner, regional office, or state supervisory authority.

Sincerely,

/S/

JoAnn M. Johnson
Chairman

[Enclosures](#)