

Building a Footprint for Solid Member Business Lending Practices

Introduction

Almost every headline in the daily newspaper, on-line trade journal, or evening news conveys a message of doom and gloom. Is that because there is no good news to report? Or that good news is not attention grabbing and therefore less appealing?

There are good things happening at Pennsylvania credit unions within their member business loan (MBL) programs and good news to share as a result. The purpose of this whitepaper is to focus on this positive news....that MBL programs are thriving and performing in safe and sound ways when done thoughtfully, logically, and collaboratively.

This whitepaper has been created by Wayne Grinnik, CEO of Keystone Business Lending Solutions, LLC (Keystone); Jim McMahon, CEO of Member Business Financial Services, LLC (MBFS); and Molly Snody, Director of Business Advisory Services with the Pennsylvania Credit Union Association (PCUA).

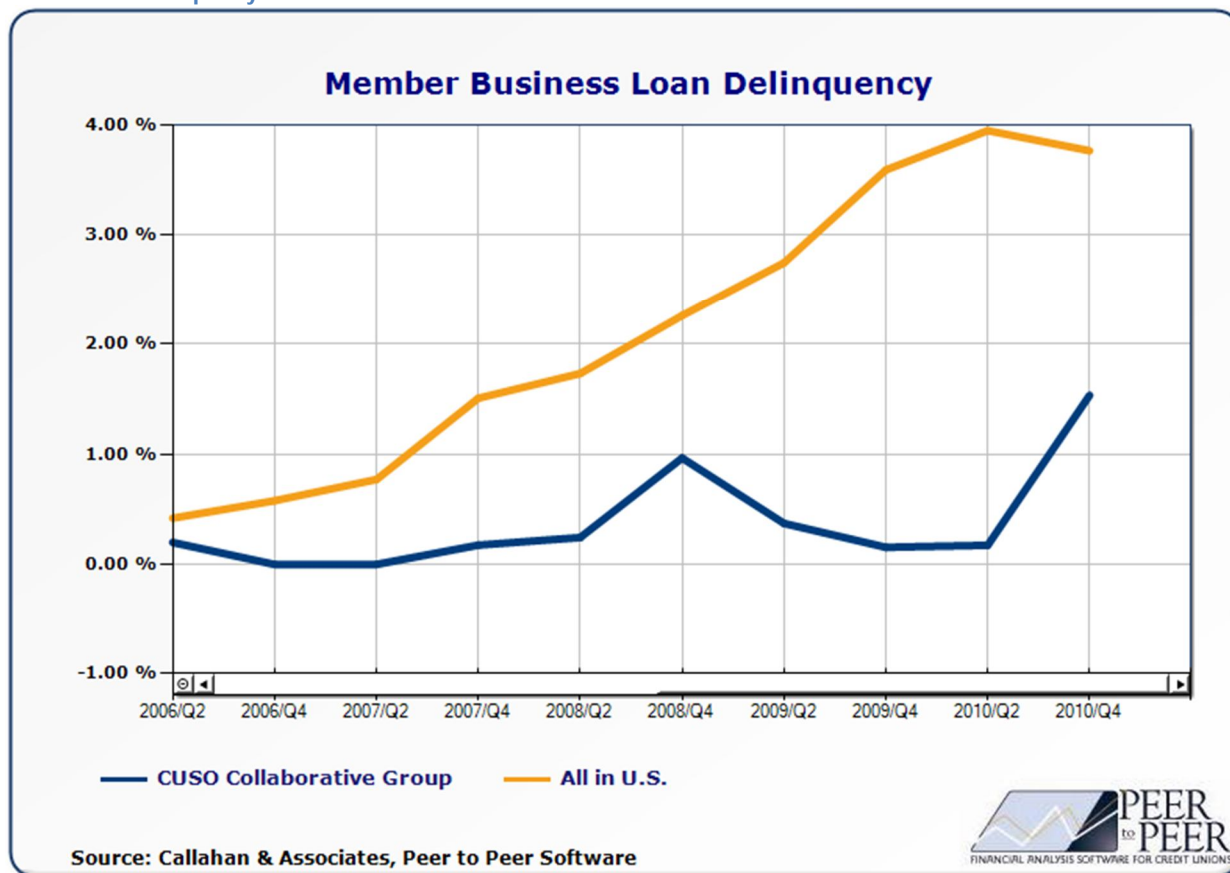
Keystone is an MBL CUSO located in Wexford Pennsylvania and provides business lending back office services to six owner credit unions and a few affiliates. MBFS is also a MBL CUSO. It is located in Philadelphia Pennsylvania and provides business lending back office services to its twelve owner/user credit unions. One of the twelve owner/users of MBFS is new to the program in 2011, so for the purposes of this report only eleven of the twelve owner/users were included in the statistical data contained in this report. PCUA located in Harrisburg provides a variety of business services to a number of credit unions in PA and neighboring states. For the purposes of this whitepaper only, the three primary clients of commercial credit analysis services were included.

Collectively, this report contains information focused on the 20 credit unions (the Group) represented by the two CUSOs and PCUA. These 20 credit unions range in total assets from \$37 million to \$1.1 billion. Total assets of the Group exceed more than \$4.3 billion. Demographically, the locations of the credit unions in the Group span from the far western counties of Pennsylvania across the state into Delaware.

Background

Examiners are more focused now than ever on defaults and delinquency, especially within MBL portfolios. Comparatively, the Group has performed significantly better than the collective group of US credit unions that offer MBLS. Table 1 on Page 2 shows this in indisputable detail. The Group had a combined MBL delinquency rate 1.54% at the end of 2010, while the nation's business lending credit unions averaged a significantly higher delinquency rate of 3.76%. In fact, the chart shows that since 2006, the Group has always significantly outperformed the nation's credit unions as a whole in terms of MBL delinquency.

Table 1 MBL Delinquency



What can we attribute this low delinquency to? More conservative borrowers/lenders in PA? A consistent and more stable real estate market? Consistent, sound business loan underwriting practices? Proactive MBL portfolio monitoring? In fact, we attribute the success of the Group, especially in the recent past, to all of the above.

How These Results Were Achieved

It is not “Back to the Future” for the Group; they never really left the past. To clarify, they began their programs with the tried and true banking practices of the past; the five C’s of credit, if you will. Even during this historic economic crisis, those solid practices have been a mainstay. The Group is benefitting from the numerous years of experience that the two CUSOs and PCUA provide. This experience is regional, meaning that we each know our own distinct market areas. When this knowledge of the local region is coupled with the service provider’s wide array of experience which includes positions as credit analysts, loan portfolio administrators, loan review officers and chief lending officers, the strength and depth of the base the Group relies is significant. In addition, the service providers also have experience in the collections and workouts of business loans. This “acquired” experience allows the Group to see beyond the numbers to fully understand each business loan request and all of the areas of risks associated with it.

The CUSOs will often work with their clients during the interview and vetting process, particularly on larger or more complex loan requests. This side-by-side type of support provides the perfect environment for credit union employees to learn to ask the tough questions of the borrower. This type of constant communication is the “steel thread” that binds the fabric in this specialized area of lending.

Each service provider also offers advice on loan structuring, making sure the cash flows and source of repayment align with the type of loan being considered.

Underwriting/Analysis

Underwriting is the most critical step in any lending process, particularly in commercial lending where the loans are not cookie cutter and each industry brings its own risks. That being said, the philosophy of the Group is to “underwrite as if retain the loan” each and every time; regardless of whether the loan may be eventually sold or participated.

Each and every loan request is subjected to an adequate amount of analysis and scrutiny which includes: the creation and review of horizontal and vertical analyses of financial data and financial trends and ratios; the comparison to peer financial data when appropriate and the measurement of the adequacy of the borrower and/or guarantors to repay debt, which is proven through the creation of the traditional primary and global cash flows; and when appropriate UCA Cash Flow. Documentation of a thorough understanding of the credit union’s collateral position and collateral values is completed as well as documentation to support the credit union’s knowledge of the borrower’s business and how the money is generated and churned and the length and complexity of the borrower’s operations and cash generation cycles. The strengths and weaknesses of any credit request are considered and weighed.

Consistency in the underwriting process has been key in providing consistent performance results. Each provider (CUSOs and PCUA) insists on the use of a standard set of financial and non financial data with each new loan request and annual review. This ensures the continual flow of output in a clear and consistent manner. In addition, each provider underwrites to a set of standards and each credit union’s individual loan policy. This again leads to consistency and uniformity in results

Risk Ratings

Having a strong and consistent risk rating system in place is not only a helpful tool at time of approval, but throughout the life of the loan. Lenders expect risk ratings on their loans to change as the health of their borrowing business changes. They recognize this as necessary process and key to monitoring their overall portfolio.

The majority of the members of the Group use the same common risk rating matrix which based on a scale of 1-8 with grades 1-4 designated as Pass grades. This type of scale provides just enough delineation between Pass grade levels to allow for more accurate portfolio monitoring than a matrix with one grade of Pass.

Collateral

While Collateral is one of the 5 C's of lending, members of the Group do not make it their primary focus. They know that cash flow is the key to ensuring repayment of loans. They are proud to say they are "cash flow lenders-not collateral lenders." To the group, liquidation of collateral is always a secondary or preferably tertiary source of repayment.

But with that said, the group largely secures its MBLs with real estate, an asset here in the Mid Atlantic Region that has historically NOT been overinflated or recently subject to swift deflation in values. Over 90% of loans granted by the Group are real estate secured. More importantly, this real estate or any collateral is located within each credit union's local market, a rule they do not stray from. We know our own markets and feel comfortable lending in them. It just makes sense.

Approval Process

NCUA Regulation 723 prohibits third party providers from approving MBLs. Most of the individual credit unions in the Group rely on their own internal tiered approval process that varies in limit based on whether the credit request is secured or unsecured. Most times, loans of a larger size or complexity require the approval of a committee or group of senior credit union staff and/or board members.

This type of collective approval process, where many people are focused on making a single loan decision, provides the opportunity for the specific strengths and weaknesses of each request to be properly discussed and weighed. This is a key risk mitigation tool.

Loan Documentation

Loan documentation is almost as crucial as property underwriting and becomes most critical when default occurs. None of the Group use consumer loan documents for their business loans. They know that true commercial loan documents offer them the best protection and the most flexibility in imposing requirements of the borrower that are unique to business lending. Both CUSOs provide proper loan documents tailored to each specific loan request. On larger or more complex transactions, the CUSOs will often help coordinate document preparation through outside counsel. Each of the two CUSOs coordinates the loan closings and provides expertise when outside counsel is preparing the document set. In short, the CUSO's ensure that the right people sign the right documents and that the documents best protect the credit union's interest.

Targeted and Controlled Growth

The philosophy of the Group has been to grow their business lending portfolios in small, manageable increments. Many felt they wanted to fully understand the process and "the beast" before their portfolios grew too large too quickly. Each credit union found that this slow controlled growth allowed them to more clearly define their risk appetite. Table 2 emphasizes the steady portfolio growth of the collective Group.

Table 2 Loan Portfolio Balances

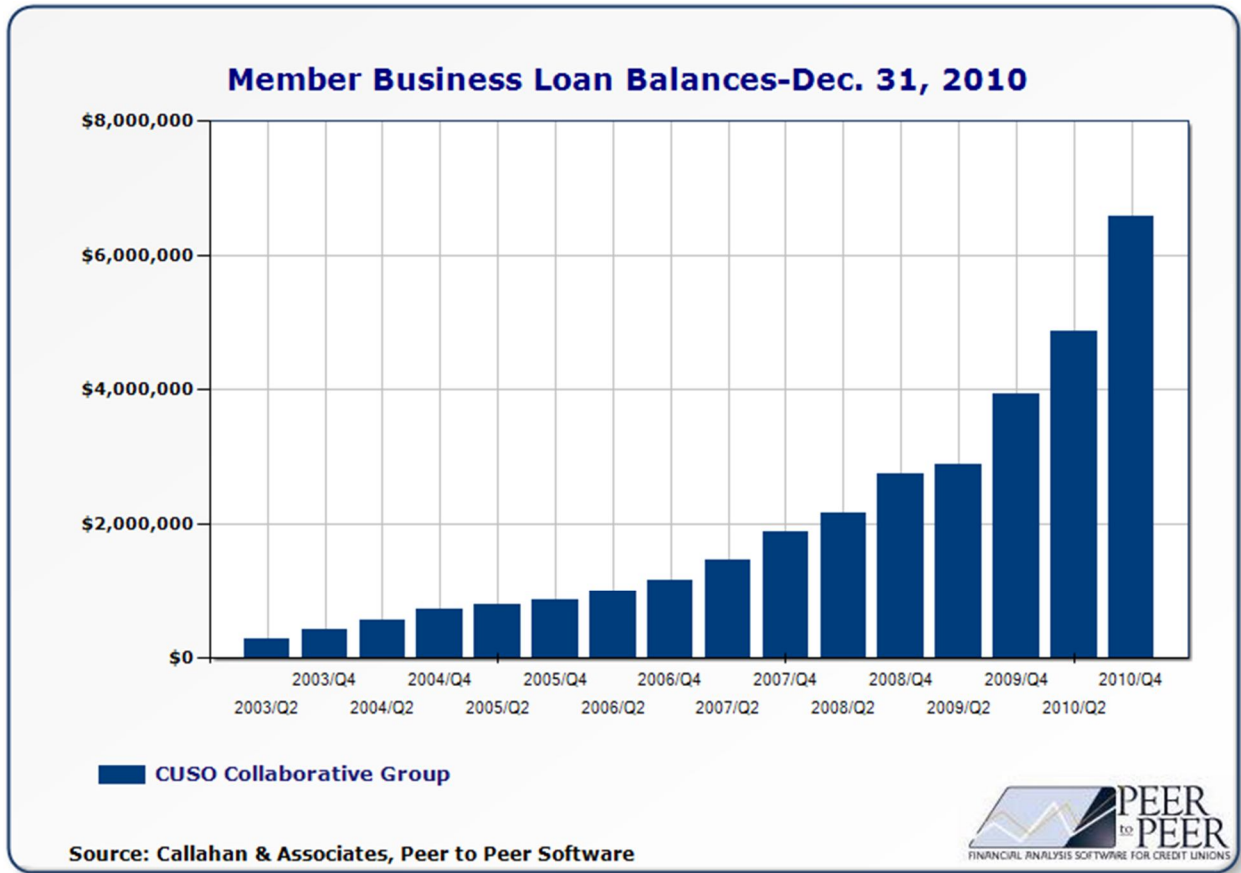
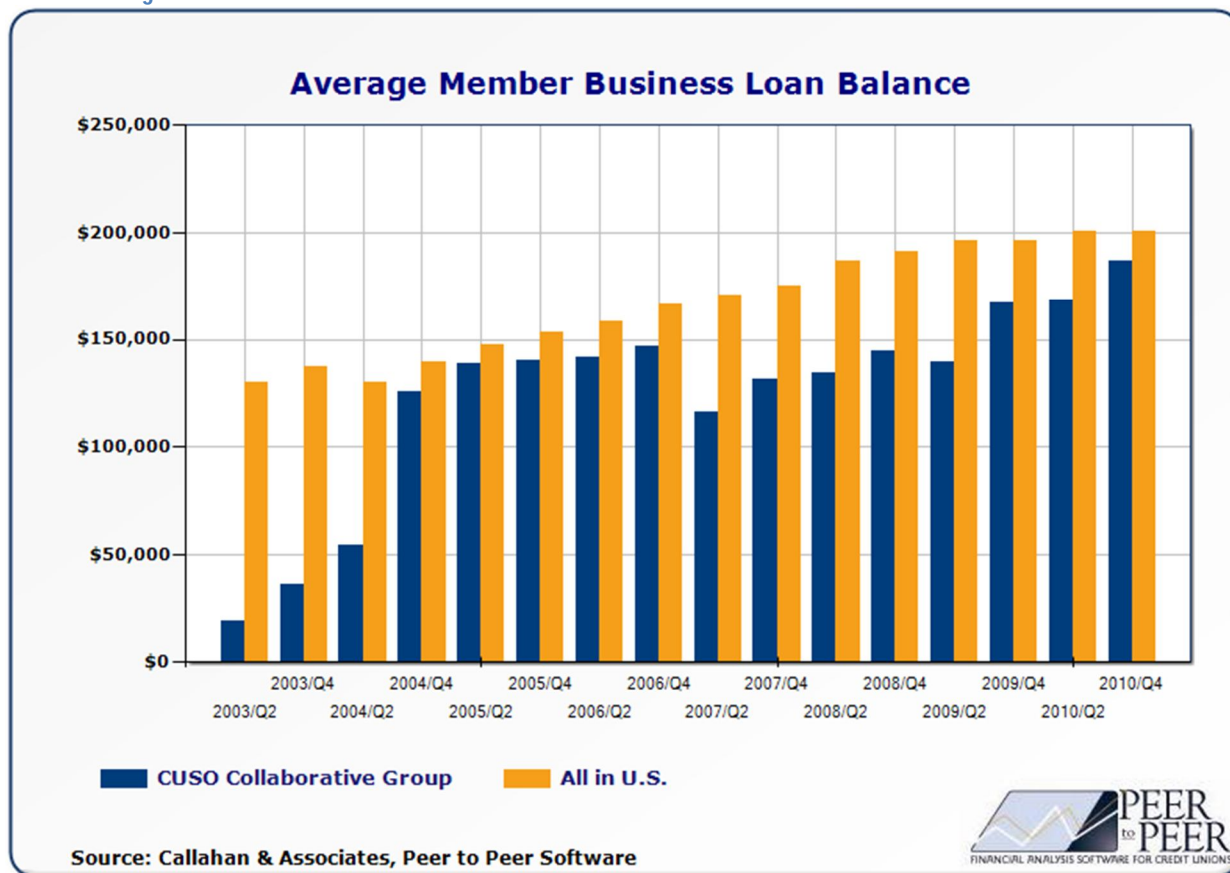


Table 3 provides evidence that the Group has traditionally made loans that on average have been smaller than the national average MBL. The growth that has occurred has not been by granting of large multi-million dollar MBLs. Growth has been slow and steady and controlled. The average loan size in 2010 for the Group was \$186,580 while it was \$200,810 for credit unions across the nation.

Table 3 Average MBL Balance



With the exception of 1-4 family rental units, the majority of the transactions could be classified as “C&I” or Commercial and Industrial loans. C&I loans are dependent upon the cash generated by the business through operations to repay the loan. These are loans granted to hair stylists, cleaning service providers, geothermal engineers, etc.

Many of the Group’s national credit union peers have found trouble in the CRE or Commercial Real Estate market; one in which the owner is generally not the occupant of the real estate and the loan is dependent upon the real estate to churn profits sufficient to cover expenses and debt. This includes loans to hotels, strip malls, office complexes, etc. CRE loans tend to be larger in dollars than C&I loans.

On-Going Loan and Deposit Portfolio Monitoring

The two CUSOs and PCUA provide initial and on-going underwriting services on loans for their life. In addition, the two CUSOs also provide commercial loan accounting services.

Clients are taught that business lending is relationship lending. Each is encouraged to not only seek out the loans, but also the depository and other ancillary products that add to the whole relationship. This not only allows our clients the right of offset in the event of a default, but it also supplies a low cost source of funds. In addition, having the depository account at the credit union allows the lender to proactively monitor the activities within the operating account to watch for abnormalities that may eventually lead to delinquency or payment blips. This early detection of operational problems as first

seen in operating accounts has allowed many client lenders the ability to react quickly to a situation before it escalates and translates into delinquency or problem loans.

The loan officers in the Group perform routine site visits documenting their comments on a “site visit form” that becomes part of the loan file. This not only shows the borrower that the lender remains interested in the business, but it allows the lender to perform collateral inspections and helps ensure that LTV compliance does not become a problem; and it allows the lender to make sure business is still being conducted as usual by the borrower. Constant contact with the borrower is a big part of a sound business lending program.

Additionally, the Group feels strongly about annually obtaining new financial information as well as tax and lien searches throughout the life of the loan; all of which are proactive portfolio monitoring practices. The group also finds it helpful to scan business papers for legal tax notices and judgments.

Participations

Some members of the Group are near or up against their business lending cap. They often sell part of their loan interests to other credit unions, often times to other members of the Group. The sale of performing loans is a great tool in not only staying within regulatory guidelines, but also a tool in managing and diversifying their loan portfolio to avoid concentrations of credit.

For those members of the Group that are the buying or purchasing credit unions, they use the following rules of thumb when making participation loan decisions: buy an interest in an MBL from only trusted sources and where the collateral is located within a day’s drive; and only buy a loan that you would book yourself; and always have it re-analyzed and the documentation re-reviewed. Some members of the Group insist on performing a site visit along with the originating lender before they commit to buying; all, strong healthy risk mitigation tools. While they may be buying small pieces of larger loans, the Group knows they are responsible for understanding each underlying business and loan structure and all of the associated risks.

Staff and Board Education

Both CUSOs and PCUA and numerous other organizations across the country provide initial and on-going educational sessions to client credit unions and others. Continual education is paramount, because business lending is complex and “you can’t hear this stuff once and get it.” It is only through repetition that business lending best practices and tips begin to make any sense. In fact, clients are encouraged to “get training on all aspects of business lending and portfolio management on going and often and from a number of sources.”

Each Group member is also provided with updated information on regulatory changes, articles concerning economic and business conditions in the market, and other general lessons learned or questions or problems.

Conclusion

Unfortunately for some credit unions and banks across the country that deviated from the five C's of credit, the economic crisis is providing a costly learning experience. For the Group, the fundamental questions outlined below are asked with each transaction and loan considered:

1. Can my borrower pay? (Cash Flow)
2. Will my borrower pay? (Character and Circumstance)
3. What do I do if my borrower doesn't pay? (Collateral)

Making sure these questions are adequately answered with each and every transaction allows the members of the Group the best possible outcome.

Authors

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