Department of Financial Institutions

Memorandum

To: North Dakota State Chartered Credit Unions

From: North Dakota Department of Financial Institutions

Date: 7/21/2011

Re: Privately Issued Student Loan Programs and Participations

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There has been some interest lately in privately issued student loan programs. The appeal of the programs is that they offer credit unions diversity and insurance for student loan products they would not otherwise have with traditional unsecured lending, creating the perception of limited risk. While the programs may seem relatively safe with apparent diversification of risk and insurance, other programs such as private label mortgage back securities had similar safeguards. In addition, a number of risks exist which are unique to student loans. Among these is a relative uncertainty of the borrowers' ability to repay the loan when due. This risk is further exacerbated by the fact that these are fairly long term loans in a low interest rate environment. While interest rate risk is mitigated through the use of variable rates, this increases the credit risk of these loans, as any increases in interest rates will lead to increases in payment amounts for borrowers. With these issues in mind, the Department is reminding credit unions to perform adequate analysis in the following areas to ensure orderly and sound growth, and to mitigate risks of the program to the institution.

Strategic Planning

Before beginning any new program, the Board of Directors should review the program to ensure that it fits within the strategic plan of the institution. The credit union should analyze all possible risks involved with the product, and determine the possible impact on the various areas of credit union operations. Analysis which should be performed includes:

- Ensure that the limits and risks (including credit risk, interest rate risk, liquidity risk, and compliance risk) fit within the risk tolerance levels outlined in the strategic plan of the credit union.

- Projected revenue, expenses (including anticipated loan losses), and anticipated rate of return. The rate of return should be analyzed to determine if the credit union is willing to accept the added risk of the program for the anticipated rate of return.

- Analysis of the costs (i.e. fees and loan payments) to the borrower within the program.

Third Party Due Diligence
Like any program, credit unions participating in privately issued student loan programs will be expected to perform an appropriate level of due diligence over all parties involved. The Regulation and Guidance section below lists a number of resources to help the credit union in this area. The parties which should be analyzed by the credit union include:

- Counterparties originating the loan. In addition to initial due diligence, the credit union should monitor the program to determine if losses on loans originated by a particular institution appear excessive. This may indicate issues in the underwriting process at the originating lender.

- The CUSO or other party underwriting, servicing, or brokering the loan, including legal review of any agreements or contracts by an attorney representing the interests of the credit union.

- Any insurance company insuring the repayment of the loan. Due diligence of the insurance company should include the credit union verifying that the insurer is operating in compliance with North Dakota Insurance laws.

Appropriate Controls, Policies, and Procedures
To limit the risk, it is imperative that the credit union establish appropriate controls over the program. Such controls include:

- Outline the proper approval and underwriting authority

- Establish reasonable and consistent underwriting criteria

- Establish growth limits for the program to ensure slow, orderly growth

- Establish aggregate loan limits for the program

- Establish limits within each category of the risk rating system of the program

- Establish systems for management to monitor the performance of the portfolio including delinquency reports and default reports from the loan servicer

- Establish systems to properly account for the loans to ensure accurate financials and call reports, including a reasonable estimate of loan losses in compliance with FAS 5 to ensure the Allowance for Loan Loss account is adequately funded

- Establish an audit system to ensure loans granted are within the underwriting guidelines established in policy

- Establish a system for the Board of Directors to monitor the program to ensure safety and soundness

While no hard individual or portfolio limits exist in regulation, an institution must set appropriate limits. Use of the individual and portfolio limits for unsecured loans outlined in part 723 of NCUA' s Rules and Regulations may be prudent limits until a loss history for this type of lending can be established. While it is realized there are different risks with unsecured student loans compared to unsecured business loans, the lack of an established cash flow and loss history does warrant a cautious approach.

Regulation and Guidance
A number of regulations exist and guidance issued related to third party due diligence and loan participations. The following are some that should be reviewed to ensure your institution remains in compliance with regulations and limits risks where possible:

- North Dakota Administrative Code 13-03-20 – Participation Loans
- NCUA Letter to Credit Unions 01-CU-20 – Due Diligence Over Third Party Service Providers
- NCUA Letter to Credit Unions – 07-CU-13 & related Supervisory Letter – Evaluating Third Party Relationships
- NCUA Letter to Credit Unions – 08-CU-26 & related Supervisory Letter – Evaluating Loan Participation Programs
- NCUA Letter to Credit Unions – 10-CU-15 – Indirect Lending and Appropriate Due Diligence