Supervisory Letter

Evaluating Current Risks to Credit Unions

Risk in the credit union industry continues to evolve and requires NCUA to continually evaluate our risk monitoring and supervision procedures. This Supervisory Letter (Letter) discusses several of the emerging risks, particularly those related to the current economic climate, and provides guidance for addressing the issues. The specific topics covered in this Letter include:

- The changing credit union business model and balance sheet composition and the challenges it creates;
- Present mortgage and real estate market and the related expectations for credit unions and examiners; and
- The Risk Focused Examination (RFE) supervision program with an emphasis on district management and off-site monitoring.

Recent failures show the results when credit union management does not prudently plan, pursues aggressive and unchecked growth, and fails to properly diversify. These failures also demonstrate the consequences associated with declining real estate markets coupled with higher levels of credit risk. Not fully understanding the risks of a new program coupled with not limiting exposure to gain experience was a material flaw in the management of these failed credit unions.

One of the key lessons learned is the need for credit union management to gain adequate experience with any new product or service in order to understand and manage the related risk. The core lesson regarding new programs is to limit exposure until management has a complete understanding of the potential risk. Even after gaining an adequate understanding, the ongoing measuring, monitoring, and controlling of the risks is essential to ensure long-term success in meeting the credit union's strategic goals.

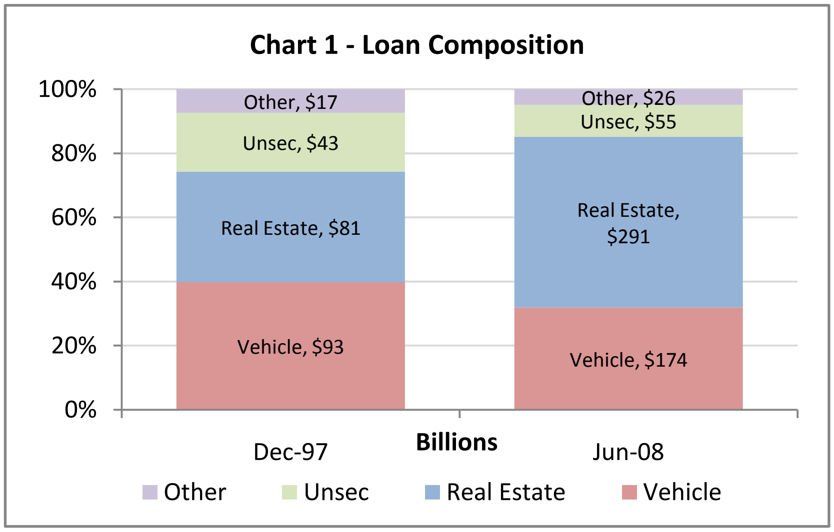
The remainder of this Letter addresses the current risks credit unions are facing along with guidance to staff. While this Letter primarily addresses the risks in real estate lending, many of the principles discussed can and should be applied to other loan products and services.

Evolution of the Credit Union Business Model

As of June 30, 2008, there were 7,972 federally insured credit unions reporting $291 billion in real estate loans. However, just as an individual credit union can have a concentration of assets, the National Credit Union Share Insurance Fund (NCUSIF) has a growing concentration risk with 7.7 percent (or 614 credit unions) of federally insured credit unions holding 78 percent (or $227 billion) of the credit union industry's outstanding real estate loans. These 614 credit unions all are in excess of $250 million in assets. As the majority of real estate loans reside in these credit unions, so does the majority of the credit and interest rate risk discussed in this Letter.[1]

Balance Sheet Structure

The structure of the credit union industry's balance sheet and income statement materially changed over the past 10 years. As Chart 1 shows, assets shifted from traditional consumer loans to real estate loans, with the latter comprising over 53 percent of total loans.



During the same period, member shares shifted from regular shares to more rate sensitive share certificate and money market accounts as shown in Table 1. In addition to greater reliance on rate sensitive shares, credit unions increased the use of borrowed funds and the reliance on fee income.

Table 1

	Dec 1997	June 2008
Real Estate Loans to Total Loans	35.0%	53.3%
Net Long-Term Assets to Assets	20.2%	32.1%
Regular Shares + Share Drafts to Total Shares + Borrowings	49.4%	36.5%
Certificates + Money Markets to Total Shares + Borrowings	38.4%	49.3%
Borrowings to Total Shares & Borrowings	0.4%	4.3%
Fee Income to Net Income	57.7%	163.2%

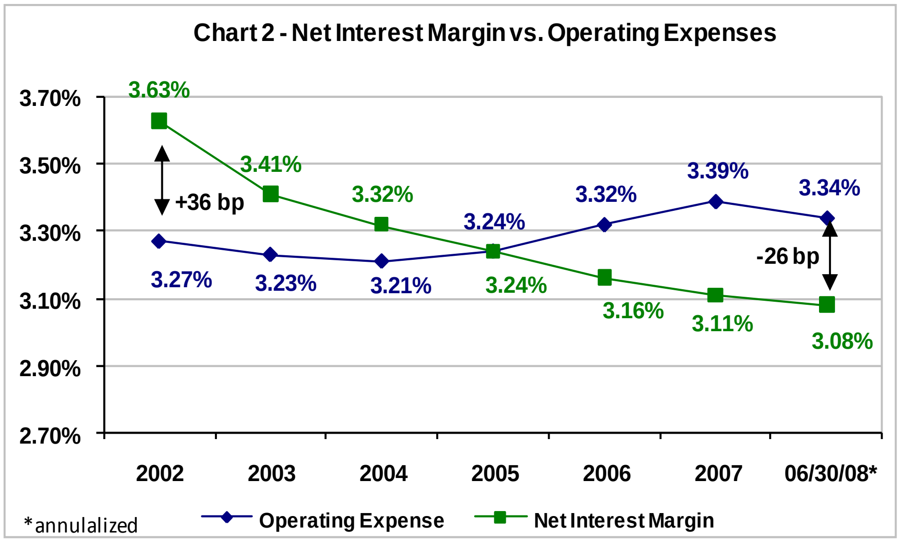
Credit unions with a balance sheet exhibiting the growing concentration in real estate loans funded by more volatile shares requires a high level of oversight and more

[1] Credit unions with assets less than $250 million can also demonstrate elevated risk levels discussed in this Letter. Examiners should apply the guidance provided to all credit unions exhibiting high risk characteristics, not only those with assets greater than $250 million.

advanced risk modeling systems. Examiners must closely scrutinize the risk systems and models employed by credit unions exhibiting these characteristics.

Earnings

The credit union industry's income structure is being impacted by changes in the balance sheet composition, the interest rate environment, and economic conditions. An increase in the operating expense ratio and compression of the net interest margin has occurred since 2005. As Chart 2 illustrates, the industry balance sheet would be unprofitable without fee income as the historical core share and loan products no longer provide sufficient spread to cover operating expenses. Credit unions not able to find additional efficiencies in operations found other ways to boost income, such as increasing loans or offering other fee-generating products or services. This trend points to a significant change in credit union operations, one that is untested in the current economic environment.



Lower levels of earnings can be acceptable depending on the level of net worth,[2] quality of assets and liabilities/shares, and the level of control exerted over the earnings structure. An overly simplistic focus on growth to increase earnings in the current environment is very likely to involve strategies that necessitate excessive risk-taking and could drive unsafe and unsound behavior.

Examiners must evaluate credit union earnings relative to the financial and operational risk exposure, strategic plans, and net worth needs based on current and potential risks. Lower levels of earnings should continue to be viewed positively if they result from a sound and well-executed strategy to balance risk exposure or to position the credit union to achieve long-term growth, financial stability, and member service objectives. Any unsafe and unsound concentration risks affecting earnings must be addressed with the management of the credit union and adequately reflected in the CAMEL and risk ratings.

[2] "*Thus, credit unions need not engage in reactive or extraordinary measures simply because earnings levels decline as a result of broader economic conditions when net worth levels meet or exceed their needs. In fact, such measures likely involve significant risks, either in terms of accepting greater risks to generate higher returns, and/or in terms of short-sighted trade-offs (e.g., increasing fees, selling "less profitable" business lines, engaging in high risk lending) affecting the longer-term strategic positioning of the credit union."*– NCUA Letter to Federal Credit Unions 06-FCU-04, August 2006

Reliance on Third-Party Providers

The methods credit unions use to obtain the assets and liabilities/shares changed dramatically in recent years while the use of third-parties to facilitate lending services increased significantly. These third-parties could be credit union service organizations (CUSOs), mortgage brokerage firms, other financial institutions, or other third-parties. Loan participations and outright purchasing of real estate loans originated by other parties has also increased. Third-party risk is addressed in Supervisory Letter No. 07-01, October 2007 - *Evaluating Third Party Relationships.* Letter 07-01 provides a good reference for examiners to use when evaluating a credit union's due diligence process.

Assessment of Risk Management Systems for Mortgage Portfolios

Since 2002, real estate values have cycled from historical increases to historical declines in certain geographic areas. As real estate valuations were dramatically increasing, mortgage loan originators expanded beyond the traditional mortgage products. Although the credit union industry does not report large amounts of non-traditional mortgage lending,[3] there is some exposure to this lending type. These loans amount to $7.2 billion, or 3.7 percent of all first mortgages, which indicates a low level of industry-wide risk. In addition to new types of mortgages, many mortgage originators demonstrated willingness to lower credit underwriting standards, including:

- low-doc or no-doc loans;
- relying on stated income without verification;
- determining capacity to repay solely on the initial payment for interest only hybrid adjustable rate mortgages (ARMs) or payment option ARMs;
- risk layering[4] through simultaneous second mortgages; and,
- high loan-to-value ratios for first or second lien loans.

The vast majority of credit unions followed traditional mortgage underwriting practices consistent with the characteristics of their field of membership. However, due to the prevalence of high risk underwriting practices in the mortgage industry over the past several years, any credit union with real estate loans on their books is likely to have increased risk exposure. For instance, if the credit union holds a second mortgage behind a senior lien underwritten using the practices mentioned, these loans are at a higher risk of default.

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[3] NCUA Call Report data for non-traditional mortgages is limited to Interest Only or Optional Payment first mortgage loans.

[4] Risk-layering refers to loans that combine multiple nontraditional features, such as interest only loans, with reduced documentation and/or a simultaneous second-lien loan. Management should demonstrate that mitigating factors support the underwriting decision and the borrower's capacity to repay. Mitigating factors could include higher credit scores, lower loan-to-value and debt-to-income ratios, significant liquid assets, mortgage insurance, or other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

While the weakened mortgage market is causing increased delinquency and loan losses across nearly all types of lending, real estate loan categories demonstrate the greatest increase. Other real estate loans (those not in a first lien position) show a higher degree of credit risk as evidenced by the significant increase in delinquency and losses during 2007 and through the first six months of 2008.

Table 2

	Range for 1997-2006	**2007**	**June 2008 (annualized)**
First Mortgage Delinquency	0.26% - 0.49%	0.64%	0.78%
Other Real Estate Delinquency	0.24% - 0.41%	0.73%	0.78%
Non-Real Estate Delinquency	1.01% - 1.30%	1.21%	1.19%
First Mortgage Charge-off	0.01% - 0.02%	0.02%	0.07%
Other Real Estate Charge-off	0.04% - 0.06%	0.19%	0.53%
Non-Real Estate Charge-off	0.67% - 1.00%	0.93%	1.25%

In some areas of the country, property values have declined in excess of 20 percent,[5] which puts even well underwritten, conventional mortgages at some risk. An article titled “Hybrid ARMs: Addressing the Risks, Managing the Fallout,” included in the summer 2008 edition of FDIC’s Supervisory Insight, begins with the following statement:

> *Recent turmoil in U.S. residential mortgage markets has shattered the long-held belief that home mortgage lending is inherently a low-risk activity.*

This observation is important when evaluating the risks faced by every credit union granting or holding real estate loans. The dramatic changes in the credit markets and in real estate valuations affect nearly all credit unions, even the vast majority that adhered to conventional real estate lending practices and products. What was once the safest loan a credit union could grant now carries with it the potential for increased credit risk, even when prudent underwriting standards are followed.

Evaluating Mortgage Portfolios

When a credit union has a large mortgage portfolio or a portfolio with high-risk characteristics, examiners need to ensure risk management practices are commensurate with the risk assumed and management clearly identifies and measures the risk taken. Examiners should determine whether risk management processes include:

- ☒ Setting individual and aggregate loan limits based on net worth and the overall risk profile within the balance sheet;
- ☒ Updating credit risk scores periodically on all borrowers;
- ☒ Monitoring home values by geographic area;

[5] Based on reports produced by the Office of Federal Enterprise Oversight and the National Association of Realtors.

- ☒ Obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and a greater reliance is placed on the collateral;
- ☒ Ensuring that appraisals obtained reflect realistic values based on current market conditions and comply with regulatory and industry requirements, especially if related to a loan underwritten by a third-party where they selected the appraiser;
- ☒ Monitoring transactional volume and activity on home equity lines of credit (HELOCs); and
- ☒ Analyzing whether increasing loan-to-value (LTV) ratios necessitate reducing, suspending, or discontinuing existing credit lines[6] (e.g., HELOCs).

Management should be producing periodic reports for the portfolio management process, including:

- ☒ Origination and portfolio trends by product, loan structure, originator channel, credit score, LTV, debt-to-income ratio (DTI), lien position, documentation type, property type, appraiser, appraised value, and appraisal date;
- ☒ Delinquency and loss distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics, such as credit score, LTV, DTI;
- ☒ Vintage tracking[7] (i.e., static pool analysis);
- ☒ The performance of third-party (brokers and correspondents) originated loans; and
- ☒ Market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values.

High Loan-to-Value Loans

In some cases, examiners will find the existence of high loan-to-value (HLTV) loans, especially in the markets with declining home values and in product lines designed to serve low-income members. When HLTV loans are present, management should monitor such loans closely. In reviewing HLTV loan portfolios, examiners should review:

- ☒ The existence and reasonableness of the board policy limit on HLTV loans to net worth;
- ☒ The repayment terms and structure of the senior liens as the risk of the senior liens impact the subordinate liens;

[6] Letter 05-CU-07, Managing Risks Associated with Home Equity Lending, outlines the circumstances when credit lines can be reduced or discontinued under Regulation Z.

[7] Risk Alert 05-Risk-01, Specialized Lending Activities – Third-Party Indirect Lending and Participations, and the accompanying supplemental guidance whitepaper on static pool analysis discusses how such analysis can be used to track the performance of most loan pools. This guidance can be applied to all non-traditional products or other loan products, not just indirect lending.

- ☒ The tracking of all LTVs in excess of 80 percent, including factors such as the existence of mortgage insurance;
- ☒ Inclusion of unfunded commitments such as available unused lines of credit in LTV computations; and
- ☒ The reporting of the aggregation of HLTV loans to the board of directors at least monthly.

<u>Mortgage Loan Workouts</u>

During an economic downturn, credit unions are more likely to offer mortgage loan workout programs to their members. Examiners must closely evaluate these programs to ensure management exercises the proper level of due diligence in developing and monitoring these inherently higher risk programs. When the credit union originated and holds the distressed loan, management should be encouraged to take appropriate actions to rework the loan as necessary to reduce the credit union's loss exposure.[8] At the same time, examiners must ensure the program does not cause unintended consequences such as masking delinquency or delaying the timely recognition of loan losses.

When reviewing loan workout programs, examiners must ensure the credit union adheres to the following minimal controls:

- ☒ Strict aggregate program limits in terms of total loans and net worth;
- ☒ A requirement for the borrower to meet traditional underwriting standards in terms of the credit score, employment stability, etc;
- ☒ If HLTVs are accepted, a documented assessment showing the current property value and anticipated value over the next 12-24 months (consider using nationally recognized real estate valuation sources), as well as the LTV at the end of that period;[9] and
- ☒ Monthly reporting to their board of directors on the loans originated under the program, including the risk profile of the portfolio related to current LTV, delinquency, losses, and credit quality.

If the credit union offers a loan workout program to members with distressed mortgages held by another institution,[10] the level of oversight and control should be equally diligent and based on time-tested sound lending practices. In addition to the controls above, there should also be a requirement for the member to obtain concessions from the originating lender so the credit union is not fully absorbing the risk of the distressed mortgage and accompanying collateral.

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[8] Letter to Credit Unions number 07-CU-06 "Working with Residential Mortgage Borrowers."
[9] This control is intended to guide credit unions making HLTV loans both to consider the current property value and to exercise caution in light of potential future declines in the property value, not to make lending decisions based on forecasted higher property values.
[10] These would be mortgages in which the credit union does not have a direct interest. In those instances where a credit union attempts to help their member out of a problem loan with another institution they should apply traditionally proven and sound underwriting guidelines.

Risk Focused Supervision and Monitoring

There are several pillars to the RFE program including examinations, supervision, and district management, each of which contributes to the program's overall effectiveness. Given the current ability of credit unions to rapidly change the composition of their balance sheet and risk profile, coupled with their growing complexity, a responsive and results-oriented supervision program is essential.

Identifying a potential problem early provides credit union management and NCUA with the best chance of resolution without requiring assistance from the NCUSIF. One of the key parts of the supervision program is off-site monitoring. However, the review of numbers by themselves often does not provide the depth of an issue. When signs of increased risk are present through off-site monitoring, the review may lead to a phone contact or an on-site contact to gain an understanding of the changes and risks.

District Management

Off-site review of the quarterly call report, financial trends, regional risk systems, and national risk reports are essential pieces of district management and the RFE process. These reviews provide insight into the impact from changes to the balance sheet structure related to a new product or service, or provide the first indication of a material change in strategic direction. The review of data must be coupled with consistent communication between the credit union and examiner for effective district management.

During on-site or off-site contacts, examiners should become aware of any new products or services, changes in strategic direction for each credit union in the assigned district, and changes in key management positions. This knowledge allows the examiner to put the financial trends in perspective and adequately evaluate the credit union's risk profile.

Where feasible, it is a good practice to address shortfalls in the planning or risk management of a new product/service or a change in strategic direction before implementation. Examiners typically become aware of these situations through the review of board minutes or other credit union documents, quarterly call reports, or through conversations with management and the officials of the credit union.[11] Among other things, plans should address prudent limitations to manage the risk to net worth, the projected costs and income, interest rate risk impact (if applicable), long-term strategic goals, and on-going monitoring.

Off-Site Contacts

Off-site supervision and timely identification of risk trends is a critical component of the overall supervision process. Ensuring growth trends are in line with strategic planning and risk management strategies is essential in determining whether there is undue potential risk to the credit union. Periodically reassessing existing asset or liability

[11] These reviews and/or conversations could be through off-site or on-site supervision.

concentrations based on changes in internal and external factors is also a valuable supervision step.

Examiners should consider the following questions when conducting off-site reviews of quarterly data, reports, and other information provided by credit unions:

- ☒ Do call reports, financial performance reports, historical warnings reports, or risk reports reflect any unusual trends, possible data errors, or anomalies warranting further review?
- ☒ Is the growth in any asset or liability category unusual or inconsistent with the credit union's strategic plan or established risk thresholds?
- ☒ Is the growth rate excessive, when all factors are considered (e.g. compared to the credit union's own historical trends, geographic, or industry trends)?
- ☒ Is the volume or concentration of any loan product or asset category excessive when measured against net worth, particularly in light of existing economic conditions?
- ☒ How is the credit union funding loan growth? Is it through current liquidity, borrowed funds, brokered deposits, or some other source or combination of sources? Does the funding source(s) create other risk considerations?
- ☒ Is loan growth from the credit union's use of a third-party? Does this represent a new vendor relationship or a change in relationship not previously reviewed?
- ☒ Are the earnings, liquidity, and net worth levels consistent with the credit union's current plans and strategies?
- ☒ Can management adequately explain their growth strategies? Do they have a solid understanding of the potential risks, and are adequate plans, systems, and controls in place to manage those risks?
- ☒ Has there been a substantial change in senior management? What is the background of the new management staff and is their tolerance for risk consistent with historical information?

Examiners should contact credit unions in a timely manner when there is a substantial change in the balance sheet composition or trends. This is particularly critical when the product or service may have unique risk characteristics or when there is concern that a concentration is developing that could create an undue level of risk not considered by management. This may necessitate an on-site contact to address the questions or concerns.

On-Site Contacts

Examiners may determine an on-site visit is necessary to review the trends and to ensure management has a full understanding of the risks associated with their strategy. It is important to remain vigilant when assessing management's strategic vision and risk management processes, especially when there appears to be a shift in strategic direction.

Open and clear communication with senior credit union management is a key element of a successful on-site contact and effective supervision. Senior management should be forthcoming with answers and support for areas of potential risk and provide examiners unrestricted access to documentation and staff members to facilitate the contact and understanding of the credit union's practices. A lack of candor or limiting access to records or staff are red flags examiners should not accept. Examiners should discuss problems involving lack of cooperation with their supervisor, communicate with the credit union officials to obtain required cooperation and/or records, and document the issues in the administrative record.

When performing on-site assessments and monitoring the risks outlined in this Letter, whether through routine examinations or interim on-site supervision contacts, examiners should constantly evaluate management's capabilities including whether:

- ☒ Short-term decisions and strategies are based on a sound business model, that all risks have been fully considered, and potential short-term gains are not being pursued to the detriment of long-term risk exposure;
- ☒ Risks being taken are commensurate with the expertise of credit union staff and with the level of available net worth;
- ☒ Potential risk to the institution is within board established risk parameters;
- ☒ Processes and procedures are appropriate in light of the risks taken; and
- ☒ Third-party vendors have been thoroughly reviewed prior to entering into such relationships and adequate controls over the product/servicing process are maintained.

Problem Resolution

When a contact discloses elevated levels of risk without prudent risk management practices, examiners must take appropriate supervisory action.

It is important to remember there does not have to be an imminent risk of loss to be a safety and soundness concern. While there is no finite list of concerns, examples include: (1) A credit union growing a program rapidly without prudent risk management practices in place; (2) A credit union with a significant mismatch in the asset/liability structure and lacking proper interest rate risk management; or (3) A credit union failing to perform initial and on-going due diligence when using a third-party.

Examiners must evaluate the situation based on their own experience, assess the individual credit unions' management of risk, and determine whether corrective action is required. When elevated risk is present and management of the risk is not sufficient, examiners must consider a credit unions' ability to continue offering a program and the potential impact to net worth using a worst-case scenario. Supervisory actions may include requiring the cessation or moderation of growth in a program until proper risk management practices are in place. As always, examiners should consult with their supervisor prior to initiating such action.

Conclusion

Diligence in NCUA's examination and supervision efforts is of paramount importance to help ensure the continued success of the industry and maintain public confidence in the credit union system. Flexibility in the examination and supervision approach is needed to match the changing credit union business model, as well as deal with the challenges presented by the current real estate market.

NCUA has issued numerous letters to the credit union industry regarding the associated risks given various economic, interest rate, or credit cycles. The core message and guidance in these letters represent sound risk management practices and are applicable today, including:

- Applying prudent policies, realistic limitations, and business strategies for all asset, liability and share categories;
- Considering carefully the risk to net worth and the level of earnings required to sustain strategies under various economic and interest rate environments;
- Employing proper diversification strategies in order to avoid excessive concentrations in or reliance on any asset, liability or share category;
- Evaluating and clearly understanding the risks involved before implementing new strategies, introducing member products, or materially increasing any loan or asset holding;
- Performing initial and on-going due diligence when using a third-party to provide services, loan underwriting, or purchase/manage assets or liabilities; and
- Measuring, monitoring, and controlling the risks from all strategies and making operational adjustments as necessary.

Resources

1. NCUA Letters to Credit Unions No. 57, June 1981 – *Diversification in the Investment Portfolio*

2. NCUA Letters to Credit Unions No 60, October 1981 - *Deregulation of Share, Share Draft, and Share Certificate Accounts*

3. NCUA Letters to Credit Unions No. 124, June 1991 - *Real Estate Secured Credit by Credit Union Members*

4. NCUA Letters to Credit Unions No. 130, February 1992 - *Changes in Interest Rates During Examinations*

5. NCUA Letters to Credit Unions No. 146, August 1993 - *Yields on Assets*

6. NCUA Letters to Credit Unions No. 154, April 1994 - *Credit Unions' Lending Policies*

7. NCUA Letters to Credit Unions No. 174, August 1995 - *Risk-Based Loans*

8. NCUA Letters to Credit Unions No. 99-CU-05, June 1999 – *Risk-Based Lending*

9. NCUA Letters to Credit Unions No. 99-CU-12, August 1999 - *Real Estate Lending and Balance Sheet Risk Management*

10. NCUA Letters to Credit Unions No. 00-CU-13, December 2000 - *Liquidity and Balance Sheet Risk Management*

11. NCUA Letters to Credit Unions No. 01-CU-08, July 2001 - *Liability Management – Highly Rate-Sensitive & Volatile Funding Sources*

12. NCUA Letters to Credit Unions No. 03-CU-11, July 2003 - *Non-Maturity Shares and Balance Sheet Risk*

13. NCUA Letters to Credit Unions No. 03-CU-15, September 2003 - *Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Portfolios*

14. NCUA Letters to Credit Unions No. 04-CU-13, September 2004 - *Specialized Lending Activities*

15. NCUA Letters to Credit Unions No. 05-CU-07, May 2005 - *Risks Associated with Home Equity Lending*

16. NCUA Risk Alert No. 05-RISK-01, June 2005 - *Specialized Lending Activities—Third-Party Subprime Indirect Lending and Participations*

17. NCUA Letters to Credit Unions No. 05-CU-15, October 2005 - *Increasing Risks in Mortgage Lending*

18. NCUA Letters to Federal Credit Unions No. 06-FCU-04, August 2006 - *Evaluation of Earnings*

19. NCUA Letters to Credit Unions No. 06-CU-16, October 2006 - *Interagency Guidance on Nontraditional Mortgage Product Risk*

20. NCUA Letters to Credit Unions No. 07-CU-06, April 2007 - *Working with Residential Mortgage Borrowers*

21. NCUA Letters to Credit Unions No. 07-CU-09, July 2007 - *Subprime Mortgage Lending*

22. NCUA Letters to Credit Unions No. 07-CU-13, December 2007 - *Supervisory Letter- Evaluation Third Party Relationships*

23. NCUA Letters to Credit Unions No. 08-CU-05, March 2008 - *Statement on Reporting Loss Mitigation Efforts of Securitized Subprime Residential Mortgages*

24. NCUA Letters to Credit Unions No. 08-CU-09, April 2008 - *Evaluating Third Party Relationships Questionnaire*

25. NCUA Letters to Credit Unions No. 08-CU-14, June 2008 - *Consumer Information for Hybrid Adjustable Rate Mortgage Products*

26. FDIC Supervisory Insights Summer 2008, Volume 5, Issue 1 http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum08/index.html