



Member Business Lending Rewards, Risks & Strategies

**Member Business Lending
Rewards, Risks, & Strategies**



Presented by:
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Educational Session

Overview

- Strategies and MBL Advantages
- The Argument for MBL Lending
- How Risky is MBL Lending?
- Concepts in Underwriting
- Five Ways Credit Unions Can Minimize Risk
- Member Value Proposition with MBLs



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MBL Strategy and Opportunity

- Member or community need
- Liquidity
- Opportunity identified
- Value to membership
 - Product, consulting, price, service
- Part of the vision of the Board of Directors
- Investing to obtain the right resources
 - People - Systems
 - Business model - Risk management

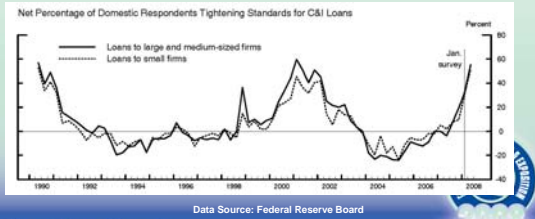


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Strategic Timing for MBLs

Accurate risk assessment & prudent underwriting are more important as competition impacts lending standards:



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Your Path to Credit Union Growth and Longevity

Growth in MBL

	Dec-04	Dec-05	Dec-06	Dec-07	CAGR*
# Credit Unions	1,560	1,730	1,851	1,987	6.24%
MBL Outstandings\$ (billions)	11.651	15.597	19.295	22.403	17.76%
Total MBL Units	83,401	101,309	115,278	127,734	11.25%
Avg. Loan Size	139,710	153,956	167,386	175,388	5.85%

* Compound Annual Growth Rate

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Your Path to Credit Union Growth and Longevity

Consumer Loan Comparison

Avg. Size	12/04	12/05	12/06	12/07	CAGR*
Member Bus. Loan	\$139,710	\$153,956	\$167,386	\$175,388	5.85%
Consumer Loan**	\$5,676	\$6,047	\$6,198	\$6,197	2.22%

*Compound Annual Growth Rate

**Excludes mortgages

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MBL Strategic Considerations

- Liquidity
- Risk Diversification
- Leverage and yield
- ALM interest rate risk (shorter & variable in certain types)
- Business development

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MBL Strategic Considerations

- Sales culture
- Deposit growth and cost
- Other income potential
- Regulatory management \$ limits and scrutiny
- Use a CUSO
- Policies, procedures, expertise, & great talent

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MBL Attractiveness

- Fee income
- Interest income
- Higher balance loans
- Variable rate loans
- Deposit accounts
 - Income
 - Fees
- Relationships
- Add member value

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MBLs: A Strategic Perspective

- Vision – not a quick solution
- Willingness to invest in the future this will take three to five years to obtain great results
- Leadership in commercial lending
- Risk – ability to judge, evaluate, accept, & manage
- Human resources



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MBLs: A Strategic Perspective

- Technology
- Expertise
- Written plan
- Financial commitment to do this right the 1st time
- Patience - business model requires commitment



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The Argument for MBL Lending

- Desire balance sheet growth
- Attractive yields
- Success by leveraging consumer lending experience and retail delivery network
- Business loans behave like consumer loans



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The Opposing MBL Argument: RISK

- MBL risk is inherently greater than consumer loan risk:
 - Credit risk more complex and difficult to analyze
 - Collateral risk heightened by limited marketability
 - Need for complicated monitoring
 - Underwriting risk if the complexity is not understood
 - Per loan exposure will significantly exceed average consumer loan
 - Yields may seem lower than needed to justify risk
 - Cost to implement the correct MBL model



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Cycle of Commercial Lending

- Identify opportunity
- Relationship - develop
- Understand need for loan
- Match need with credit union product
 - Size, collateral, rates, fees, payment terms, risk, etc.
- Underwriting & screening



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Cycle of Commercial Lending

- Appraisals
- Funding
- Servicing and monitoring
- Collection, default and/or workout 1% or less



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Managing Risk with MBLs

- Transaction Risk
- Credit Risk: cash flow, revenue source, personal income and wealth
- Collateral Risk
- Regulatory Risk
- Interest Rate Risk
- Reputation Risk



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Five Ways To Minimize Risk

1. Well-defined MBL program & policies
2. Prescreening & logical underwriting
3. Careful analysis
4. Sound risk-rating
5. Diligent servicing, monitoring & review program



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Why is Understanding MBL Risk So Critical?

Risk drives:

- Pricing
- Loan structure, terms, & underwriting
- Servicing & monitoring
- Allowance for Loan Loss (ALL) / Net profit
- Strategy



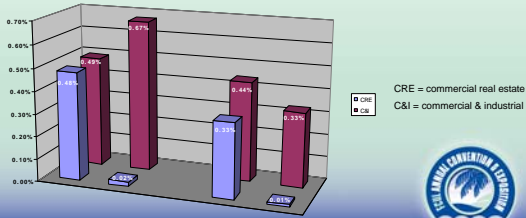
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How Risky is Member Business Lending?

- Worst experience of 100 largest U.S.-chartered banks last 12 quarters (assumes seasoned management):



CRE = commercial real estate
C&I = commercial & industrial



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Similarities Between MBLs and Consumer Loans

- Capacity / Cash Flow: Seek quality & durability
- Collateral
 - Considered secondary repayment source
 - Loan term = expected collateral life
 - Loan-to-value commensurate with risk/collateral quality
- Character
 - People pay loans



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Differences Between MBLs and Consumer Loans

- MBL cash flow can be complex to analyze
- Emphasis on MBL balance sheet trends & metrics
- MBL collateral: Less marketable = less liquid
- Capital: MBL borrower may not have as much "skin in the game" as consumer borrower
- MBLs require intensive monitoring
- Greater potential MBL loss



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Types of Member Business Loans

Two Major Segments:

- Commercial real estate (CRE)
 - Retail, industrial, office, medical, multi-family (>4 units)
 - Owner-occupied or investment
- Commercial & Industrial (C&I)
 - Most other business-purpose loans not collateralized by or used to fund real estate
 - Credit risk in one entity (no credit risk diversification)




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Types of Member Business Loans

Real Estate:

Type	Example	Characteristics
Owner-Occupied	Ford Dealership	<ul style="list-style-type: none"> • Underwrite primary business occupying property (i.e. don't rely on ability of property to generate income) • Market-approach to value • Owned by one or more principals controlling the occupant business • Usually 1-unit, or more than 1-unit if principal's business occupies > 50% of square footage
Non-Owner Occupied (a.k.a Investment)	Apartment Building	<ul style="list-style-type: none"> • Underwrite the property's ability to generate net operating income (NOI) • Income approach to value by capitalizing NOI • Below-market rents may depress value




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Types of Member Business Loans

Real Estate:

Type	Example	Characteristics
Acquisition & Development	Vacant Land Converted to Single Family Home Building Lots	<ul style="list-style-type: none"> • Finance land acquisition, construction of engineering (soft costs), and roads and utilities (hard costs). • Appraisal estimates lot absorption rate. May include bulk sale or discounted cash flow analysis if absorption is expected to extend several years. • Repayment through sale of lots to third-parties. • Release lien on individual lots upon receipt of "lot release price," which should be established so the loan is 100% repaid upon the sale of 75% - 80% of all lots. • Borrower must demonstrate sufficient liquidity to carry the project.



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Types of Member Business Loans

Real Estate:

Type	Example	Characteristics
Residential Construction	Pulte Homes	<ul style="list-style-type: none">Financing can be approved on a home-by-home basis or in the form of a master demand note sufficient to fund several homes under construction simultaneously.Standard residential appraisal should provide collateral support.

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Types of Member Business Loans

- “Going Concern Real Estate”
(Business loans with real estate as primary collateral)
- Gas station, convenience store, bowling alley, golf course, car wash, church
 - Real estate is single-purpose property
 - Appraisal differentiates between real property value and business enterprise value
 - Church loans should be supported by commitment of congregation

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Types of Member Business Loans

- ### Machinery & Equipment Loans
- Stamping presses, CNC (computer numeric controlled) machines, construction equipment
 - Some machines require building modifications and may not be practically possible to remove
 - Consider ability to access collateral in event of default
 - Lien perfection through Uniform Commercial Code (UCC) filing; UCC search if refinancing

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Types of Member Business Loans

Working Capital Revolving Line of Credit

- Repay by converting current assets to cash
- Availability based on formula (e.g. 75% of receivables < 90 days, 50% inventory)
- Current assets include:
 - Accounts receivable
 - Inventory
 - Raw materials (e.g. rolled steel)
 - Work-in-process (e.g. partial door assembly)
 - Finished goods (e.g. completed car door assembly)



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Staff: The Backbone of Risk Management

- Front-end staff (marketing & origination)
 - Business development officers
 - Loan officers
 - Credit analysts / credit officers
- Back-end staff (servicing & monitoring)
 - Loan officer (depending on business model)
 - Credit analysts / credit officers
 - Loan review
 - Collections
 - Work-out / legal counsel



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MBL Policies

- Complying with regulations a good start
- Don't forget:
 - Loan monitoring
 - Servicing and follow-up
 - Collection / Work-out
- Periodic Board review



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Sound Risk-Rating

- Weights various risk factors given the circumstances of the credit being underwritten
- “1” represents the least amount of risk
- “9” represents the greatest amount of risk



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Sound Risk-Rating

- Can help determine:
 - Loan pricing, advance rates, etc.
 - Estimates of Allowance for Loan Loss
 - Estimating likely loan profit
 - Differential handling of late payments and delinquencies
 - Differential handling of collections based on outcome predictions



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Sound Risk-Rating

- Initiated at conclusion of underwriting process, before approval
- Should be loan system data field
- Can be updated as deemed relevant
 - Collection issues
 - Covenant defaults



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**MBL Strategic Markets
Credit & Collateral Standards**

- High-risk industries
 - Contracting
 - Restaurants
 - Retail
 - Any start-up
- Capital-intensive industries
 - Speculative land development
 - Metal stamping

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**MBL Strategic Markets
Credit & Collateral Standards**

- Cyclical industries
 - Bowling alleys, golf courses, ice cream, tanning salons, landscaping
- High-risk collateral
 - Dated receivables from unrated obligors
 - Stale inventory and work-in-process
 - Unimproved or single-purpose real estate

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Underwriting: Pre-Screening

- Functions of pre-screening
 - Identify undesirable:
 - Industry
 - Borrower
 - Principal
 - Collateral
 - Assess initial risk rating
 - Formulate potential loan structure based on:
 - Why the need to borrow
 - How the loan will be repaid

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Underwriting: Pre-Screening

Why does the member need to borrow?

	Good	Bad
Declining efficiency		✓
Growth	✓	
Fixed asset acquisition	✓	
Changes in trade credit	✓	✓
Decrease in net worth		✓
Starting a new business		✓

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Underwriting and Pre-Screening

- How long has the member been in business?
- What collateral can the member offer?
- Would the member qualify for a consumer loan?
- Review the member's personal credit score and bankruptcy indicator

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Monitoring: Risk-Rating

- Can help determine:
 - Loan pricing, advance rates, etc.
 - Estimates of Allowance for Loan Loss
 - Estimating likely loan profit
 - Differential handling of late payments and delinquencies
 - Differential handling of collections based on outcome predictions

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Member Business Lending Rewards, Risks & Strategies

Monitoring: Risk-Rating

- Initiated at conclusion of underwriting process, before approval
 - Updated annually
- Should be loan system data field
- Can be updated as deemed relevant
 - Collection issues
 - Covenant defaults



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Monitoring: Review Program

- Review function should report outside of lending function
- Sample based upon:
 - Risk rating
 - Large dollar relationship
 - Delinquency status
 - Results of covenant testing
 - Specific identification



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Monitoring: Review Program

- Assess completeness of receipt of financial statements
- Analyze all current financial information
- Calculate current cash flow / collateral coverage
- Reassess risk rating



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Monitoring: Reporting

- Reports senior lending management should review
 - New loans
 - Commitments and outstandings
 - Loan-to-Value exceptions
 - Delinquency
 - Loan covenant testing
 - Document exceptions
 - Overdrafts



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Thank You!



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- Audit Services
- Risk Assessment Consulting
- Mergers, Strategies and Collaboration
- Internal Audit Co-Sourcing
- Information Technology Assurance
- Vulnerability Assessments
- Penetration Testing
- Regulatory Compliance Programs
- Loan Loss and Delinquency Control Systems
- CUSO Business Plans and Feasibility




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APPENDIX



Your Path to Credit Union
Growth and Longevity

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Recommended Reading

- FDIC Outlook (FDIC's Quarterly Industry Analysis)
www.fdic.gov
- Risk Management Association
www.rmahq.org
- Equipment appraisal & auction
www.dovebid.com
- Industry research
www.economy.com
www.firstresearch.com


Your Path to Credit Union
Growth and Longevity

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Required Knowledge

- Financial, managerial, and tax accounting
- Macro- and micro-economics
- Industry-specific business practices, trends, and life-cycles
- Corporate finance and operation of capital markets
- Analytical techniques
- Commercial loan underwriting
- Commercial credit / commercial law
- Marketing and negotiation techniques


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Recommended Qualifications

- Accounting / finance degree
- Two years of commercial lending experience, including knowledge of:
 - Cash flow methodologies
 - Various business entities
 - Loan product types
 - Documentation procedures
 - Regulations
- Strong written and oral communication skills
- Generalist for small business lending
- Specialist for asset or industry specific focus

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