NATIONAL CREDIT UNION ADMINISTRATION

WASHINGTON, D.C. 20456

September 21, 1990

Mark J. Causgrove
Supervisory Committee
American Sterilizer Company Federal Credit Union
2545 West 23rd Street
Erie, Pennsylvania 16506

Re: Conflict of Interest and Appraisals (Your August 10, 1990, Letter)

Dear Mr. Causgrove:

You have asked whether the use of an appraisal performed by a board member's spouse on a real estate loan to another board member is permissible. Although the practice is not a violation of the FCU Act or NCUA's Rules and Regulations, it may present other problems. This opinion is based on information we received subsequent to your August 10 letter.

BACKGROUND

A member of the board of directors of American Sterilizer Company Federal Credit Union ("FCU") applied to the FCU for a second mortgage on his home. You have informed us that the transaction value of the loan was less than $50,000. The board member requested that instead of using an appraiser normally used by the credit union, he received a written appraisal from the spouse of another board member. The spouse is a qualified appraiser who has done some appraisals for the credit union in the past. The FCU's general policy

FOIA
Vol I, G Real Estate
C

is to use a designated realtor (appraiser) for all appraisals; however in the past this policy has not been strictly honored since the FCU has allowed some borrowers to select their own appraiser. You have also informed us that the spouse-appraiser did not charge a fee or receive any compensation for any appraisals she has conducted for members of the board.

Analysis

LOANS

Section 701.21(c)(8) of the NCUA Regulations (12 C.F.R. 701.21(c)(8)) covers conflicts of interest and FCU loans; it states in part that:

> A Federal credit union shall not make any loan or extend any line of credit if, either directly or indirectly, any commission, fee or other compensation is to be received by the credit union's directors, committee members, senior management employees, loan officers, or any immediate family members of such individuals, in connection with underwriting, insuring, servicing, or collecting the loan or line of credit. However, salary for employees is not prohibited by this Section. For purposes of this Section . . . "immediate family member" means a spouse or other family member living in the same household.

Although the spouse appraiser is engaged in the underwriting process and is the spouse of a board member, she does not come within the purview of this section because she is not receiving any compensation for her work. Under section 701.21(d)(5) of the Regulations, board members may not receive any preferential treatment in the rates, terms and conditions of any loan made to them. Normally, the use of a requested appraiser by the board member could be construed as a more favorable loan condition. Considering this practice is not atypical at the FCU, it may not constitute preferential treatment for the board member. However, if the appraiser-spouse only does free appraisals for board members and not other FCU members, then it does give at least the appearance of preferential treatment.

APPRAISALS

Allowing the borrower, rather than the lender, to select the appraiser on a real estate loan is not a sound lending practice. This policy is reflected in NCUA's new appraisal regulation. Section 722.5(b) of NCUA's Rules and Regulations (12 C.F.R. 722.5(b)) states:

> If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the federally insured credit union or its agent, and have no direct or indirect interest, financial or otherwise, in the property or transaction. . . .

Under this section, the FCU must directly hire an appraiser free of conflict of interest. Thus, this section would prevent the board member from hiring his own appraiser (which in this case is arguably not free of any conflict of interest). However, this provision of the regulation is only effective if the transaction value of the real estate loan is over $50,000. In the FCU's situation, this provision was not violated because the transaction value of the loan was less than $50,000. In addition, the appraisal was performed before the August 9 effective date of the regulation.

On October 20, 1989, NCUA issued Letter to Credit Unions #112 (enclosed) which discussed the use of appraisers. It stated that FCU's should select appraisers who are "independent of influence from the credit union, the borrower, the seller or any other third party." Arguably the spouse-appraiser is not free of influence from the borrower-board member or the credit union since she is married to a director. Although the practice does not currently violate the FCU Act or NCUA Regulations, it is arguably not in conformance with Letter #112.

We have discussed the FCU's practice with both NCUA's Office of Examination and Insurance and the Region II Office. To conform to current NCUA guidelines and prevent further similar occurrences, the FCU should adopt written real estate lending policies stating that the FCU will directly employ qualified and independent appraisers on all real estate loans.

Sincerely,

Hattie M. Ulan
Associate General Counsel

GC/MM:sg
SSIC
90-0832

Enclosure

cc: Director, Office of Examination and Insurance
Region II Director

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 **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

TPH:ltm

U.S. GOVERNMENT PRINTING OFFICE