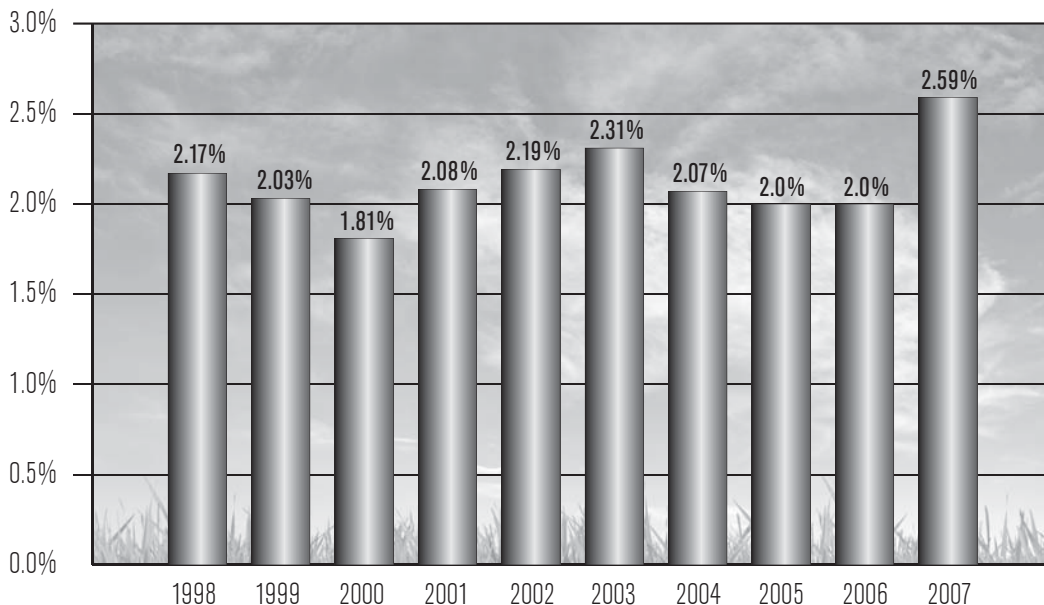


# The Credit Union Mortgage Lending Environment: How We Got Here

## Section 1

Although mortgage lending has ancient roots in many civilizations and countries, federal credit unions are relative newcomers to the mortgage lending business. They gained the authority to offer mortgages only in 1978. And although some state-chartered credit unions have always been allowed to offer mortgages, the reality is that credit unions are latecomers to mortgage lending. In the past decade, credit union market share has only risen from 2.17 percent of the market in 1998 to 2.59 percent in 2007 (figure 1.1). While the CUNA 2007 Credit Union Environmental Scan reports more than half (56 percent) of credit union members have first-mortgage loans, only a small percentage of members have these loans with their credit union. With such a small market share and percent of U.S. credit union members having chosen their credit union for their mortgage needs, credit unions have an excellent opportunity for growth. From 1998 to 2007, the dollar volume of credit union mortgage originations increased from \$31.9 billion to \$60.3 billion, about a 90 percent increase (figure 1.2).

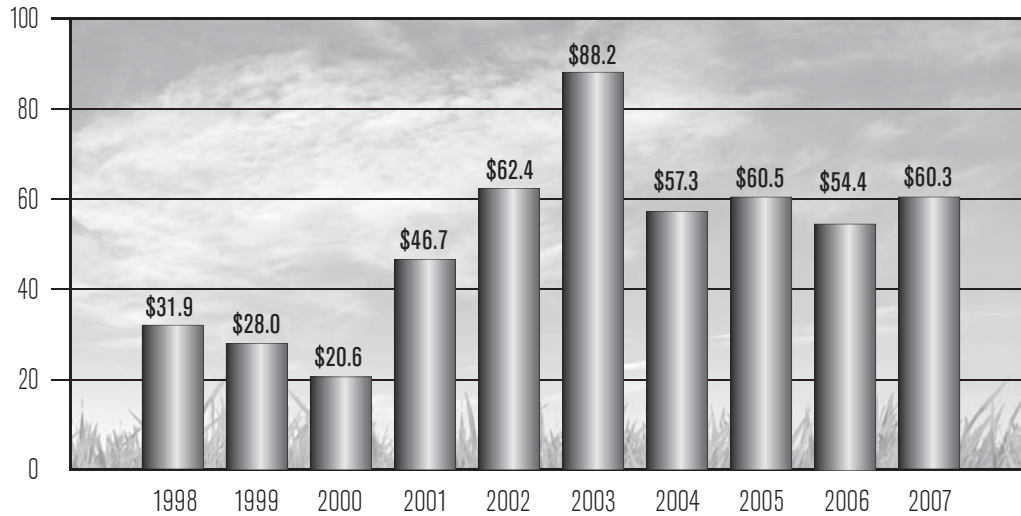
**Figure 1.1 Credit Union Mortgage Market Share**



Source: CUNA Economics and Statistics

## Figure 1.2 Credit Union First Mortgage Originations

Dollars in Billions



Source: CUNA Economics and Statistics

Despite not having captured significant market share, credit unions do enjoy a natural advantage over other financial institutions. Credit unions consistently earn high marks for customer satisfaction in a variety of surveys. For more than twenty straight years, credit unions earned the highest marks in customer satisfaction of any financial service organization in an independent poll conducted by the *American Banker*, a trade newspaper. In the last survey conducted, 71 percent who identified a credit union as their principal financial institution were “very satisfied,” compared with 63 percent of customers of banks.

In addition, the CUNA 2006–2007 National Member Survey reported that 75 percent evaluate their credit union loan rates as better than elsewhere (for members who consider a credit union to be their primary financial institution). This shows members have a much more positive view of the cost of a credit union loan compared to loans from other financial institutions.

Other financial institutions must spend a significant amount of time and resources to get the mortgage business in the door. Members, already happy with their credit union, may only need to become aware and gain an understanding of what the credit union’s mortgage program offers to consider a credit union mortgage as an option. This assumes that the types of mortgages the credit union offers meet the member’s needs—for example, a low down payment or a fifteen-year term—and are at competitive rates.

Competing lenders are willing to invest a significant amount in getting the business because if home is where your heart is, they’re aware of an important corollary: The mortgage financing of that home is the key link to the homeowner’s heart and mind. The mortgage transaction creates the strongest bond between the member and the credit union. Survey results repeatedly show that (on average)

members with mortgages use more products and services of the credit union. A CUNA Mutual survey found that some 85 percent of members with a first mortgage at a credit union consider the credit union to be their primary financial institution. The data are clear: The mortgage loan is a major factor in a member making the credit union his or her primary financial institution.

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*The mortgage transaction creates the strongest bond  
between the member and the credit union.*

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And the competition is well aware of this phenomenon. The mortgage application provides the financial institution with a mother lode of information—a complete picture of the member’s finances. This, in turn, helps the lending institution with its cross-selling efforts. Giving up a mortgage to a competing institution places the entire member relationship at risk.

Boosting the credit union’s mortgage loan portfolio has the added benefit of diversifying its assets as well as generating fee and investment income. Relying only on auto and consumer loans puts the credit union’s entire loan portfolio in jeopardy if it were to lose a major portion of the market. As the foundation of the member’s relationship with the credit union, a mortgage loan is the tie that binds. Your chances of capturing other business are increased, thereby strengthening your market position and your balance sheet.

Without a mortgage program, a credit union cannot be a full-service financial institution. Without an understanding of the pivotal role mortgages play in the member relationship, a credit union puts itself at risk of losing not only the mortgage to the competition but also other loans, savings accounts, and other business.

As noted in the introduction, being in the mortgage business is a major commitment for a credit union. The mortgage department should not be viewed as an island or a separate empire. A successful mortgage program must start with a clear commitment from the board and senior management. It must be considered an organizational priority, not as a department or product to be managed. Ideally, it affects every area of the credit union—from frontline staff to back office operations, from accounting to marketing, from board policy making to personnel decisions. Legal and regulatory considerations are paramount.

Your credit union must comply with a host of laws and regulations regarding real estate lending. Given the complex nature of real estate lending, this is not surprising. Not only must management and mortgage lending staff be trained to understand any rules promulgated by your credit union regulator and state government that pertain to first mortgage lending, but they must also understand the Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Real Estate Settlement Procedures Act, Truth-in-Lending Act, Financial Institution



Reform, Recovery and Enforcement Act of 1989 (FIRREA), and USA Patriot Act. In addition, regulatory issues related to your credit union's operations as a business must be understood and complied with.

## **A Brief History of Credit Union Regulations**

The mortgage lending regulations from the National Credit Union Administration (NCUA) have shaped the mortgage lending programs of virtually every credit union in the United States—federally chartered credit unions as well as state-chartered, federally insured credit unions. Although federal credit unions gained the authority to offer mortgages in 1978, it was in October 1989 that the NCUA addressed credit union participation in real estate lending and set forth lending issues and guidelines as a result of meeting with credit union trade associations and industry and credit union representatives. In June 1991, these issues were again addressed. The new guidelines, NCUA Letter No. 124, superseded all other real estate guidelines previously issued by the NCUA. This letter quickly provided the foundation for the way credit unions built their mortgage programs in the 1990s. Letter No. 124 reenforced that credit unions needed to offer real estate loans and that it was not the NCUA's intention to curtail them but to clarify areas of risk and concern. That letter went on to influence the way credit unions wrote lending policies and worked with the secondary market. Letter No. 124 laid out specific guidelines for documentation and encouraged credit unions to use secondary market standards for their underwriting. This letter has proven to be one of the building blocks of success for credit unions in mortgage lending.

In April 1994, under the direction of then new chairman Norman D'Amours, the NCUA issued Letter No. 154. This letter again reenforced that mortgages needed to be an integral part of the credit union strategy and encouraged credit unions to remember they were “making credit available to people of small means, for provident purposes.” It also reminded credit unions that “a strong mortgage lending program needed to be accompanied by a demonstrated ability to manage any resulting increase in risks.”

The NCUA remained relatively quiet on the subject of mortgage lending until August 1999, when it issued Letter No. 99-12. In this letter, entitled “Real Estate Lending and Balance Sheet Risk Management,” the regulator once again stated that “mortgage loans are an important loan product for many credit unions to remain competitive in serving their member needs.” That said, however, the NCUA then reminds credit unions there are a variety of risks associated with mortgage lending, including interest-rate risk, liquidity risk, and credit risk.

Historically, the NCUA has predicated the main thrust of its examination process on the comprehensive review of credit quality. NCUA examiners continue to evaluate this area thoroughly. Letter No. 99-12, however, reminded credit unions that the same prudent attention given to credit risk in earlier years

must also be given to interest-rate and liquidity risk. The NCUA made it clear that examiners evaluate a credit union's understanding and methodology for measuring interest-rate risk relative to the balance sheet risk the credit union has elected to acquire. The credit union's supervisory committee also plays a role. According to the NCUA, as an internal control measure, the credit union's supervisory committee should conduct periodic independent reviews of the interest-rate risk management process to ensure the adequacy of policies and compliance with policy limits.

In September 2003, the NCUA issued Letter No. 03-15, entitled "Real Estate Concentrations and Interest Rate Risk Management for Credit Unions with Large Positions in Fixed-Rate Mortgage Positions." At that time, the NCUA reported that of all credit unions that held first mortgage loans, nearly one in ten had 25 percent or more of its assets invested in fixed-rate first mortgage loans. Also, the ratio had more than doubled in the previous ten years. Due to concern over potentially high exposure to rising interest rates, the NCUA issued the letter as direction on managing this risk potential and to provide the questions which would be posed by the NCUA examiners.

In July 2007, the NCUA issued Letter No. 07-09, entitled "Interagency Statement on Subprime Mortgage Lending." This letter addressed risks and lending practices associated with certain subprime adjustable rate mortgage (ARM) products that can cause payment shock. The statement gave direction on prudent risk management practices for institutions offering these products. The statement also encouraged credit unions to work constructively with residential mortgage borrowers through prudent workout agreements that are consistent with safe and sound lending practices when borrowers are in or approaching default.

Credit unions can expect the NCUA to continue close scrutiny of real estate lending practices, especially considering that at the end of 2007, real estate loans comprised the largest portion of total loans at 51.45 percent.

(See Appendix A for full text of these NCUA letters.)

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*The NCUA has reminded credit unions that the same prudent attention given to credit risk in earlier years must also be given to interest-rate and liquidity risk.*

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## **Consumer Protection Regulations**

From Equal Housing Opportunity requirements to guidelines for advertising interest rates and corresponding APRs in the newspaper, mortgage lending is subject to a variety of consumer protection rules. Most of the consumer protection regulations came to be because of marketplace abuse. So chances are, additional consumer protections may be warranted in the future, particularly in



the area of e-commerce. Credit unions are dealing with these issues when they move the lending function to the Internet.

As credit unions outsource functions, they may expose themselves to unexpected risk generated by their business partners. And as credit unions make the decision to move outside of their immediate geographic area, they face the need to become fluent with state-level regulations. If they choose to do business with additional investors or the Federal Housing Administration or Department of Veterans Affairs, they encounter legal issues in both of those areas. Furthermore, almost every strategy the mortgage department implements has legal ramifications.

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It is absolutely essential for senior management to identify the necessary legal resources early on to ensure the legal impact of strategic decisions is considered. That makes having competent legal counsel imperative. For many credit unions, that means hiring outside counsel to review contracts, forms, new promotional material, and other documents associated with the mortgage lending process. Your counsel—whether in-house or retained—should be part of the mortgage lending team and advise you on the technical legal aspects of the mortgage product as well as ensure your business partners are holding up their end of the bargain.

Additional sources of regulatory information are the association resources available. Both CUNA and the Mortgage Bankers Association provide regularly updated regulatory information on their web sites. For assistance in locating vendors, both state and local associations may be a source of referrals, as are the Internet-based special interest groups sponsored by CUNA and other groups.

Like the tides, rules and regulations relating to mortgage lending may rise and fall, but you can count on them to have an influence on the way you must conduct your lending operation. Unfortunately, many credit unions fail to build a strong cooperative relationship with their legal counsel. This can result, at best, in a lack of unity within the credit union's operations and, at worst, in penalties and examination problems because of noncompliance.



## The Fine Print: Vendor Contracts Need Scrutiny

Be aware that when you outsource functions, such as the technology that drives your mortgage lending program, you need a contract in place that shares the risk. Here from Credit Union Magazine's News Now is advice on dealing with vendor contracts.

"Just because a technology vendor has a good product doesn't necessarily mean the vendor has a good contract," notes **Brian Witt** of the law firm **Farleigh, Wada, and Witt**, Portland, Oregon. "Remember, there's no such thing as a standard contract," he said. "A contract doesn't exist that couldn't be improved. Most vendor contracts start out being too one-sided—they favor the vendor too much and they need to be balanced so both parties share the risks."

Be familiar with these contract terms:

- **Term**—When the contract begins and ends.
- **Performance standards**—Clearly spelled out functional specifications. Get your vendor to commit to uptime and downtime percentages. "Less than one-half of all contracts I review spell this out," Witt says. Also include maintenance responsibilities in this section. Specify "how quickly the vendor will correct the problem or make compliance upgrades and who pays for them."
- **Renewal term**—Watch out for contract renewals that take effect without prior written notice. Notify your vendor seven months before the end of your contract (or even earlier, according to other mortgage lending experts) to say you're not going to renew under the current terms, Witt advises. "This gives you an out, regardless of whether or not you plan to renew."
- **Warranties**—Make sure your system functions well and complies with federal and state law and that your warranties extend through the life of the contract.
- **Limitation of liability**—These provisions are the most complicated and difficult to change. If a vendor disclaims warranties, put express liabilities back into the contract. Watch out for any language that limits liability amount or is a disclaimer of third-party damages. Take a careful look at language that deals with sole or limited remedies and language that imposes a statute of limitations on any legal actions you might bring against the vendor.
- **Confidentiality**—These provisions are okay if they're balanced.
- **Indemnification**—Make sure these provisions are balanced and not weighted toward the vendor.
- **Pricing adjustments**—If you don't get language to limit the dollar amount or percentage of price increases, you're essentially writing the vendor a blank check.
- **Payments**—For large installations, hold 20 percent back until you're satisfied with the system's performance.



### Section 1

## **Legal Counsel Plays Intimate and Integral Role in Mortgage Program**

*by Steve Eisenberg, executive vice president, general counsel,  
Pentagon Federal Credit Union.*

The relationship between counsel and management for a mortgage program must cover the complete continuum of a program's activities. Moreover, the relationship must be fairly "intimate" in nature. The plain fact is that a mortgage operation's legal ramifications are so complex and extensive that to have a relationship to any lesser degree than a complete marriage of the program and legal professionals will expose the credit union to unwarranted risks and exposures.

The legal terrain is simply scattered with an extraordinary number of land mines. These run the practical gamut from operational schemes that do not comport with regulatory requirements to contracts that do not provide adequate legal risk management coverage to small problems of members, which turn into costly lawsuits in terms of both monetary exposure to reputation risk.

The partnership of operational and legal resources must begin at the conception of a mortgage-related idea and thereafter, walk hand-in-hand through the program's life span. This means that, among other critical points, there must be a coordinated effort to conceptualize each element of the program; create the legal framework to support it; assist in the evolutionary process to ensure the vast array of current legal constraints are adhered to; assist in the administrative/judicial resolution of issues which arise; and, to provide counsel regarding the development of third-party support activities.

Regrettably, the bottom line is that operational activities, and particularly those connected to real estate, are heavily encumbered with legal constraints. A mortgage program cannot operate effectively or efficiently without knowledgeable input from legal counsel.

