



DCU BULLETIN

Division of Credit Unions

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Safe & Sound Expansion of MBL Portfolios

The Division of Credit Unions (Division) worked to extend to Washington state chartered credit unions (WSCCUs) the flexibility they need to effectively provide members with the loans to develop their businesses and thereby strengthen the economy in Washington. WSCCUs must follow Chapter 208-460 WAC requirements for Member Business Lending (MBLs). This rule and the statutory requirements on the safe and sound operation of credit unions provide the authority to make MBLs within state chartered credit unions.

As of June 30, 2005, 43 of 79 WSCCUs had a MBL portfolio and 35 of the 43 WSCCUs held less than 5% of their assets in MBLs. In addition to various MBL portfolio sizes, the size of individual MBLs vary. The current rule provides for credit unions wishing to extend small business loans to members as well as credit unions wishing to make MBLs on a much larger scale. The Division recognizes there are credit unions at various places along the size continuum. The Division expects WSCCUs with larger MBL operations to demonstrate adequate sophisticated standards of operation to manage and mitigate the associated risks.

Expertise

WAC 208-460-040 requires the following: “The credit union must utilize the services of an individual with at least two years direct experience with the type of lending the credit union will be engaging in...” The rule continues “Credit unions do not have to hire staff to meet the requirements of this section; however, credit unions must ensure that the expertise is available.”

Credit unions need to be aware the two years requirement is a minimum. In most cases that level of experience does not allow the staff to understand the impact of the full business cycle on loans of various types. For this reason ten or more years experience is desirable. The Division expects close adherence to the requirement for experience in the specific loan types the Board has approved in the MBL policy. It should also be noted, the experience of a loan officer is of little benefit should more senior management fail to understand or implement recommendations suggested by that loan officer.

To ensure adequate expertise to manage the risks of business lending, some credit unions with a small MBL portfolio hire consultants or buy services from a credit union service organization with commercial lending experts. Generally, the Division finds this approach acceptable if the MBL portfolio is not a material percentage of assets and the consultant/purchased services are adequate to manage all MBL risks.

For the Division's examination purposes, a "material amount" is defined as the lesser of \$25 million or 5% of assets invested in MBLs. Once a credit union has reached a "material amount" of member business loans on the books, the Division expects to find credit union employees with the required expertise to manage a MBL portfolio. The Division examines the adequacy and completeness of ongoing evaluation of all aspects of managing the business loan portfolio. Generally, when the Division finds safety and soundness issues because the risks are not managed and mitigated according to industry standards for commercial lending, the common cause is a lack of adequate in-house expertise.

Application for MBL authority above 12.25% of assets

A few credit unions have applied for approval to make MBLs above the 12.25% of assets aggregate limit found in WAC 208-460-130 and -140. Before approving an application for expanded aggregate MBL authority, the Division examination must verify the credit union meets similar safety and soundness practices of commercial lending by a bank of similar size. The Division examination follows the examination standards used by the FDIC. (see Appendix A).

Prior to applying for such expanded authority, the Division expects a credit union to engage a third party, qualified to assess the management of a commercial lending operations, to do a thorough review of all phases of its member business lending. The third party review should use standards found in the FDIC guidelines in Appendix A. In addition, the credit union's internal auditor and external audit should also identify areas for improvement. The credit union should adequately

address any findings of the third party review and audit prior to application for expanded MBL authority. If the credit union internal audit function does not have extensive experience auditing member business loans, the Division expects the credit union to have a well qualified third party that understands the FDIC Standards perform an annual review of the business lending operation.

Upon receipt of an application for expanded aggregate MBL authority, the Division will schedule an on-site, limited scope examination. Typically, the examination team will be composed of a Division examiner, a National Credit Union Administration examiner, and a bank examiner. Upon the examination's conclusion that the credit union operation is as safe and strong as those of similar sized banks, the application may be approved. At a minimum, the on-site MBL examination will consider the various reports and program elements found in Appendix B. After approval of expanded MBL authority, all ongoing examinations will continue to use FDIC standards applicable for evaluating a commercial lending operation.

If you have questions about this Bulletin, please contact Mike Delimont at (360) 902-8753 or MDelimont@dfi.wa.gov.

APPENDIX A

FEDERAL DEPOSIT INSURANCE CORPORATION 12 CFR PART 364 - STANDARDS FOR SAFETY AND SOUNDNESS

Operational and Managerial Standards with application to MBLs

A. **Internal controls and information systems.** An institution should have internal controls and information systems that are appropriate to the size of the institution and the nature, scope and risk of its activities and that provide for:

1. An organizational structure that establishes clear lines of authority and responsibility for monitoring adherence to established policies;
2. Effective risk assessment;
3. Timely and accurate financial, operational and regulatory reports;
4. Adequate procedures to safeguard and manage assets; and
5. Compliance with applicable laws and regulations.

B. **Internal audit system.** An institution should have an internal audit system that is appropriate to the size of the institution and the nature and scope of its activities and that provides for:

1. Adequate monitoring of the system of internal controls through an internal audit function. For an institution whose size, complexity or scope of operations does not warrant a full scale internal audit function, a system of independent reviews of key internal controls may be used;
2. Independence and objectivity (reporting to the supervisory committee);
3. Qualified persons;
4. Adequate testing and review of information systems;
5. Adequate documentation of tests and findings and any corrective actions;
6. Verification and review of management actions to address material weaknesses; and
7. Review by the institution's audit committee or board of directors of the effectiveness of the internal audit systems.

C. **Loan documentation.** An institution should establish and maintain loan documentation practices that:

1. Enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis;
2. Identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;
3. Ensure that any claim against a borrower is legally enforceable;
4. Demonstrate appropriate administration and monitoring of a loan; and
5. Take account of the size and complexity of a loan.

D. Credit underwriting. An institution should establish and maintain prudent credit underwriting practices that:

1. Are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made;
2. Consider the nature of the markets in which loans will be made;
3. Provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
4. Establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors;
5. Take adequate account of concentration of credit risk; and
6. Are appropriate to the size of the institution and the nature and scope of its activities.

E. & F. Not applicable to commercial lending

G. Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1. Conduct periodic asset quality reviews to identify problem assets;
2. Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
3. Compare problem asset totals to capital;
4. Take appropriate corrective action to resolve problem assets;
5. Consider the size and potential risks of material asset concentrations; and
6. Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

The FDIC, Division of Supervision Manual of Exam Policies, Section 3.1 on loans, is also a valuable resource.

APPENDIX B

APPLICATION REQUIREMENTS TO INCREASE MEMBER BUSINESS LOANS (MBLs) LIMITS under WAC 208-460-140

Provide the following information to the Division for our review to determine the prudent limit for your MBL portfolio and the plan for moving to that limit should it be approved.

- A. A copy of your current member business loan policy (including officer lending limits, and most recent board approval date)
- B. The requested limit sought for your MBL portfolio, with any other limitations you are proposing to the portfolio
- C. An explanation of the need to raise the limit above the current limit
- D. Documentation supporting your ability to manage the current MBL portfolio, including as a minimum:
 - 1. The history of loan losses, current loan delinquency, loan grading system, and Allowance for Loan & Lease Loss analysis applicable to MBLs
 - 2. Volume and cyclical or seasonal patterns
 - 3. Diversification by collateral type, include unsecured as a “type”
 - 4. Diversification by geographic location
 - 5. Concentration of credit to one borrower or group of associated borrowers in excess of 15% of reserves (excluding the Allowance for Loan Losses account)
 - 6. Underwriting standards and practices
 - 7. Types of loans grouped by purpose and collateral
 - 8. The qualifications of personnel responsible for approving, underwriting and administering MBLs (including collection department)
 - 9. An organization chart of the MBL department and copies of the resumes for all officers and employees in the MBL department,
 - 10. A description of the experience and training of credit union executive management (CEO, CFO, CLO & internal audit), and
 - 11. A description of the experience and training of supervisory committee members and directors in understanding and monitoring the risk of an MBL portfolio
- E. If not included in the above, provide information on the following:
 - 1. The current percentage of MBLs to total loans and to net worth
 - 2. The annual percentage of MBLs to total loans over the last five years
 - 3. The number, amount, and list of MBLs with no personal guarantees
 - 4. The number and amount of unused MBL lines of credit (LOC), excluding car dealer flooring LOCs
 - 5. The number and amount of car dealer flooring lines of credit
 - 6. The number and amount of MBL applications in process
 - 7. The number and amount of MBL construction and development loans
 - 8. The number and amount of MBLs to uncompensated directors or committee members and their immediate family members

9. Copies of the most recent internal audit and Supervisory Committee/CPA audit as well as any 3rd party reviews relating to MBLs with the credit union response
10. A copy of your MBL's internal controls and collection procedures, if not included in A. above
11. What do you anticipate in annual MBL growth for the next 5 years as to type and percentage of MBLs. Briefly describe how plans for sale or purchase of MBLs fit within the business plan of the credit union
12. How do you monitor the economic condition and forecast of the geographic areas served by MBLs?
13. Provide a list all MBL participations purchased and sold over the past 5 years. Include borrower name, loan number, term, loan rate, fixed or variable rate, any fees or other compensation, and purchasing institution. Describe which participations are sold with recourse.
14. Briefly describe the process used to find, qualify and document a sale or purchase of MBL participations. Provide copies of template agreements used and copies of any comments about the agreements from your attorneys.