I. PURPOSE

Examiners must ascertain the overall potential financial impact of lending activities (risk of loss) and determine the levels of risks present in the loan portfolio. Management's knowledge, abilities and effectiveness, as well as whether the lending staff have sufficient knowledge to underwrite loans in compliance with regulations and safe and sound lending standards must be evaluated.

II. PRIMARY REFERENCES / RELATED REGULATIONS

1. Michigan Credit Union Act:
   - **a.** Section 342(3)(b): The Board must establish maximum limitations on loans
   - **b.** Section 342(3)(i): The Board must adopt policies necessary for operations
   - **c.** Section 401: Domestic credit union; powers
   - **d.** Section 421: Credit Committee and loan officers
   - **e.** Section 422: Loan agreement with member or another domestic credit union
   - **f.** Section 423: Loan conditions
2. NCUA Rules and Regulations, Part 741.203: Minimum loan policy requirements
3. Truth in Lending Act (Regulation Z)
4. Equal Credit Opportunity Act (Regulation B)
5. Military Lending Act
6. Credit Union Bulletin 2005-08-CU

III. MINIMUM PROCEDURES

1. Review loan policies and procedures. The Board of Directors must develop and adopt comprehensive, written loan policies which define each type of loan product offered. These policies must promote safety and soundness within the credit union. At minimum, the loan policy should address the following:

   - **a.** Individual, aggregate, and portfolio limits for each type or class of loan.
   - **b.** Loan application and underwriting documentation requirements, and loan approval criteria. Loan approval criteria must include such factors as debt ratios, loan-to-value ratios, disposable income, recent verification of

income and employment, credit history, tax returns, and financial statements.
- **c.** Procedures and documentation to approve exceptions to the loan policy.
- **d.** Payment terms, amortization periods, and maximum maturity for each loan type.
- **e.** Collateral requirements and valuation methods, including criteria and procedures for substitution and release of security.
- **f.** Criteria for real estate and commercial lending, including approved loan structures and participations, loan-to-value limitations, trade areas, assumption criteria, appraisals and valuation requirements, title and hazard insurances, annual monitoring, and other risk management factors.
- **g.** Controls and practices to ensure compliance with all applicable State and Federal regulations, governing disclosures, and underwriting requirements.
- **h.** Policies, procedures, and tracking systems to ensure receipt of perfected liens, recorded mortgages, current insurance, and loss payee status.
- **i.** Criteria and timeframes for classifying and charging off various loan types.
- **j.** Collection procedures and timeframes.
- **k.** Extension and refinancing criteria and limitations.

2. Review the terms and interest rate structure for the various types of loans. Determine whether the interest rates and terms offered are reasonable for each type of loan and whether the interest rates adequately address the level of risk in each type of loan.

3. Compile a sample of loans to review. The sample should contain, at a minimum, the following types of loans:
- **a.** Recent loans (granted since the last contact). There should be sufficient representation of each type of loan in the portfolio, to ascertain the overall level of risk being assumed in present/recent lending practices. The Examiner-in-charge shall dictate the general size and composition of the loan sample.
- **b.** Large Loans/Concentrations: Loans with high balances or concentrations of loans to individuals or groups should be included in the sample to ascertain compliance with policy or identify other material risks.
- **c.** New Loan products.
- **d.** Rapidly growing programs.

e. Loan types that present higher levels of risk (e.g. real estate, MBLs, participations, indirect, student, insider loans, and extensions or workout loans).

f. Review AIRES share and loan download queries. At minimum, the review should include the following queries; paid ahead loans, balance unchanged after 90 days, accrued interest greater than balance and payment, and negative shares.

g. Loans with unusual characteristics: Examiners should review the AIRES download for any loans with the following characteristics:

- **i.** Advanced due dates;
- **ii.** Unusually low or high interest rates;
- **iii.** Balances greater than the original amount or greater than credit limits;
- **iv.** Loans that should have matured by examination date;
- **v.** Other unusual terms;
- **vi.** High accrued interest relative to payment amount (for current loans);
- **vii.** Unusual characteristics (PO Boxes, Business names, Business Tax ID #s, etc.).

4. Review loan files.

a. Review applications for completeness and reasonableness. Credit applications must contain sufficient information to determine the purpose for the loan, to carefully analyze the character and financial condition of each loan applicant, cosigner and guarantor, and to ascertain their ability to repay fully and promptly. Members must sign credit applications. Unsigned requests for advances under an open-end revolving credit plan or pre-approved line-of-credit plan may be honored as provided in the underlying contract and policies adopted by the Board of Directors. Each credit application must be retained until disposition is authorized by the Board of Directors. Applications may not be disposed until the latter of:

- **i.** Twenty-five months after the date of the denied application
- **ii.** Five years after consummation

b. Analyze the credit risk for each file. Determine whether the lending staff performed adequate credit analysis prior to granting the loan, including review of the following:

- **i.** Credit report.
  1. Determine whether the credit report is recent enough to provide reasonable evaluation of current creditworthiness

(generally less than 6 months old). The credit union's loan policy should provide guidelines regarding the timing requirements for credit reports.

2. Review the credit report for public filings. These include bankruptcies, tax liens, civil judgments, and collections.
3. Review the trade lines. Evaluate the types of credit and the length of time the trade lines have existed.
4. Consider the number of recent inquiries, which can indicate escalating debt and/or other very recent loans not yet appearing elsewhere on the credit report or loan documentation.
5. Review the credit score, the reasonableness of such, and compliance with related policy guidelines.
6. Review balances in relation to credit limits. High balances relative to credit limits are a risk indicator.

ii. Calculate the debt ratio. Review the credit union's loan policy for debt ratio guidelines. The policy should specify whether the credit union uses gross or net income. When calculating the debt ratio, the examiner should:

1. Use income from pay stubs or other proof of income, if available.
2. Use debts from the credit report and those listed on the application, avoiding duplication.

c. Determine if the loan terms (including loan rate, etc.) for each loan reviewed complies with lending policies and/or procedures and are reasonable. Determine if exceptions were approved in an appropriate manner and as required by policy.

d. Determine whether the interest rate structure provides sufficient return relative to the risk associated with each type of loan. Various factors may be considered in determining the overall risk, including:

i. Borrower's creditworthiness (often measured by credit scores);
ii. Collateral value, reliability, and life span;
iii. Length of loan term;
iv. Other known or reasonably foreseen factors.

e. Determine whether the loan was approved by person(s) with appropriate lending authority. The Board of Directors or the Credit Committee must establish lending authority limits for all appointed loan officers (per the Bylaws). No loan, line of credit, renewal of a loan or line of credit, extension agreement, deferral of payments, release of security, or substitution of security on a loan may occur until approved in writing by a majority of the members of the credit committee, the Board of Directors, or a loan officer to whom such authority has been properly delegated. Credit union records must document who granted the approval.

5. For insider loan reviews, ensure loans to officials are approved by the Credit Committee or the Board of Directors if the institution does not have a Credit Committee. No official may act as a cosigner or endorser for borrowers, except as permitted by law. A loan officer may be delegated the authority to approve only the following classes of loans to officials:
   a. Loans fully secured by shares and deposits.
   b. Loans under an existing open-end revolving credit agreement provided a specific amount has been pre-approved by the credit committee or the Board of Directors, if there is no credit committee.

7. Ensure loan files contain appropriate contracts and receipts. Each loan or other extension of credit must be evidenced by a promissory note or other binding agreement signed by the borrower. Each disbursement must be as directed by the borrower and evidenced by a proper voucher, receipt, check, or draft. Disbursements under a pre-approved line of credit agreement may be honored remotely if the borrower can be authenticated.

8. Review compliance with the Military Lending Act, including ensuring sufficient policies and procedures exist for compliance.

9. Loan exceptions should be discussed with management, allotting enough time to give management the opportunity to provide supplemental information/explanation. Loan exceptions shall detail exceptions to policy, regulation, and/or safe and sound lending practices. Disagreements with management regarding exceptions should be documented.

10. Other procedures should be performed as deemed appropriate to evaluate the overall risk profile of the loan portfolio. Any available management reports shall be requested and reviewed, for this purpose.

IV. PROCEDURES TO PERFORM PERIODICALLY:

1. Review a sample of denied loans.
   a. Determine whether the credit union has complied with the Equal Credit Opportunity Act and other applicable regulations, including all related disclosures and timing.
   b. Evaluate the reasons for denial, identifying possible discriminatory or other unfair practices.
   c. Evaluate whether denial practices are consistent, comply with policies, and reflective of the Board's documented level of tolerable risk. The credit union's financial condition is a consideration when evaluating whether not enough or too much risk is being avoided through the credit union's loan denials.

2. Sample or review all key employee and/or official loans**.** Perform a detailed analysis of loan documentation and account histories to ascertain:
   a. If the Board, or the Credit Committee, if the domestic credit union has a Credit Committee that does not include any credit union employees, is approving any loan or other extension of credit to or purchase of an obligation of the general manager/CEO as per the Michigan Credit Union Act.
   b. If practices are preferential and/or in violation of the MCUA (including rate and terms granted to insiders).
   c. If there are any red flags indicating inappropriate activity (unexplained journal entries or file maintenance activity).
   d. Whether loans are amortizing properly through legitimate payments.
   e. Whether there are any other red flags indicative of insider abuse or fraud.

3. Ensure management is reviewing lending activities throughout the year to ensure conformity with the loan policy adopted by the Board of Directors.

V. ATTACHMENTS / FORMS

1. 10301 A Sample Lending Items Requested for Examination