

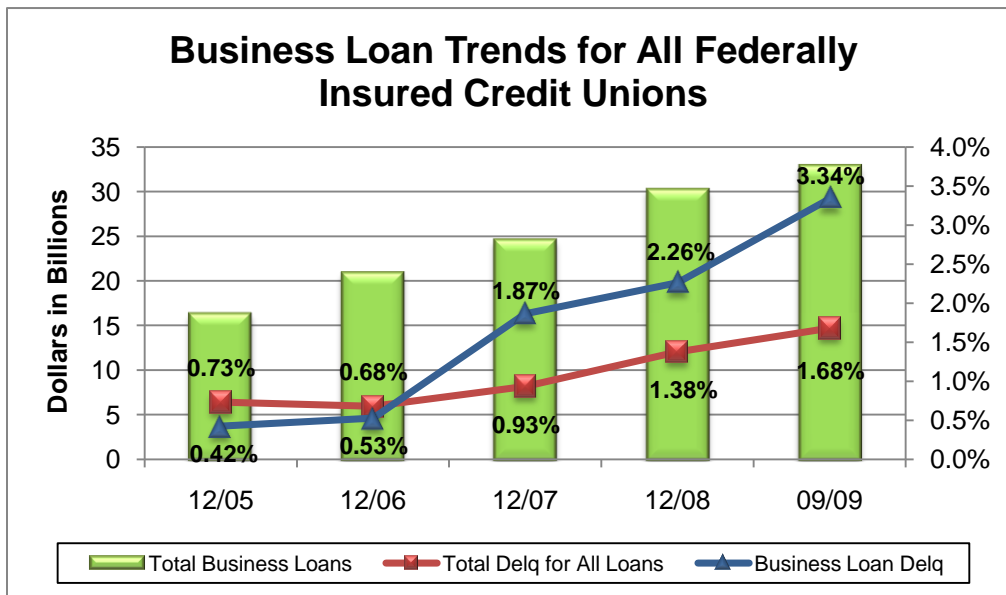


# Supervisory Letter



## Current Risks in Business Lending and Sound Risk Management Practices

The September 2009 Financial Performance Report data reflects an increasing portion of loans allocated to business lending. Business loans have grown from 3.56 percent of total loans in 2005 to a current level of 5.70 percent. The graph<sup>1</sup> below shows the trends in business loan growth and delinquency.



As business lending continues to grow, the exposure to economic fluctuations that impact such loans is going to have an increasing effect on loan performance and the risk in the portfolio. The percentage of delinquent business loans spiked since 2006 to 3.34 percent, almost double the percentage of total delinquent loans.

While business lending only comprises 3.76 percent of total assets, it is clear more credit unions are becoming involved in this type of lending and many credit unions

<sup>1</sup> The data used in the graph is based on information in the September 30, 2009, Financial Performance Report. Total business loans include member business loans, as well as purchased business loans and participations to nonmembers, less unfunded commitments. Total delinquent ratio for all loans is calculated using total delinquent loans greater than 2 months divided by total loans. Business loan delinquency is calculated using business loans delinquent greater than 2 months divided by total business loans less unfunded commitments.

already involved in business lending are growing their portfolios. There are also credit unions that either have reached the regulatory aggregate business lending limit or are above the limit due to satisfying at least one of the three exceptions in 12 C.F.R. §723.17.<sup>2</sup>

Business lending has unique characteristics and more complex variables than consumer lending. Risk management practices should be properly evaluated and commensurate with the level and complexity of loans granted. The adequacy of the credit union’s net worth position should be considered in concert with risk exposures from business lending to help ensure safe and sound growth of such lending. For the purpose of this guidance, business lending includes all business-purpose loans regardless of whether or not it qualifies as a member business loan (MBL) under 12 C.F.R. Part 723.

## RISKS IN BUSINESS LENDING

### 1. Business Lending Concentration Risks

Different types of business lending present different levels of risk. As shown in the table below, 80.70 percent of all outstanding business loans are reported as real estate loans. However, it is important to recognize that all types of loans have increased over time, with the exception of construction and development (C&D) business loans, which experienced minor decline since the previous year. Credit unions actively involved in any business lending should perform ongoing risk assessments to identify concentrations.<sup>3</sup>

Type of Business Loan	12/05	12/06	12/07	12/08	9/09
Real Estate	\$ 12,553,533,861	\$ 16,396,302,680	\$ 19,675,581,163	\$ 24,486,599,671	\$ 26,484,393,773
C&D	1,218,086,468	1,747,043,337	2,022,439,025	1,965,410,914	1,682,390,920
Agricultural	789,803,904	868,711,321	984,271,889	1,108,170,527	1,206,346,122
SBA Loans	234,632,345	482,936,466	426,969,199	519,635,376	542,746,241
Unsecured	71,108,063	71,539,036	110,876,638	133,685,286	144,070,946

The credit risk assessment should identify potential concentrations by stratifying the portfolio into segments that have common risk characteristics or sensitivities to economic, financial, or business developments. Concentrations can be by loan type, industry, collateral, geographic area, individual or associational group of borrowers,

<sup>2</sup> 12 C.F.R. §723.17 allows exceptions to the aggregate limit under the following circumstances: (a) credit unions with low-income designation or participate in the Community Development Financial Institutions program; (b) credit unions chartered for the purpose of making member business loans; (c) credit unions having history of primarily making member business loans.

<sup>3</sup> A concentration is not defined by regulation but is more governed by the product volume in relation to such items as net worth, assets, and total loans, with the benchmark for identifying a concentration being its potential safety and soundness implications for the credit union.

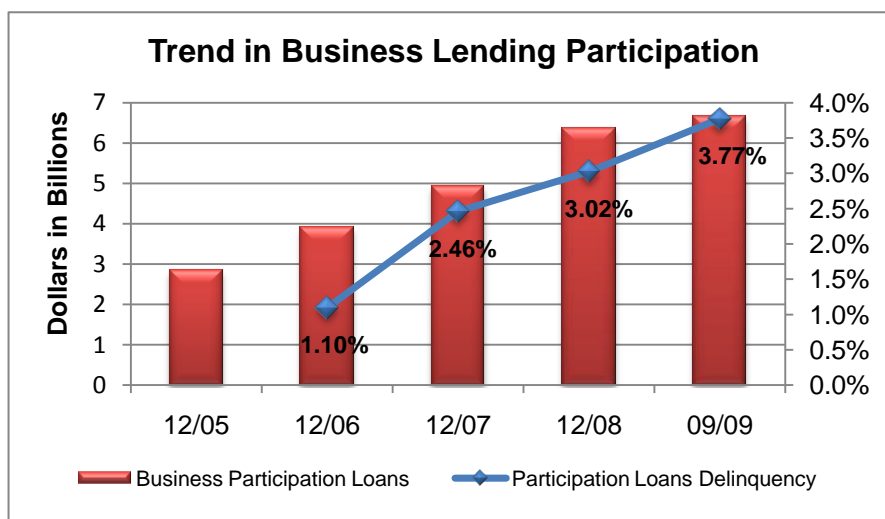
business lines, etc. Stratification should be supportable and not divided into multiple segments simply to avoid the appearance of concentration risk.

A manageable level of concentration risk will vary by credit union depending on portfolio risk characteristics, quality of risk management processes, net worth position, staff size, and staff experience level. Credit unions should identify and monitor credit concentrations, establish internal concentration limits, and report all concentrations to management and the board of directors on a periodic basis. Depending on the results of the risk assessment, the credit union may need to enhance its risk management systems. In addition, credit unions should establish supportive data warehousing<sup>4</sup> to track changes in loan quality over time.

## 2. Business Loan Participation Risks

Loan participation credit and concentration risks are increasing rapidly. Since 2005, purchased business loans and participation in nonmembers loans have more than doubled from \$2.8 billion to almost \$6.7 billion as shown in the graph. The risk has also increased resulting in loan participation delinquency more than tripling from 2006 to 2009.<sup>5</sup>

Although a properly managed loan participation program can benefit both selling and buying credit unions, it is important that all parties involved are fully aware of the various potential risks and the degree of risks. The degree of risk varies depending on the following:



- credit union is the seller or buyer;
- sale is with recourse or non-recourse;
- size and complexity of the individual loans;
- aggregate exposure to net worth;

<sup>4</sup> Data warehousing is a collection of data designed to support management decision making. Data warehouses are computer based information systems that are home for "secondhand" data that originated from either another application or from an external system or source. Warehouses optimize database query and reporting tools because of their ability to analyze data, often from disparate databases and in interesting ways. They are a way for managers and decision makers to extract information quickly and easily in order to answer questions about their business. Unlike operational databases that are set up to handle transactions and that are kept up to date as of the last transaction, data warehouses are analytical, subject-oriented and are structured to aggregate transactions as a snapshot in time.

<sup>5</sup> Participation delinquency information was not available prior to 2006.

- portfolio size including unfunded commitments;
- level of experience and expertise on both sides of the transaction; and,
- external economic factors.

Credit unions should be aware of various regulatory requirements for both loan participation and business loans, and not exceed regulatory limits without first obtaining an approval for a waiver, if available, prior to approving the loan. The loan waivers are non-transferable and each credit union that would exceed its regulatory limits must obtain its own waiver prior to participating in that particular business loan. For example, if the selling credit union has an approved loan waiver, a buying credit union must obtain the same type of waiver.

Purchase of nonmember loans or nonmember loan participations may expose the credit union to business lending risk if these loans constitute a MBL if made to a member. As a result, these loans count towards the aggregate limit on net member business loan. Once the aggregate of member and nonmember business loan balances are at the regulatory limit, a credit union must obtain regional director approval before any additional business loans, including nonmember loans, are made or purchased.<sup>6</sup>

Credit unions that are actively involved in loan participations and/or purchasing nonmember business loans should maintain risk management systems that appropriately address the level of risk associated with these loans. Credit unions should perform due diligence over the ongoing servicing at least annually and develop trigger points for action with originator when the loan does not perform in accordance with the loan documents (i.e. delinquency, missing financial statements, noncompliance to loan covenants).<sup>7</sup>

## **RISK MANAGEMENT PROCESS**

A credit union's oversight of a business loan portfolio should be commensurate with the size and complexity of the portfolio, as well as the risk associated with the level and type of concentrations. Examiners should evaluate and ensure management establishes a risk management framework that identifies, monitors, and controls the various risks associated with business lending. An effective risk management process involves the following key elements:

- **Board and Management Oversight**  
The board of directors has ultimate responsibility for the level of risk assumed by the credit union. The board must establish policy guidelines and approve the overall lending strategy that addresses the level and nature of exposure acceptable to the credit union. This includes evaluating resources to ensure staffing levels are appropriate for the level and complexity of the portfolio and

<sup>6</sup> 12 C.F.R. §723.16(b) provides information on obtaining waiver to allow credit unions that are at its aggregate limit to purchase nonmember business loans.

<sup>7</sup> Letter to Credit Union 08-CU-26, "Evaluating Loan Participation Programs" provides detailed information regarding risk assessment, due diligence, and risk measurement, monitoring and controls to evaluate buying and selling credit unions.

establishing suitable MBL pricing model that integrates into the credit union's overall asset liability management program. The operational management needs to implement procedures and controls to effectively adhere to and monitor compliance with established lending policies and strategies. Both the board and management need to periodically review information that identifies and quantifies the nature and level of risk and adjust strategies and policies to respond to changes in market conditions. Credit unions should obtain updated appraisals or collateral valuation when the loan or project is impaired or when market conditions are deemed to have deteriorated.

- **Portfolio Management**

Credit unions should manage not only risk of individual loans but also risk in the entire portfolio. Concentrations of loans that are similarly affected by cyclical changes in the market can expose a credit union to an unacceptable level of risk if not properly managed. Management should regularly evaluate the degree of correlation between related business sectors and establish internal lending guidelines and concentration limits to control the overall risk exposure. Management should develop appropriate strategies for managing concentration levels by identifying specific adverse market conditions and creating feasible contingency plans to reduce or mitigate concentrations such as loan participations and whole loan sales.

- **Credit Risk Review Function**

A strong credit risk review function is critical for self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the credit unions to assess credit quality and, ultimately, to identify problem loans. Risk ratings should be risk sensitive, objective, suitable for the types of loans underwritten, and reviewed regularly for appropriateness.<sup>8</sup> Credit unions should assign risk ratings at loan origination and update periodically over the life of the loan. With loan participations, credit unions should assess the risk rating system used by the originator and not rely on the assigned risk rating without basis. Credit unions should consider rating the participation loan using the internal risk rating system to ensure that the loan complies with the risk threshold established by the board.

- **Management Information Systems (MIS)**

A strong MIS should provide management with sufficient information to identify, measure, monitor, and manage concentration risk. This includes meaningful information on portfolio characteristics relevant to the credit union's lending strategy, underwriting standards, and risk tolerances. Credit unions are encouraged to stratify the portfolio by characteristics that would provide useful information to properly assess the risks. Examples of characteristics include loan type, collateral, geographic area, individual or associational group of borrowers, business lines, etc. Management reporting should be timely and in a format

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<sup>8</sup> The Office of Comptroller of the Currency Handbook "Rating Credit Risk" provides a comprehensive, but generic, discussion of the objectives and general characteristics of effective risk rating systems.

clearly indicating changes in the portfolio risk profile, including risk-rating migrations. Reporting and monitoring of business loans should be commensurate with the size, complexity, and risk exposure of the portfolio.

- **Market Analysis**

A market analysis should provide the credit union's management and board of directors with information to assess whether the business lending strategy and policies continue to be appropriate in light of changes in market conditions. Market analysis is particularly important as a credit union considers decisions about entering new markets, pursuing new lending activities, or expanding into existing markets.<sup>9</sup> Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk. Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. Credit unions should perform periodic market analyses for the various loan types and geographic markets represented in its portfolio and demonstrate that it has an understanding of the economic and business factors influencing its lending markets. The sophistication of the analysis will vary by market share and exposure, as well as the availability of market data.

- **Credit Underwriting Standards**

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations as appropriate. Credit unions should not rely solely on the collateral value and must perform proper identification of repayment source and accurate assessment of cash flow to ensure the borrower can adequately service the debt. The lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the lending staff (whether internal staff or an external third party) to evaluate all relevant credit factors. In establishing policies, a credit union should consider both internal and external factors, such as market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. The lending policies should permit exceptions to underwriting standards only on a limited basis and clearly identify who can approve the exceptions. Credit union management should be monitoring and reporting exceptions to both internal lending standards and regulatory limits<sup>10</sup> to the board of directors on a regular basis. If the credit union exceeds regulatory limits without having an appropriate waiver, examiners must take necessary corrective actions to ensure this violation is resolved in a timely matter.

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<sup>9</sup> As part of the market analysis, credit union should assess the risk associated with potential environmental liability if contamination is discovered on real property financed by the credit union. Letter to Credit Union 08-CU-13, "Environmental Liability: Risk Management Guidance" provides information regarding environmental risk considerations and ways to mitigate this risk.

<sup>10</sup> 12 C.F.R. Part 723 specifies the loan to value thresholds, which vary depending on the type of loan. 12 C.F.R. §723.10 outlines eight regulatory constraints where a credit union can obtain a waiver, including waiver of LTV limits, from NCUA regional office. An institution should monitor all loans with approved waivers and have those readily identified for examiner review.

- **Portfolio Stress Testing and Sensitivity Analysis**

Credit unions should perform portfolio level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and net worth. Further, credit unions should consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. Examples of common risk characteristics include loan type, collateral, geographic area, individual or associational group of borrowers, business lines, etc. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of the business loan portfolio.

## **MANAGING RISKS IN BUSINESS LENDING**

Credit unions are facing a challenging environment with overall market conditions weakening due to the slowdown in the housing market, deterioration of liquidity in the credit market, tightening of lending terms, and overbuilding in certain residential and commercial markets. The following are actions that credit unions can take to help manage changes in the market condition:

- **Increase or maintain strong net worth level** – Net worth provides protection against unexpected losses, particularly in stressed markets. Credit unions with significant exposure to business loans may require higher net worth position due to uncertainty in market conditions causing an elevated risk of unexpected losses. Since individual loans are larger in size, the exposure per loan can be much higher.
- **Ensure Allowance for Loan and Leases Losses (ALLL) are adequately funded** – Credit unions are expected to determine the adequacy of the ALLL in accordance with GAAP, their stated policies and procedures, management's best judgment, current and updated appraisals, and relevant supervisory guidance. In addition, risk ratings, data on adverse market condition, and changes in the borrower's credit standing are items to consider when developing tools for reserving purposes and environmental loss factor. Credit unions with significant business loans should consult interagency guidance provided in NCUA Accounting Bulletin No. 06-01, issued December 2006<sup>11</sup> and ensure ALLL accounts are adequately funded in a timely manner.
- **Manage business loan portfolios closely** – Credit unions should maintain prudent lending policies, use MIS and data warehousing to provide useful information on the business portfolio, and implement strong credit review and risk rating systems to identify deteriorating credit trends. As part of effective portfolio management, credit unions should maintain ongoing close relationships with borrowers.

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<sup>11</sup> The NCUA Accounting Bulletin 06-01 distributes an interagency advisory that reiterates key concepts and requirements included in GAAP and existing ALLL supervisory guidance.

- **Maintain updated financial and analytical information** – Credit unions should maintain recent borrower financial statements, cash flow statements, rent rolls, guarantor personal statements, tax return data, and other income performance information for all business loans including loan participations. As real estate market conditions change, management should consider the continued relevance of appraisals performed during high growth periods, and update appraisal reports as necessary. Further, credit unions should conduct periodic property inspections to ensure the collateral condition does not adversely impact the value.
- **Strengthen the loan workout infrastructure** – Credit unions should have adequate resources and sufficient staff with appropriate skill sets to manage an increase in problem loans and workouts. Credit unions should develop a ready network of legal, appraisal, real estate brokerage, and property management professionals to handle additional prospective workouts. In addition, sufficient control systems should be in place to maintain appropriate Troubled Debt Restructuring accounting requirements and to ensure that workout portfolios do not severely compromise the net worth position.<sup>12</sup>

## **SUPERVISORY OVERSIGHT**

Examiners should review the national risk reports and financial performance reports to identify credit unions potentially exposed to significant business lending risks as part of the ongoing supervisory monitoring processes. These reports may depict trends that portray increasing risk such as rapid business loan growth, high business delinquency and/or charge-offs, and low and declining net worth position. The effectiveness of a credit union's risk management practices will be a key component of the supervisory evaluation of the risk in the business lending program. Examiners should engage in dialogue with board and management to assess business loan portfolio exposure levels and risk management practices. Credit unions experiencing recent, significant growth in business lending or have notable exposure to a specific type of business loans should receive closer supervision than those demonstrating a successful track record of managing the risks with no significant market changes.

## **SUMMARY**

Business lending continues to be a fast growing product line for many credit unions and provides valuable service to the members by offering alternative option to acquire funding needed to start, grow and maintain businesses. However, the current economic environment poses challenges for credit unions that are actively involved in business lending. Credit union management needs to have adequate risk management processes in place for the size and complexity of the business loans granted.

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<sup>12</sup> The Federal Financial Institutions Examination Council "Policy Statement on Prudent Commercial Real Estate Loan Workout" details risk management practices for loan workout arrangements, and regulatory reporting and accounting considerations.



Examiners are instrumental in critically reviewing processes and best practices, including those in this supervisory letter, and in helping guide management to properly manage related risks in an effort to ensure continued safe and sound operations. Ultimately, it is the credit union's responsibility to demonstrate there are adequate policies, procedures, experience, and systems to ensure the MBL risks remain commensurate with net worth levels and risk tolerance threshold.

# APPENDIX A

## List of Resources

The concepts and principles set forth in this Supervisory Letter were derived and adapted from guidance previously issued by the National Credit Union Administration and other federal regulatory agencies, including the following:

Federal Deposit Insurance Corporation. Managing Commercial Real Estate Concentrations in a Challenging Environment. FIL-22-2008. Issued March 17, 2008.

<http://www.fdic.gov/news/news/financial/2008/fil08022.html>

Federal Financial Institutions Examination Council. Policy Statement on Prudent Commercial Real Estate Loan Workout, issued October 30, 2009.

[http://www.ncua.gov/news/press\\_releases/2009/FFIEC\\_PR\\_CRE\\_Workouts\\_10-30am.pdf](http://www.ncua.gov/news/press_releases/2009/FFIEC_PR_CRE_Workouts_10-30am.pdf)

Interagency Final Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, published in Vol. 71, No. 238 of the Federal Register, on Tuesday, December 12, 2006.

<http://edocket.access.gpo.gov/2006/pdf/06-9630.pdf>

National Credit Union Administration. Accounting Bulletin No. 06-01, issued December 2006.

[http://www.ncua.gov/GenInfo/GuidesManuals/accounting\\_bulletins/2006/06-01-Bulletin.pdf](http://www.ncua.gov/GenInfo/GuidesManuals/accounting_bulletins/2006/06-01-Bulletin.pdf)

National Credit Union Administration. Letter to Credit Unions No. 08-CU-13, May 2008. Environmental Liability: Risk Management Guidance.

<http://www.ncua.gov/letters/2008/CU/08-CU-13.pdf>

National Credit Union Administration. Letter to Credit Unions No. 08-CU-26, November 2008.

Evaluating Loan Participation Programs. <http://www.ncua.gov/letters/2008/CU/08-CU-26.pdf>

National Credit Union Administration. Rules and Regulations, Parts 701.22, 723.

[http://www.ncua.gov/Resources/RegulationsOpinionsLaws/rules\\_and\\_regs/NCUA%20R%20&%20R%20Book%201%20May%208%202008.pdf](http://www.ncua.gov/Resources/RegulationsOpinionsLaws/rules_and_regs/NCUA%20R%20&%20R%20Book%201%20May%208%202008.pdf)

Office of Comptroller of the Currency. Controller's Handbook on Credit Risk Rating. Issued April 2001. <http://www.occ.treas.gov/handbook/RCR.pdf>