DCU BULLETIN

Division of Credit Unions

Washington State Department of Financial Institutions

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May 17, 2011 (revised May 24, 2011) No. B-11-03

Safe and Sound Student Loan Programs

Division of Credit Unions is giving closer attention to new loan programs[1]. Recently, examiners found a few Washington credit unions have adopted student loan programs with very limited research and few controls. Examiners will expect to find the following conditions before a student loan program will be considered safe and sound for Washington credit unions.

1. A thorough due diligence review must be performed and documented analyzing the conditions, costs, and benefits to the credit union of the program before implementing the program. This due diligence would, at a minimum, follow the guidance in the National Credit Union Administration's Letters to Credit Unions:
    - 01-CU-20 Due Diligence Over Third Party Service Providers,
    - 07-CU-13 Supervisory Letter - Evaluating Third Party Relationships,
    - 08-CU-09 Evaluating Third Party Relationships and
    - 10-CU-15 Indirect Lending and Appropriate Due Diligence.

    One key objective of the credit union due diligence will be for management to understand the program and be prepared to make appropriate adjustments to protect the credit union as risk levels fluctuate.

2. The due diligence review should include analysis of all contracts by an attorney representing the interests of the credit union. Recommendations to strengthen the contract in favor of the credit union should be implemented when they are practical.

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[1] Examples of new loan programs that caused material losses to the insurance fund are out-of-state construction programs, home equity lines of credit, indirect auto loans, and a new real estate loan program. For more detail, see the chart on page 3 of the Inspector General's Capping Report is available on the NCUA website at http://www.ncua.gov/Resources/OIG/Files/Reports/2010/OIG-10-20OIGCappingReportMLRs_11.23.10.pdf .

3. The due diligence review should include reputation risk by analyzing all of the costs (i.e. fees and loan payments) to the borrower of a private student loan program. While students may seek funding beyond scholarships and federal aid (such as grants, work-study, loans, veteran benefits), critics have chastised some lenders for high cost debt to students as well as inflexible repayment options. Before offering indirect lending through third parties who charge high fees, credit unions should carefully evaluate the program so they don't put their pro-consumer reputation at risk.

4. As a result of the due diligence analysis, the credit union should have projected its expected revenue, expenses and an anticipated rate of return on the amount invested in the student loans.

5. After reviewing the results of the due diligence analysis, the credit union board should adopt a policy governing the loan program. The student loan policy may be incorporated as part of the overall loan policy of the credit union. The credit union should also have a vendor management policy, before embarking in an indirect student loan program.

   If the student loans are risk-priced, management should set reasonable limits on the amount of loans in each risk category. A credit union with an indirect student loan program should carefully analyze the third party's underwriting criteria. The credit union's indirect loan policy should clearly establish specific underwriting standards and have clear requirements for the loans the credit union will accept from vendors. The credit union should periodically audit the program to ensure all loans meet the credit union's indirect underwriting criteria.

6. We would expect a credit union to limit the concentration of private student loans on the books, as a new unsecured loan program, to growth of <u>no more than 10% of the credit union's net worth per year</u>. This limit should remain until the credit union has more than three years of satisfactory experience with the student loan program, including at least two years collecting material amounts of loans that have entered the principal and interest repayment period.

7. The credit union will provide an adequate allowance for loan. The experience of student loan reinsurance programs, other private student loan programs, and federal student loan programs may be informative on selecting a reserve ratio for the first few

years of the program. However, the credit union should recognize the federal student loan programs may have controls and guarantees in place that the credit union is unable to duplicate to achieve similar lower risk. Therefore, private loan programs may have a higher risk profile than federal student loan programs and require additional reserves.

An estimate of losses using the various factors discussed above should continue until the credit union has a three year loss history for the program. Any new loss history approach should contain a significant number of loans that have entered the principal and interest repayment period and have a demonstrated repayment history.

8. Insurance associated with a student loan product must meet requirements of the Washington Insurance Code in Title 48 RCW. A credit union should verify the insurer is licensed in Washington.

9. The membership eligibility of each individual must be verified prior to making or buying the loan.

10. Management should provide ongoing monitoring of service quality provided to members by third parties as well as the financial health of third-party vendors. Management should make adequate, alternative provision for servicing the loans should that course become necessary. This will include contractual provision for access to data and systems as may be appropriate to safeguard the assets and reputation of the credit union.

11. The interest rate risk characteristics of the student loans must be appropriately included in the measurement of interest rate risk before and after implementation of the program.

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