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December 11, 1989

Mr. George A. Hammerton
President
Navy KWest Federal Credit Union
Post Office Box 1898
Key West, FL 33041-1898

Re: Balloon Loans (Your August 7, 1989, Letter)

Dear Mr. Hammerton:

You have asked several questions concerning limitations on balloon loans. In general, such loans are permissible regardless of the type of property securing the loan. As to extending subsequent loans to refinance the balloon payments, such subsequent loans are permissible as long as the series of transactions reflect no intent to circumvent the FCU Act and NCUA's Rules and Regulations concerning loan maturity limitations.

BACKGROUND

Your Federal credit union ("FCU") makes both residential and nonresidential real estate loans structured as either three or five-year balloon loans. Amortization for such loans is based upon a maximum of thirty years. The FCU has no contractual obligation to renew, extend, refinance, or rollover the loan. In your opinion, each balloon loan is a separate and distinct contract from any subsequent balloon loan which the FCU may extend. In some of these cases, to reduce expenses to your members, your credit union prepares and records a Mortgage Modification, rather than preparing completely new loan documents at the end of the balloon term.

FOIA Vol. I.C.2

ANALYSIS

Your questions and our answers follow:

1. "Does the making of subsequent balloon loans which would exist:

a. [Non-Residential Real Estate Secured] beyond 12 years from the date that the first balloon loan was made (to that particular member using that particular property) violate any statute or regulation?"

Answer. No, as long as there is no intention to violate the 12-year loan maturity restrictions in the FCU Act and NCUA Rules and Regulations. (See 12 U.S.C. 1757(5) and 12 C.F.R. 701.21(c)(4).) In addition, FCU's should be cognizant of all risks such loans present to the credit union's safety and soundness. Each subsequent loan must meet the FCU's written loan policies. Please note the business loan requirements found in Section 701.21(h) of the NCUA Regulations (12 C.F.R. 701.21(h)).

b. [Residential Real Estate Secured] beyond 30 years from the date that the first balloon loan was made (to that particular member using that particular property) violate any statute or regulation?"

Answer: First, please note that FCU's may issue 40-year mortgages on residential real estate secured by a first lien on the property. (See Section 701.21(g) of the NCUA Regulations for additional regulatory requirements.) Again such balloon loans are permissible as long as there is no intent to circumvent the maturity limitations found in the NCUA Rules and Regulations. (See 12 C.F.R. Sections 701.21(c)(4), 12-year limitation; 701.21(f), 20-year limitation; and 701.21(g), 40-year limitation). Your FCU must comply with all other applicable regulatory requirements.

Although permissible, such loans may present safety and soundness concerns. FCU's must extend all loans based on the FCU's written loan policies (12 C.F.R. 701.21(c)(2)). All loans must meet certain safety and soundness concerns. Your NCUA examiner and the regional office in Atlanta are better able to address these concerns.

2. "Does the use of the Mortgage Modification procedure to facilitate subsequent balloon loans violate any applicable statute or regulation?"

Answer: Your letter did not describe in detail the "Mortgage Modification procedure" used by your FCU. We assume the procedure involves adjusting the loan contract terms while retaining the FCU's required lien status on property securing a loan when subsequent loans are extended. As stated above, an FCU issuing a second loan to pay off a member borrowers balloon loan must show the intent to treat such loans separately. Merely adjusting the loan terms on existing loan documents, although economically appealing, may not reflect an intent to comply with FCU Act and NCUA Regulation loan maturity limitations. FCU's issuing subsequent loans using a modification of mortgage have a greater burden in showing the loans are separate and distinct contracts if the subsequent loans would violate the maturity limitation for the type of loan.

OTHER ISSUES

As you know, all consumer loans must comply with the disclosure requirements of Regulation Z (12 C.F.R. Part 226). Any subsequent loan or refinancings must comply with Regulation Z. NCUA recently issued guidance concerning mortgage lending in Letter to Credit Unions No. 112. A copy of Letter 112 is enclosed.

Sincerely,

Hattie M. Ulan

HATTIE M. ULAN
Assistant General Counsel

Enclosure

NCUA LETTER TO CREDIT UNIONS

NCUA LETTER NO. 112

DATE: October 20, 1989

TO THE BOARD OF DIRECTORS OF THE FEDERALLY INSURED CREDIT UNION ADDRESSED:

Credit union participation in real estate lending has increased significantly during the past several years. As a regulator and insurer, we are keenly interested in credit unions maintaining mortgage loan portfolios that are as safe and sound as existing consumer loan portfolios. To that end, NCUA met recently with credit union trade associations, industry and credit union representatives to discuss real estate lending issues and to develop real estate lending policies consistent with current industry standards.

Real estate lending by credit unions has increased to 21 percent of total assets, significantly changing the basic structure of credit union balance sheets. Policies, procedures and risks associated with real estate lending differ markedly from those related to typical consumer loans. Credit unions currently involved in or thinking about entering real estate lending must become thoroughly familiar with the implications of that decision.

<u>The information provided here about real estate lending applies to all types of real estate loans including home equity line-of-credit, second mortgage or first mortgage.</u> The following information and guidelines result from the observations of credit unions, industry experts, state regulators and NCUA:

o **INTEREST RATE RISK** - Holding mortgage loans in a loan portfolio exposes lenders to interest rate risk, meaning that interest rates could increase significantly from the rates on the loans held in the portfolio. This is true regardless of whether mortgage loans are fixed-rate or variable-rate. Variable-rate loans do control interest rate risk to a certain degree.

o **LIQUIDITY RISK** - Holding mortgage loans in a loan portfolio exposes lenders to liquidity risk because mortgage loans require large amounts of share capital. This funding need could prevent the credit union from meeting other consumer loan needs or share withdrawal requirements. In extreme cases, credit unions could be forced to borrow in order to meet liquidity needs.

o **CREDIT RISK** - Mortgage loans present a degree of credit risk which differs from that of consumer loans in view of long-term nature of the loan. Careful credit analysis of a borrower's capacity to repay a long-term debt is necessary and requires a residential mortgage credit report for each borrower. Establishing firm loan-to-value ratios on mortgage loans also helps to limit credit risk.

o **FIXED-RATE LOANS.** These mortgage loans represent significant interest rate and liquidity risk to credit unions which do not sell them into the secondary markets. Members with fixed-rate loans will typically refinance them when rates turn down and hold them when rates rise. Credit unions are advised to limit the amount of long-term fixed-rate mortgage loans held in portfolio. Other mortgage lenders sell loans into the secondary market to manage this risk.

o **VARIABLE-RATE (ARM) LOANS.** Although these loans offer some interest rate protection, they are usually made with annual and lifetime interest rate caps. In addition, ARMs are often offered at lower rates to be competitive. The lower initial ("teaser") rate and annual caps cause the return on these loans to be relatively low in the short term. ARMs also represent a somewhat higher credit risk than fixed-rate loans, and long-term ARMS can also potentially cause liquidity problems if held in portfolio. Credit unions are advised to limit the amount of long-term ARM loans that are held in portfolio. As is the case with fixed-rate mortgages, other mortgage lenders sell these loans into the secondary market to manage this risk.

o **SECONDARY MARKET LENDING STANDARDS** - The established secondary market for first mortgage loans (Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC)) has a long and successful history of making and promoting mortgage loans in the United States. This extensive experience, involving millions of loans across the country, has developed uniform lending policies, procedures and practices. The ability of lending institutions to originate mortgages and then sell them into the secondary market has enabled lenders to originate numerous loans without tying up capital for long terms. Participation in the secondary market reduces both interest rate and liquidity risk to lenders. Participation in the secondary market, however, requires strict adherence to established industry mortgage lending standards.

o **DOCUMENTATION** - Use of FNMA/FHLMC Uniform Instruments ensures that the documentation associated with mortgage loans is complete and consistent with secondary market standards. Use of other than Uniform Instruments for documentation virtually precludes a lender from participating in the secondary market. Of equal importance, reliance on Uniform Instruments provides some assurance of complete and accurate documentation of mortgage loans.

o **APPRAISALS** - Each loan secured by an interest in real property should be supported by a written appraisal performed by a qualified appraiser. Appraisers selected by the credit union should be independent of influence from either the credit union, the borrower, the seller or any other third party. Appraisers should be experienced and qualified by accredited and recognized appraisal organizations and/or state requirements. Appraisals should be consistent with the Uniform Standards of Professional Appraisal Practice developed by the Appraisal Foundation.

o **MARKET CONDITIONS/INDUSTRY STANDARDS** - Lending in any area requires a thorough knowledge of the local market, laws, customs and pricing. Credit unions entering the real estate lending field must develop a complete and current understanding of local market conditions for each market in which it participates. Failure to understand this important aspect and maintain current knowledge represents a risk.

o **PERSONNEL** - Real estate lending requires specialized skill and knowledge which is different from that of consumer lending. Staff dealing with real estate loans must be acquired either through hiring experienced staff or providing adequate training prior to developing a real estate lending program.

o **QUALITY CONTROL** - The board of directors should require regular loan monitoring reports addressing the credit, collateral and interest rate risk within the real estate loan portfolio.

REAL ESTATE LENDING GUIDELINES

Credit unions making loans secured by real estate must have in place lending policies and practices to ensure safe and sound operations. Credit unions must understand the interest rate, liquidity and credit risks peculiar to mortgage lending and rely on qualified personnel in making mortgage loans.

Credit union examiners will regularly examine for current, written board of directors' actions detailing the credit union's policies and procedures on real estate lending. Boards of directors are expected to review these policies annually. Credit unions with a significant portion of their total assets (greater than 25%) in loans secured by real estate can expect additional time and attention during the regular examination.

Credit union policies should be in writing and, at a minimum, should establish the following:

(i) Types of real estate loans that will be offered, i.e. home equity line-of-credit, second mortgage, first mortgage, fixed-rate, variable rate.

(ii) The credit union's trade area for real estate loans.

(iii) Percentage of credit union assets that will be invested in real estate loans by category, type and in total.

(iv) Qualifications and experience of personnel involved in making and administering real estate loans.

(v) Underwriting guidelines consistent with the requirements of an established secondary market, such as FNMA, FHLMC.

(vi) Monitoring and quality control standards addressing the credit, collateral and interest rate risk within the real estate portfolio.

(vii) Loan processing guidelines consistent with the requirements of the established secondary market, such as FNMA, FHLMC.

(viii) Pricing methods consistent with current market conditions and the credit union's ability to offer competitive products.

APPRAISALS (later this year, NCUA will issue regulations on appraisals, as required by the Federal Financial Institutions Reform, Recovery, and Enforcement Act. The following is not only sound business but should assist you in complying with future regulations.) - Credit unions should require a current written valuation of the market value of the property securing each real estate loan determined through the use of a qualified, independent appraiser.

Appraisers shall use the Uniform Standards of Professional Appraisal Practice in determining market value and shall document the results of the appraisal on the FNMA/FHLMC Uniform Residential Appraisal Report (form FNMA 1004 or FHLMC 70.) The board of directors should select appraisers which:

(i) have no financial interest in the real estate being appraised;

(ii) are independent of influence from the credit union, the borrower, the seller or any other third party;

(iii) have demonstrated experience in appraisals of property similar in type and value to that being considered and provide evidence of professional certification, license, or other recognition of their competence in their field, as appropriate.

NCUA will continue to monitor this area and, if necessary, make appropriate regulatory changes. Credit unions have a proven record of meeting marketplace changes and increasing their financial strength. With a sound business plan, education, training and common sense credit unions should continue their remarkable success. Thank you for your cooperation.

FOR THE NCUA BOARD

Roger W. Jepsen

ROGER W. JEPSEN
Chairman

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