Chapter 203

LOAN REVIEW

Introduction

Corporate credit unions (corporates) were initially created to provide liquidity resources to the natural person credit union (credit union) industry. Over time corporates have come to offer a wider array of products and services; however, they are still the primary source of liquidity and wholesale funding for most credit unions. Historically, risk within corporate loan portfolios has been considered low due to the small percentage of overall assets that loans represent, and due to the unique deposit structure of member credit unions where debt is considered senior to share deposits. However, given the key role that corporates play as a liquidity resource to member credit unions, it is imperative that corporates have effective policies and practices in place to ensure that funding is available to the membership, and that it can be provided in a manner that limits credit and liquidity risks to the corporate.

Lending activities of corporate credit unions are governed by Section 704.7 of the National Credit Union Administration (NCUA) Rules and Regulations (Regulations). Credit may be extended directly from the corporate to the borrower, or provided via pass-through and guaranteed loans from the Central Liquidity Facility (CLF) and the National Credit Union Share Insurance Fund (NCUSIF). In either circumstance, Section 704.7 sets forth specific limitations and responsibilities that corporates must adhere to when making loans to member credit unions and other borrowers.

Regulatory Requirements.

Section 704.7(a) requires that all corporates operate according to a lending policy which addresses, at a minimum, the following items:

1. Loan types and limits;
2. Required documentation and collateral; and
3. Analysis and monitoring standards.

Loans by corporate credit unions to other credit unions are exempted by Section 107a(c)(1)(B)(v) of the Federal Credit Union Act from the statutory and regulatory requirements imposed on business loans. However, Section 704.7 of the Regulations sets forth the following other limitations regarding corporate lending:

1. Loans to Member Credit Unions - Section 704.7(c)(1). The maximum aggregate amount in unsecured loans and lines of credit to any one member credit union, excluding pass-through and guaranteed loans from the CLF and the NCUSIF, shall not exceed 50 percent of capital. The maximum aggregate amount in secured loans and lines of credit to any one member credit union, excluding those secured by shares or marketable securities and member reverse repurchase transactions, will not exceed 100 percent of capital.

2. Loans to Non-Member Credit Unions - Section 704.7(d)(1). A loan to a credit union that is not a member of the corporate, other than through a loan participation with another corporate, is only permissible if the loan is for an overdraft related to the providing of correspondent services pursuant to Section 704.12. Generally, such a loan would have a maturity of only one business day.

3. Loans to members that are not credit unions - Section 704.7(c)(3). The aggregate amount of loans and lines of credit to one member, other than a credit union or corporate CUSO, shall not exceed 15 percent of the corporate's capital plus pledged shares. Any loan or line of credit made to a member, other than a credit union or a corporate CUSO, unless exempted by Section 723.1(b), must be made in compliance with Part 723 of Regulations, which governs member business loans, unless such loan or line of credit is fully guaranteed by a credit union, or fully secured by U.S. Treasury or agency securities. Those guaranteed or secured loans must comply with the aggregate limits of Section 723.16, but are exempt from other requirements of Part 723.

4. Loans to Corporate CUSOs - Sections 704.7(c)(2), (d)(2), and (e)(2). Loans to corporate CUSOs, whether members or nonmembers, are governed by Section 704.11. The aggregate of all investments in and loans (including lines of credit) to member and non-member corporate CUSOs cannot exceed 30 percent of the corporate's capital. However, a corporate may loan to corporate CUSOs an additional 15 percent of capital if collateralized by assets in which the corporate has perfected a secured interest under state law. (See Section 704.11(b)). Note that while NCUA's Rules and Regulations Section 704.7(e)(2) states that corporate CUSOs are not subject to Part 723 of regulations, this statement is made relative to loan limitations in Part 723, which are superseded by limits imposed by Section 704.11. Loans to corporate CUSOs are still subject to the due diligence requirements imposed on business loans by Section 704.11(c), which incorporate selected subsections of Part 723 by reference.

5. Participation Loans with Other Corporates - Section 704.7(f). Corporates may enter into loan participations with other corporates, contingent that each corporate retains at least 5 percent interest in the face value of the loan. A master participation loan agreement must be in place before the purchase or sale of the participation, and each participating corporate must exercise the same due diligence as if it were the originating corporate credit union. Corporates are allowed to participate in loans with natural person credit unions, but only if they have been approved for Part V Expanded Authority, or have requested and received a waiver permitting this activity. The limits established by the OCCU Director will govern this activity, and can be determined from the approval paperwork.

6. An analysis of the financial and operational soundness of the borrower, and the borrower's ability to repay, must be performed prior to loan approval. A corporate may assess prepayment penalties, if these are called for by the loan contract. When loans are issued to a corporate's natural person members, all consumer lending regulations will apply.

Types of Corporate Lending

Corporates offer a variety of loan products to their membership, including, but not limited to: overnight settlement loans, term loans, and secured and unsecured line of credit loans. While underwriting procedures and limitations may differ for each individual type of loan product, in all instances it is imperative that loan policies, practices, and personnel are effective in managing credit and liquidity risks.

CLF Loans

Corporates act as agents of the CLF through U.S. Central Credit Union. In this capacity member credit unions can gain access to a stable source of liquidity without the need to make a direct investment in CLF stock. CLF loans are primarily liquidity loans, and by law cannot be used to expand the investment and loan portfolios of the member credit unions. Any loans made as an agent of the CLF must meet the CLF's lending criteria. The corporate should maintain appropriate documentation evidencing the fact that the loan has been authorized and guaranteed by the CLF, and that these lending criteria have been met.

NCUSIF Guaranteed Loans

In certain situations loans may be disbursed with guarantees from the NCUSIF. This generally occurs when a natural person credit union is being liquidated or is subject to some other administrative type action. In any event, NCUA will guarantee repayment of the loan to the corporate. The corporate should maintain the appropriate documentation on file to evidence the loan guarantee.

Settlement Loans and Short-Term Liquidity Loans

The most common types of loans offered by corporates are settlement loans, short-term liquidity loans, and reverse repurchase loans. Term financing is less common, but term loans are a product that most corporates offer.

Normally, corporates will extend settlement lines of credit based upon the members asset size, anticipated needs, and ability to repay (i.e. financial strength). The line of credit will normally be used for both settlement and short-term funding shortages. The line may be "committed" (guaranteed) or "advised." A committed line of credit is always available to the member, while an advised line of credit is available at the discretion of the lender (corporate) at the time of the request. Normally, revolving lines of credit that require no advance notice by the borrower will carry a higher rate of interest than a credit line where advances must be requested and approved. This is indicative of the fact that the lender (corporate) will have the ability to decline the advised loan advance if, at that time of the request, a financial review indicates that the borrower's financial condition has deteriorated to the point where ability to repay is in question.

The decision to discontinue a member's settlement funding can have material financial and reputation repercussions to the corporate, the member credit union, and natural person members of the member credit union involved. A corporate should have preexisting procedures in place which address how to proceed with the settlement funding process when a member credit union has overdrawn its settlement line or otherwise presents increasing levels of credit risk. Such procedures should address offset of the loan balance by the member's other deposit accounts at the corporate, requirements for additional loan collateral, and involvement of alternative funding resources, such as investment repurchase arrangements and the CLF.

Short-term credit line loans may be secured or unsecured. Normally, secured lines will be priced at a lower rate of interest than unsecured lines, and are often committed lines, rather than advised lines.

When evaluating the ability to repay a settlement or short-term line of credit obligation, the major evaluation criteria should be the strength of the borrower's balance sheet and ability to generate funds inflows and/or convert assets to meet cash flow needs. Normally, these loans will be repaid via the settlement of cash letters and ACH deposits in transit, as well as normal cash flows received from loan amortizations and maturing investment balances. Therefore, liquidity of the members' receivables is crucial to the satisfaction of the obligation. In most instances settlement loans should carry a maturity of one day, while short-term line of credit loans normally should be retired within 12 months of the initial advance. Settlement and line of credit balances that remain outstanding for periods longer than those stated could indicate serious funds management deficiencies on the part of the borrower, or a misuse of the proceeds of the advance (i.e. using line of credit loans to fund long term consumer and real estate lending).

Reverse Repurchase Agreements

Corporates often enter into repurchase agreements with member credit unions where investments are "purchased" from members in order to provide the members with short-term cash funding. These repurchase transactions are accounted for in a manner very similar to a secured loan. In a typical repurchase transaction the corporate will extend a loan advance to the member credit union. The loan is "secured" by investment securities owned by the member credit union.

The corporate receives a "fee" which is represented as the difference between the agreed upon price of the securities as of the day of the settlement date of the transaction and the agreed upon future repurchase price. Normally, a margin of at least 102 is required to adequately secure this type of lending transaction; however, this margin requirement should be increased if the securities taken as collateral exhibit high volatility or price risk. It is imperative that the corporate have appropriate internal controls in place to determine the market value of collateral on a daily basis, and that the collateral obtained is a legal investment for corporate credit unions pursuant to Section 704.5.

Term Loans

Term loans are normally used to fund long-term capital expenditures or product offerings for member credit unions and affiliated organizations. The repayment of term financing is heavily dependent upon the long-term financial strength of the borrower; therefore, the lender should not only focus upon the ability of the borrower to generate a short-term cash flow, but also review long-term earnings capability.

Normally, term loan advances will be secured with specific fixed assets, investment securities, or loan receivables. The effective securitization and valuation of these assets is crucial in managing credit risk on a term loan advance.

Participation Loans

Participation lending is allowed under Section 704.7. Participation with other corporates on loans is presently uncommon, but some corporates have shown interest in participation lending, and this could be a service that is offered more frequently in the future.

If a corporate is participating with other corporates on loans, the examiner should ensure compliance with all the requirements of Section 704.7(f), and that the same due diligence was required on the participation loan that is required on all other loans originated by the corporate. The examiner should review the file, including the credit analysis process, security agreements, and participation agreement. If there is extensive activity in this area, the examiner should review a loan sampling of sufficient size and scope to determine the adequacy of the corporate's practices and procedures for each type of loan participation being entertained, and the level of risk each presents.

Lending Risk Assessment

Since loans typically comprise a small percentage of a corporate's total assets, the extent of review of individual loan files will be determined by the EIC. The main focus of the loan review is to determine if the corporate has detailed policies and procedures for all types of loans offered, and that these are being followed in actual practice.

If information developed during the review of policies and procedures reveals a serious problem, the examiner has the option of expanding the review of individual loans as necessary to identify the extent of the problem and the corrective actions required. Reasons for expanding or contracting the loan review will be discussed in the Corporate Examiner Memorandum for Lending and in the confidential section of the report. Regardless of the size of the loan review, serious problems will normally require development of a Document of Resolution to resolve them.

Written Lending Policies and Procedures

Section 704.7(a) requires that all corporates maintain written lending policies. Written policies and procedures should be commensurate with the volume and complexity of the corporate's lending program.

The board-approved policies should establish general risk limitations and authorizations regarding the corporate's lending function. Written procedures should detail the corporate's loan underwriting, monitoring, and reporting practices. Policies should also be specific as to collateral requirements, and procedures should be in place for valuing collateral taken as security on loans.

The examiner should review all written policies and procedures to determine that they adequately set forth restrictions, limitations, and appropriate internal controls over the lending function. The examiner should determine that written policies and procedures are periodically reviewed and revised as economic, competitive, and market changes dictate. The written policies and procedures should provide for sound credit risk and liquidity management, while also ensuring a competitive lending function for the corporate.

In general, the examiner should determine that the written policies and procedures:

1. Identify the types of loan products that the corporate will offer. The policies and procedures should include the specific characteristics, limitations, and underwriting requirements for each loan product (e.g. security requirements, cash flow requirements, pricing).

2. Specify how the value of acceptable types of collateral will be determined and subsequently monitored, and identify the process needed to adequately perfect security interests in such collateral.

3. Identify the specific terms and maturities of different types of loan products. Repayment terms should ensure amortization of loans sufficient to meet the funding needs of the corporate. Repayment terms should also be related to any expected declines in collateral value, and the overall cash flows of the borrower.

4. Require that all loan terms be set in a written lending agreement between the corporate and the borrower, which, for loans other than lines of credit, should be sufficient to retire a note within 12 years.

5. Contain loan pricing strategies that comply with statutory interest rate limitations.

6. Identify management and staff members responsible for underwriting loan requests, and their approval authorizations.

7. Are consistent with the corporate's ALM and funds management objectives. Examiner staff should determine that loans are being advanced with the profitability and liquidity needs of the corporate in mind.

8. Identify specific guidelines by which the borrower's credit worthiness will be assessed. This will include a listing of key financial ratios that will be evaluated. Policies and procedures need to specifically identify thresholds of acceptable financial and statistical data and trends.

9. Provide for periodic compliance reviews independent of the lending function. A periodic compliance review or audit of the lending policies and practices should be required in order to determine the effectiveness of the policies and procedures, as well as lending staff's adherence to the policy requirements and objectives. This requirement may be found in internal audit or other policies, if not specified in the lending policy.

10. Establish requirements for identifying delinquent loans, loan classifications, and "watch list" preparation and maintenance.

Loan Underwriting Procedures and Documentation

The corporate should make an assessment of the financial and capital strength of the borrower. Adequate procedures must also be in place to securitize and value assets taken as collateral on loans so that they may be converted to appropriate cash flow in the event of a default.

The examiner must ascertain that the corporate has performed the appropriate due diligence to determine the ability of the borrower to repay the debt, and that this analysis is periodically updated throughout the life of the loan or line of credit.

As part of the lending review, the examiner should determine that corporate management is taking adequate measures to continually assess the borrower's financial strength. The ability of loan officers to determine the financial strength of prospective borrowers is crucial in managing credit, interest rate, and liquidity risk on both secured and unsecured lending transactions.

Financial Analysis

The examiner should determine that the loan officers are performing and documenting a sound financial analysis of borrowers. Financial ratios that may be used to determine the solvency, earnings potential, and liquidity of potential borrowers include, but are not limited to:

Solvency Ratios:

1. Capital/Total Assets;
2. Net Capital/Total Assets; and
3. Debt/Capital.

Earnings Ratios:

1. Net Income/Average Assets;
2. Operating Expenses/Average Assets;
3. Net Interest Margin/Average Assets;
4. Fee Income/Operating Expenses; and
5. Net Loan Losses/Average Loans.

Liquidity Ratios:

1. Current Assets/Current Liabilities;
2. Delinquent Loans/Total Loans; and
3. Long Term Assets/Total Assets.

The examiner should determine the corporate is using proper financial analysis tools to evaluate specific types of loans. When evaluating a long-term secured loan, the loan officer must determine that the member demonstrates adequate capital and long-term earnings ability. In addition, current and future value of collateral taken as security must be evaluated. The ability to convert collateral to cash must also be verified by the loan officer.

The examiner should determine the loan officer initially evaluated <u>at least</u> three years of the borrower’s financial performance to estimate the credit union’s or affiliated organization’s financial strength and liquidity. This analysis should be updated periodically throughout the life of the loan (please refer to Ongoing Monitoring, below).

The examiner also should be aware that the corporate will have some knowledge of the borrower's management team, and therefore, may be able to make subjective assessment of their skills in managing the financing of the credit union's assets. Any subjective assessment should be detailed in the loan officer's credit review. Financial ratio and credit analysis should be undertaken on, at least, an annual basis, with more frequent reviews performed for active lines of credit, large concentrations, and "watch list" loans.

Review of Independent Audit Reports

A valuable tool in assessing the financial condition and internal control structure of the debtor is the independent audit report. Corporate loan policies should require that a copy of each borrower's independent audit report, including any management letter, be obtained on an annual basis. The audit may often disclose internal control, management, and operational deficiencies that could be material in the decision to grant credit.

Collateral Analysis

Corporates often extend loans to member credit unions and other affiliated organizations that are secured by specific assets. In many cases corporates have required that a "blanket" lien be placed on all the assets of a credit union entering into a line of credit agreement with the corporate. When filing a blanket lien the corporate does perfect a security interest. However, without also making a determination as to specific assets to be secured, and determining lien position as to those assets, the corporate may not be gaining much collateral value.

When an examiner is making a determination as to the validity of security interests, it is important to ensure that the corporate has practiced appropriate due diligence in perfecting a security interest, and ensuring a first position on assets identified as collateral. If these aspects of collateralization cannot be confirmed, the loan should be considered unsecured.

In instances when a blanket lien is filed out of "an abundance of caution" in conjunction with a sound ability to repay on an unsecured transaction, the examiner should not be overly critical of the corporate's collateral interests. However, in instances when collateral is deemed critical to reducing credit risk on the loan, the examiner should determine that the corporate has taken sufficient action to perfect a valid security interest in the collateral, and determine that the value of collateral is sufficient to securitize the loan balance.

In most cases collateral on corporate loans falls into five different categories:

1. Member share deposits;
2. Members' investment securities;
3. Commercial real estate;
4. Interests in member credit union loan portfolios; and
5. Other tangible assets.

In order to perfect valid security interests in each type of asset, specific steps must be taken as to documentation, legal filings, and overall due diligence.

The three requirements for the creation of a security interest are stated in the Uniform Commercial Code (UCC) Section 9-203. Once the following requirements are met, the security interest attaches:

1. The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral;
2. Value has been given to the debtor; and
3. The debtor has rights to the collateral.

Thus, unless collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description need not be very specific or detailed as long as it reasonably identifies the collateral. It is most important that the creditor files appropriate documentation with applicable state authorities, and that a lien search is performed to determine that no other creditors have prior interest in the assets secured. The examiner may need to consult state laws regarding the perfection of security interests, to determine that the corporate has adequately secured its position in any assets collateralizing a loan. The corporate should maintain a written legal opinion regarding the legality of all forms used The opinion should provide assurance that the corporate's procedures for securing interests in collateral whether it be deposits, investment securities, real estate, loans, or other tangible assets, is adequate and legally binding.

In the instance where a loan is secured by shares deposited in the corporate, the perfection of the security interest is achieved via the security agreement entered into with the member and the Statutory Lien Provisions set forth in the Federal Credit Union Act. The corporate's possession of the cash accounts provides a "perfected" interest in the accounts according to the UCC provisions listed above.

In the event that a corporate extends credit secured by cash not on deposit at the corporate, a lien search should be performed, and a UCC-1 filed with the appropriate state authorities identifying the cash accounts that were being encumbered as security on the loan. It is also recommended that the institution holding the deposit acknowledge the corporate's interest in the collateral.

Ongoing Credit Review

A credit review should not end with the review of the initial credit application. Corporates issue commercial credit, repayment of which is heavily dependent upon the borrower's ability to maintain financial strength through changing economic and competitive conditions. The examiner should determine that the corporate's lending policies and practices provide for an effective program of ongoing credit analysis of borrowing members and affiliates.

Credit reviews, including an evaluation of financial, statistical, and organizational information, should be completed for each borrowing institution on at least an annual basis. More frequent reviews should be initiated depending upon the type of credit issued, fluctuation in value of collateral, amount of dollars outstanding, frequency of advances on credit lines, and the financial condition of the borrower.

All credit reviews should be documented, and evidenced by a loan officer's written assessment as to the financial and operational stability of the debtor. Many corporates enlist the services of third party data aggregators who compile various ratios based on NCUA 5300 Call Report information. Such analytical information can have value, but, standing alone, it is not sufficient to establish the corporate's due diligence. The credit review must establish the scope of the analysis, and loan officers should document in narrative format the rationale behind conclusions for increasing, decreasing, or merely maintaining an open credit line. If the examiner deems that initial and ongoing credit reviews are not adequately verifying the debtor's financial condition and ability to repay, then a finding and record of action should be provided in order to facilitate corrective action.

Examination Objectives

The objectives for reviewing a corporate's lending program are as follows:

1. Determine the degree of credit risk exposure inherent within the corporate's lending program, in relation to its capital position.

2. Determine the adequacy of policies, practices, procedures, and controls regarding loan portfolio management, in relation to current market and economic conditions.

3. Determine if corporate staff are processing loans within policies and procedures.

4. Determine compliance with applicable laws, rulings, and regulations.

5. Determine if members are treated equitably during the implementation of the corporate's lending policies, practices, and procedures.

6. Determine if timely corrective actions are initiated when policies, practices, procedures, or controls are deficient, or when violations of laws or regulations are noted.

Examination Procedures

See Corporate Examination Procedures - Loan Review (OCCU 203P).

Examination Questionnaire

See Corporate Examination Questionnaire - Loan Review (OCCU 203Q).

References

1. Commercial Bank Examination Manual, Board of Governors of the Federal Reserve

2. Regulatory Handbook, Thrift Activities, Office of Thrift Supervision

3. Examiner's Guide, National Credit Union Administration

4. Comptroller's Handbook for National Examiners