DCU BULLETIN

Division of Credit Unions
Washington State Department of Financial Institutions
Phone: (360) 902-8701 ***FAX: (877) 330-6870***

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Guidance on 1- to 4-Family Dwelling Loans After the Enactment of S. 2155

The Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155) altered the definition of a member business loan (MBL). The revised definition brings important changes to the aggregate MBL limit, the 5300 Call Report, and the calculation of risk-based capital. Specifically, Section 105 of the Act amended the statutory MBL limit to exempt all loans secured by a 1- to 4-family dwelling from the definition of a MBL. Therefore, a credit union should not report any loans secured by a 1- to 4-family dwelling (whether or not it is owner occupied) as a MBL. The Division of Credit Unions (DCU) will publish an Interpretive Letter to clarify that due to the enactment of S. 2155, a loan secured by a 1- to 4-family dwelling is not considered a MBL for Washington State chartered credit unions, even though WAC 208-460 is not being amended to update the MBL definition.

Although a loan secured by a 1- to 4-family dwelling is no longer defined as a MBL, its credit risk characteristics remain unchanged. To evaluate the credit risk, the examiner will analyze whether the borrower is dependent on rental income from the 1- to 4-family dwelling. If the borrower is dependent on the rental cash flow for repayment, the examiner will expect the credit union to underwrite and manage the credit as a commercial loan. If the borrower is not dependent on rental cash flow for repayment, the credit union may underwrite and manage the credit similar to its residential mortgage loan[1] program.

<u>Originating a Loan with a 1- to 4-Family Dwelling as Collateral</u>

Generally if the member is not relying on the cash flow from the rental property to repay the loan, the credit union may originate and manage the credit similar to loans in its residential mortgage loan program. For example, members may own a duplex or a second home from which they receive rental income to offset the expenses associated with the property, but their primary income source, as derived from a monthly salary or other consistent non-rental income, is sufficient to make the loan payments. These types of loans may be originated and funded by the credit union's residential mortgage loan department,

[1] Residential mortgage loan means any loan primarily for personal, family, or household use that is secured by a mortgage, deed of trust, or other consensual equivalent security interest in a dwelling.

and documented to secondary market standards or other standards outlined in the credit union's internal policies and procedures. Documentation requirements and handling of these loans is not expected to be different from a typical residential mortgage loan.

If the member relies on rental income for loan repayment or a member has a portfolio of several 1- to 4-family dwellings that secure a loan or loans, then DCU examiners will expect to find the loan(s) to be originated in the credit union's MBL department.

Underwriting Considerations

If a member has a 1- to 4-family dwelling held as an investment property where the loan repayment is not dependent on the rental income and the rental property does not provide for a majority of the member's income, this loan may be underwritten similar to a residential mortgage loan program. Therefore, secondary market guidance or internal policies can dictate the maximum loan-to-value ratio, the maximum debt-to-income ratio and other criteria necessary to approve the loan. Loan underwriting and processing can be done by the residential mortgage loan department.

However, underwriting standards and the complexity of the credit risk analysis should increase as the number of rental properties financed for a borrower or associated borrowers increases. When a borrower finances multiple rental properties and the repayment of a loan depends on the successful operation of the multiple residential rental units, a comprehensive global cash-flow analysis of the borrower and principal is usually necessary to properly underwrite, evaluate, and administer the lending relationship. These tasks are typically handled by the MBL staff and not the residential mortgage loan staff. For rental properties that may not sustain sufficient cash flow to adequately pay down the loan during economic downturns, the examiner may also look for other sources of repayment, such as guarantors. Specifically, examiners will expect the credit union to fully analyze the corresponding rental market, properly analyze the sufficiency of rental cash flow to service the debt, evaluate the sufficiency of the collateral property, and satisfactorily evaluate the borrowers/guarantors.

Monitoring and Periodic Loan Reviews

The amount of ongoing monitoring for a commercial loan with collateral as a non-owner occupied 1- to 4-family dwelling is dependent on the complexity of the member's loan with the credit union and the member's income sources.

For a member using a 1- to 4-family dwelling as collateral and who is not dependent on the rental income for loan repayment, the credit union may use residential credit risk-management practices and is not expected to obtain periodic income statements and tax returns, unless needed for troubled debt restructuring or modification of a delinquency.

However, when the member is dependent on the rental cash flow from the 1- to 4-family dwelling to repay the loan, the loan should be monitored like other commercial loans. Current income statements and tax returns should be reviewed typically on an annual basis, and periodic evaluations of the collateral may be necessary as well. Management must ensure the loan adheres to the credit union's policy and procedures as they pertain to annual reviews, risk ratings, loan loss provisioning, etc. Additionally, qualified MBL staff should manage the lending relationship.

DCU understands that the credit risk management of a 1- to 4-family dwelling loan portfolio does not have a one-size fits all approach and that effective management of this program is dependent upon the credit union's size, complexity and business model. It is important that a credit union's risk assessment and its policies, procedures and processes are appropriate for the specific risks associated with the type of lending. Additionally, repayment sources should be identified and satisfactorily evaluated for sufficiency and reliability, and the credit union's loan analysis should adequately address the relevant criteria as outlined in WAC 208-460-050(9).

DCU examiners will expect to find that loans secured by a 1- to 4-family dwelling are properly identified, reported, and managed in a safe and sound manner.

Any questions regarding this Bulletin should be directed to Doug Lacy-Roberts, Program Manager, at Doug.Lacy-Roberts@dfi.wa.gov or (360) 902-8753.