DCU BULLETIN

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July 9, 2004 No. B-04-
07

Member Business Loans (MBL)

The Division of Credit Unions (Division) continues to closely monitor the member business loans (MBLs) in credit unions. This bulletin is intended to provide an examiner's perspective on MBL portfolios.

While discussions of MBLs have been in the press lately, only a few Washington state chartered credit unions have significant portfolios of MBLs. Half of the Washington state chartered credit unions report no MBLs.

MBLs held by Washington state chartered credit unions as of December 31, 2003

Number of CUs	Categories
43	Have no MBLs
38	MBLs-to-total assets are greater than zero and less than 5%
2	MBLs-to-total assets are greater than 5% and less than 12.25% of total assets
3	MBLs-to-total assets are greater than 12.25% of total assets
86	Total Washington state charter CUs as of 12/31/2003

The Division expects credit unions to demonstrate all elements of prudent risk management over MBLs, in compliance with the limitations in Chapter 208-460 WAC and consistent with the commercial loan requirements for a bank of similar asset size. The Division will continue to work with those credit unions that choose to expand their MBLs. However, credit unions are reminded the higher return on MBLs is offset by the significant costs and risks associated with making the loans and managing the portfolio.

Policy
Examiners will review for prudent MBL management, including sound policies. The MBL policy requirements are contained in WAC 208-460-050. The lending policy should not be a static document but must be reviewed annually by the Board or more frequently in light of

changing circumstances, such as new regulation, local economy, or member borrowing needs. Examiners will criticize a credit union that has very broad policy guidance on MBL lending without specific limits on the MBL portfolio. Please refer to the list of topics in Appendix A for the MBL policy.

In addition, MBL procedures are required for loan monitoring, servicing and follow-up, and collection. The policies and procedures must should be clearly defined and set forth in a manner to provide effective supervision by the directors and senior officers.

Lending Experience Requirements

Examiners will review resumes and other evidence demonstrating that MBL personnel are qualified based on level of education, experience, and extent of formal training. WAC 208-460-040 requires MBL personnel to have at least two years direct experience with the type of lending the credit union will be engaging in. Credit unions may not make construction and development (C&D) loans unless it utilizes an individual with at least five years of direct experience in C&D loans. [see WAC 208-460-030 (4)] **This experience is critical.** As a credit union increases its percentage of MBLs- to-assets, examiners expect senior management, staff, selected directors, and internal auditors to demonstrate adequate previous experience to understand and manage the risks associated with business loans.

Administering MBL Portfolios and Participations

A few credit unions have chosen to contract with third parties for underwriting, to meet the knowledge and experience requirements for MBLs. Others have purchased participation interests in MBLs originated by another credit union or bank. Whether using a third party or purchasing participations, a credit union must still demonstrate it has the experienced staff to handle the initial due diligence review, the ongoing credit analysis, and ongoing administration of the portfolio. For example: certain types of commercial lending will require extensive ongoing credit analysis to help protect the credit union investment with timely actions. Examiners will be looking for the appropriate expertise on staff to handle all aspects of the loan relationship. Credit unions with limited expertise on staff may do well to develop the MBL portfolio gradually over several years to allow the opportunity for staff to learn what is necessary to manage the loan relationship.

Examination Loan Review

Examiners will perform an extensive MBL loan review. Examiners are paying particular attention to the credit union's MBL **cash flow analysis,** expecting to see a thorough analysis of sources of repayment for a loan. Generally a MBL's primary source of repayment will be the cash flow of the borrower with collateral as a secondary source. Examiners will select MBLs for review based on both the risk of the loan as well as a statistical sampling. In most exams, a significant portion of the MBL portfolio will be reviewed, which may lengthen the exam beyond the time experienced before the credit union became involved in the MBLs.

Loan Review System, Credit Grading and Allowance for Loan & Lease Losses (ALLL)

The complexity of a credit union's loan review system should vary based upon the credit union's asset size, type of operations, and management practices. Examiners expect an effective loan review system but not necessarily a separate loan review department. Examiners will check the effectiveness of loan review process. This will include assigning initial credit grades, ensuring credit grade changes are made when needed, and compiling information necessary to assess the adequacy of the ALLL.

Accurate and timely credit grading is an essential component of an effective loan review system. Credit grading involves an assessment of credit quality, the identification of problem loans, and the assignment of risk ratings. An effective system provides information for use in establishing valuation allowances for specific credits and for the determination of an overall ALLL level. WAC 208-460-110 and 120 provide guidance for establishing the proper level for the ALLL.

Loans to Insiders

Examiners will verify compliance to the prohibition of loans to certain individuals associated with the credit union as contained in WAC 208-460-020.

MBLs to directors may be made only after the board of directors has approved the loan and the director(s) who is a party involved in the transaction was recused from the decision making process. The Division defines recused as follows: the director must be excused and leave the room before the board discusses the loan (including whether to make and how to manage the loan) and votes, returning when the discussion and vote on the MBL is concluded. The meeting minutes must clearly state the recusal and <u>fully document</u> the loan consideration discussion. Given the potential for conflict of interest, the Division cautions credit unions against making a MBL to a director. Examiners will be reviewing these loans carefully.

Investment Properties Are MBL

A non-owner occupied 1-4 family residential property (rental) is included in the definition of MBL (WAC 208-460-010). Examiners will verify an adequate MBL policy for rentals, meeting requirements of WAC 208-460-050 and accurate reporting on the quarterly call report.

Borrower's Equity in Construction and Development Lending

Construction and development (C&D) loans are high-risk loans requiring sophisticated underwriting and administration. A significant exposure in any type of construction or development loan is that full value of the collateral does not exist at the time the loan is granted. The credit union must guard against many risks, including contractor failure to produce the project as contracted, threat of liens filed on the property, unreliable market analysis due to unmarketable or difficult-to-market project, and inadequate funding to complete the project. Examiners will check for compliance of prudent C&D policies and procedures, such as inspections and verification that loan funds are used properly to complete construction or development of the property serving as collateral. Examiners will also verify compliance of equity requirements required to offset some of the project risk. For this reason, WAC 208-460-030(2) outlines the requirements for the borrower's equity interest in a project; a minimum of 25% equity for construction and 30% equity for development loans. Examiners will be looking for documentation of a minimum of 10% cash equity invested in the project by the borrower.

Unfunded Commitments

A number of credit unions have been unclear about the role of unfunded commitments in the definition of MBL. WAC 208-460-010 (1) clearly includes any unfunded letters of credit, lines of credit or commitments in the MBL balance reported on the quarterly call reports.

Conclusion
If a credit union has questions about any of the MBL requirements, the Division has examiner specialists in commercial lending, and is able to consult with other Division of Banks experts on MBLs on specific issues. The Division is committed to helping credit unions continue to make member business loans in a safe and sound manner. Please do not hesitate to contact the Division regarding MBLs.

Note:
DCU anticipates issuing another bulletin regarding application requirements for MBL limit waivers in early August.

Appendix A

The MBL policy should address the following elements:

1. General types of business lending in which the credit union will engage;
2. Lending authority of each loan officer, senior credit union official, and loan or executive committee;
3. Responsibility of the board of directors in reviewing, ratifying, or approving loans;
4. Guidelines under which unsecured loans will be granted;
5. Guidelines for setting interest rates and the payment terms for secured and unsecured loans;
6. Loan-to-value (collateral) limits and the required collateral value documentation required by the credit union for each type of secured loan;
7. Guidelines for obtaining and reviewing real estate appraisals as well as for ordering reappraisals;
8. Maintenance and review of complete and current credit files on each borrower including leases, floor plans, inventories, as appropriate;
9. Appropriate and adequate collection procedures including actions to be taken when borrowers fail to make timely payments;
10. Limitations on the maximum volume of business loans in relation to total assets;
11. Description of the credit union's normal trade area and the circumstances under which the credit union may extend credit outside of such area;
12. Guidelines, which address the goals for the portfolio mix, risk diversification and the loan-to-one-member concentrations. These guidelines should cover the credit union's plans for monitoring and taking appropriate corrective action, if deemed necessary;
13. Guidelines addressing the credit union's loan review and grading system ("Watch list");
14. Guidelines addressing the credit union's Allowance for Loan Losses review; and
15. Guidelines for adequate safeguards to minimize potential environmental liability.