NCUA LETTER TO CREDIT UNIONS

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

DATE: June 1999 **LETTER NO.: 99-CU-05**

TO: Federally Insured Credit Unions

SUBJ: Risk-Based Lending

This Letter to Federally Insured Credit Unions provides guidance on managing the benefits and risks associated with risk-based lending. Other federal financial institution regulators recently issued similar guidance regarding what they term "subprime lending programs."

Risk-based lending is a means by which a credit union may be able to more effectively meet the credit needs of all its members. It involves setting a tiered-pricing structure that assigns loan rates based upon an individual's credit risk. Risk-based lending generally has the most significant benefit for two broad categories of borrowers:

- those attempting to "repair" their credit due to previous mishandling of credit (e.g., seriously past due credit, prior charge-offs, bankruptcy, etc.) and
- those attempting to establish credit (e.g., first time borrowers, borrowers with little credit history).

Although the rates paid by borrowers with less than perfect credit histories are higher than rates paid by borrowers with strong credit histories, these members are able to obtain loans without paying the excessive fees charged by many alternative "financial providers" such as finance companies, rent-to-own stores, title loan companies, and pawnshops.

Risk-based loans can be profitable, provided the rates charged by the credit union are sufficient to cover the loan loss rates and overhead costs related to underwriting, servicing, and collecting these loans. However, 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., the Equal Credit Opportunity Act).

Risk-based lending benefits borrowers with strong credit histories by providing them lower interest rates. A properly planned risk-based lending program rewards borrowers based on how they manage their credit histories. As a member's credit history improves, risk-based lending should recognize and reward the borrower's financial improvement. To work properly, risk-based lending requires:

- specialized expertise,
- sound planning, and
- reliable monitoring and control systems.

Risk-based lending is complex and requires well-honed credit granting skills. It can be a high-risk activity that requires additional due diligence to properly identify, measure, monitor, and control risk. Risk-based lenders may discover that they underestimated the default risks and associated collection costs. Credit unions should consider the additional risks inherent in risk-based lending and determine if these risks are acceptable and controllable given the credit union's staff, financial condition, size, and level of capital support. A well-conceived business plan that addresses those risks is necessary for credit unions in this activity to maintain safety and soundness.

It must be remembered that the purpose of credit union risk-based lending is to make loans available to members who might not qualify otherwise. Therefore, a properly structured risk-based lending program that meets their credit needs should bring new higher-risk borrowers into the credit union, and not merely result in the re-pricing of existing lending profiles.

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; and
- programs for rewarding risk-based borrowers who perform well.

The attached Appendix provides the credit union more detailed information regarding risk management issues it should address before embarking on a risk-based lending program.

Capitalization

Risk-based lending activities can present a greater demand on the credit union's capital and the National Credit Union Share Insurance Fund (NCUSIF); therefore, the level of capital a credit union needs to support this activity should correspond with the risks incurred. For most credit unions engaging in this activity, their current level of capital is sufficient. However, credit unions should keep in mind that the amount of capital necessary to maintain safety and soundness will vary according to the volume and type of risk-based lending pursued and the adequacy of the credit union's risk management program. Examiners will review the credit union's documentation of its method used to determine the amount of capital necessary, and will evaluate the overall capital adequacy on a case-by-case basis.

Examination Objectives

Due to the complexity and specialization associated with risk-based lending, examiners must carefully evaluate this activity during regular examinations and, if necessary, during supervision contacts. In reviewing risk-based lending programs, examiners will:

- evaluate the extent of risk-based lending activities;
- determine whether management adequately planned for this activity;
- assess whether the credit union has the financial capacity to conduct risk-based lending safely without undue concentration of credit and without overextending capital resources;

- ascertain if management has committed the necessary resources in terms of technology and skilled personnel to manage the program;
- evaluate whether management has established adequate lending standards and is maintaining proper controls over the program;
- determine whether the credit union's contingency plan adequately addresses issues that could arise during a period of an economic downturn or when financial markets become volatile;
- analyze the program's performance, including profitability, delinquency, and losses;
- consider management's response to adverse performance trends, such as higher than expected prepayments, delinquencies, charge-offs, and expenses; and
- determine if the credit union's compliance program effectively manages the fair lending and consumer protection compliance risks.

Sincerely,

/S/

Norman E. D'Amours
Chairman, NCUA Board

Appendix

Following are some essential risk management issues that a credit union should address before embarking on a risk-based lending program:

- Planning and Strategy. Credit unions instituting risk-based lending programs should proceed slowly and cautiously to minimize the impact of unforeseen personnel, technology, or internal control problems and to determine if favorable initial profitability estimates are realistic and sustainable. Before engaging in a risk-based lending program, the board and management should ensure that the program is consistent with the credit union's overall business plan and risk tolerances. Risk assessment should incorporate operating, compliance, and legal risks. Risk issues which credit unions involved in risk-based lending must address include:

  ◊ attracting and retaining qualified personnel;
  ◊ investing in technology necessary to manage a more complex portfolio;
  ◊ lending solicitation and origination strategies that allow for after-the-fact assessment of the credit union's underwriting; and
  ◊ establishing appropriate feedback and control systems.

- Staff Expertise. Risk-based lending may require staff to acquire specialized knowledge and skills in areas such as credit granting, marketing, pricing, loan origination, and collections. For most credit unions, supplementing staff training should be sufficient; however, some credit unions may find it necessary to hire additional staff. Servicing and collecting loans generated in risk-based lending programs can be labor intensive.

- Lending Policy. A risk-based lending policy should be appropriate to the size and complexity of the institution's operations and should state the goals of the risk-based lending program. The policy should, at a minimum, address the following lending standards:

  ◊ types of products offered, as well as those that are not authorized;
  ◊ portfolio targets and limits for each credit grade or class;
  ◊ lending authority clearly stated for individual loan officers, supervisors, and credit committee;

- ◊ a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative/servicing costs, expected charge-offs, and capital;
- ◊ collateral evaluations and appraisal standards;
- ◊ well-defined and specific underwriting parameters (i.e., acceptable loan terms, debt-to-income ratios, loan-to-collateral value ratios for each credit grade, and minimum acceptable credit score) that are consistent with applicable supervisory guidelines;
- ◊ procedures for separate tracking and monitoring of loans approved as exceptions to stated policy guidelines;
- ◊ credit file documentation requirements such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision; and
- ◊ correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards.

Credit unions that use credit scoring should adapt the scoring model for members targeted in a risk-based lending program. Frequent review and updating of credit scoring models will help ensure that the assumptions remain valid and that the credit union complies with applicable consumer laws.

- Purchase and Loan Participation Evaluation. Credit unions that purchase risk-based loans from other credit unions or participate in risk-based loans with credit unions involved should consider the cost of purchasing and servicing these loans as well as loan losses that may result from these loans.

  Performing a thorough due diligence review before committing to purchasing risk-based loans is crucial.

- Loan Procedures. Credit unions that offer risk-based lending programs should establish procedures that provide for diligent monitoring of loan performance and strong collection efforts, such as:

  - ◊ calling delinquent borrowers early and frequently;
  - ◊ investing in technology such as automatic dialing for follow-up telephone calls;
  - ◊ assigning more experienced collection personnel;

- ◊ moving quickly to foreclose or repossess collateral; and
- ◊ allowing few extensions.

Risk-based loan procedures should be in writing and at a minimum should elaborate:

- ◊ billing and statement procedures;
- ◊ collection procedures;
- ◊ content, format, and frequency of management reports;
- ◊ asset classification criteria;
- ◊ methods to evaluate the adequacy of the allowance for loan losses account;
- ◊ criteria for allowing loan extensions, deferrals, and re-agings;
- ◊ foreclosure and repossession policies and procedures; and
- ◊ loss recognition policies and procedures.

- <u>Loan Review and Monitoring</u>. Credit unions with risk-based lending programs should have information systems in place to analyze their loan portfolios (e.g., by originator, loan-to-value, debt-to-income ratios, and credit scores). Reports produced should enable management to evaluate the performance of the lending program and compare actual to expected results.

- <u>Consumer Protection</u>. Credit unions that originate or purchase risk-based loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Credit unions providing risk-based loans should institute compliance management programs that identify, monitor, and control consumer protection problems associated with risk-based lending. Following are some consumer regulations that apply to risk-based lending programs:

  - ◊ Truth-in-Lending
  - ◊ Regulation X, the Real Estate Settlement Act (RESPA)
  - ◊ Equal Credit Opportunity Act
  - ◊ Fair Housing Act

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