The Business Lending Opportunity for Credit Unions

Providing Value to Members While Diversifying the Loan Portfolio

For: Chief Executive Officers, Chief Operating Officers, Chief Lending Officers, Chief Information Officers, Chief Financial Officers and other Credit Union Leaders

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Executive Summary:

Many credit unions are looking to expand their offerings and recognize that the small business market is a highly desirable sector of the industry. Transitioning into member business lending (MBL) can be a challenge for inexperienced credit unions, but the opportunity it presents to drive growth and member satisfaction is substantial. This white paper explores some best practices for credit unions seeking to start up or expand their small business lending programs, including understanding your members' needs, hiring experienced staff, and leveraging the use of technology to reduce loan cycle times and help manage risk.

The Member Business Lending Opportunity for Credit Unions

The key difference between credit unions and banks is both subtle and crucial. Enter a bank branch and you're a "customer;" walk into a credit union and you're a "member." Credit unions focus on their members' best interests, and outstanding service is a cornerstone of delivering the best possible value to members. Serving the small business market is a natural extension of the credit union philosophy.

The U.S. Small Business Administration reports that small businesses have generated 63% of net new jobs in the U.S. between 1993 and mid-2013.

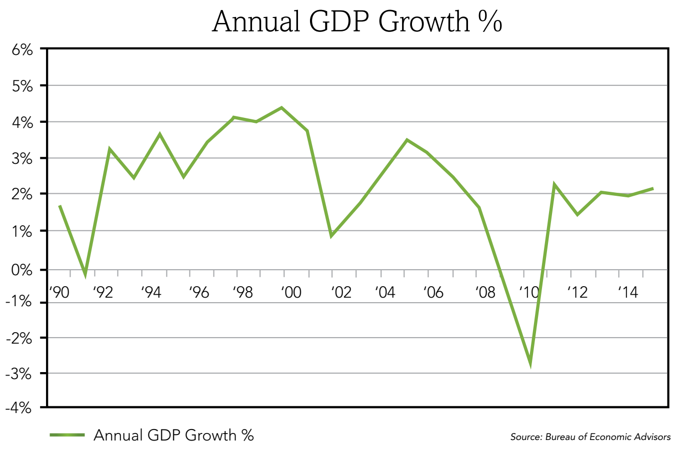
By offering small business loan and deposit services to their membership, credit unions can be an economic driver and help support job growth within their local communities.

According to Henry Wirz, CEO of $2.1 billion asset SAFE Credit Union in Sacramento, Calif., business lending is "the engine of growth in our community."

The recent financial crisis was an extremely trying time for small businesses across the U.S. Hit hard on two fronts, small businesses were forced to deal with shrinking consumer demand while facing tightening lending standards from traditional banks, effectively cutting off the supply of available capital. Faced with their own issues, banks turned their focus internally, prioritizing capital ratios over helping their long-time customers navigate the serious challenges of this historic downturn. With cash flow slowing to a trickle and no alternative sources of funding, many small businesses had no recourse but to lay off staff or close their doors forever.

Fast forward seven years and the economy is finally, fitfully on the mend. Annual gross domestic product (GDP) growth hit a low of -2.8% in 2009, but has since rebounded to a positive 2.4% rate in 2014. Similarly, the U.S. unemployment rate, which hit a high of 10.0% in October 2009, has fallen to 5.6% as of December 2014.

The American consumer has returned to work and is returning to the marketplace, and small businesses are positioned to grow once again.



Historically, small business owners have turned to commercial or community banks to fund growth, but bad memories of the recession still linger. Today, the banking industry's traditional leadership in small business banking is shrinking, and credit unions have a historic opportunity to step in and fill the void.

In this white paper, we break down the rich opportunity for credit unions in the small business sector, explain the key drivers and future prospects of this potentially lucrative market, and establish some best practices for credit unions interested in starting up or expanding their member business lending programs.

Credit Unions Find Growth Opportunities in the Aftermath of the Financial Crisis

Across the nation, credit unions are building assets and growing memberships. According to the Credit Union National Association (CUNA), credit unions saw annualized asset growth of 4.8% in 2014, compared with 3.9% growth in 2013.

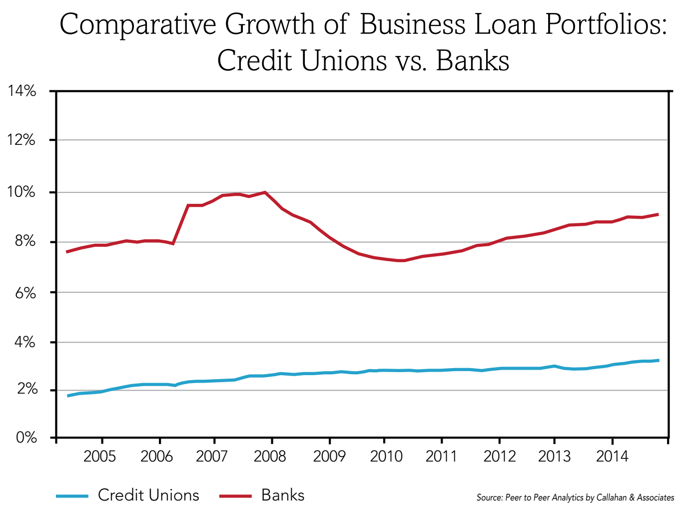
This growth was driven by a solid increase in deposits (5.7% in 2014 vs. 3.9% in 2013), along with an impressive 10.4% growth in loan balances (vs. a healthy 7.3% in 2013). Total credit union membership increased by 3.1% across the nation, up from 2.5% in 2013.

This strong, balanced growth can be attributed to a number of factors including solid fundamental performance by credit unions in consumer lending and mortgage banking. Another key, yet less examined driver is the growing trend of credit unions moving into member business lending.

Since the recession, credit union loan originations have steadily increased, from $250.8 billion in 2010 to a high of $354.3 billion in 2014. Although first mortgage originations have fallen slightly since the post-recession, the low rate home refinancing boom, consumer loans and on a smaller scale, business loans have surged to more than fill this gap. In 2014, organic growth in auto lending portfolios (20.9% for new autos and 12.9% for used cars) and MBLs (14.0%) has led the charge. As a result, average loan to share ratios have turned the corner after years of decline, reaching a healthy 74.8% in 2014.

Member Business Lending Can Drive Growth and Member Satisfaction

An examination of lending data over the past 10 years clearly supports the case for credit unions and small business lending. As the chart on this page demonstrates, credit unions steadily grew their MBL portfolios over the past decade, from 2% to 4% of total assets. Over the same period, banks' portfolios remained relatively stagnant and actually showed significant declines during the late-2000's recession, as traditional banks strategically diversified away from the small business market.

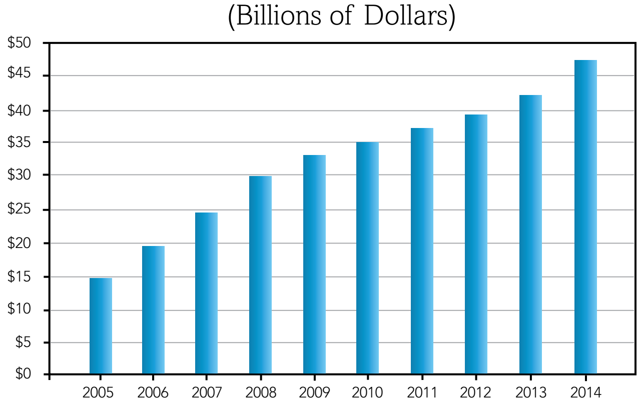


"Commercial banks have been reducing their exposure in CRE [commercial real estate] for several years now (starting around 8-10 years ago). Some banks are starting to get back into it now somewhat," says Dennis Beaver, principal at Hill Street Consulting, LLC, a firm that helps credit unions get started in member business lending.

According to Jason Bierman, vice president and chief administrative officer at $1.1 billion Corning Credit Union, "There can be a lot of opportunity [for credit unions] depending on your local market. A few years ago a lot of banks retreated in certain areas due to the recession and it was easier to gain new business. Now banks have come back and competition can be intense. There is still opportunity, but it may be more challenging to break into the market, and margins will be lower than several years ago."

According to the U.S. Small Business Administration, member business loans at federally-insured credit unions quadrupled from $11.3 billion to $47.5 billion over the past 10 years. At the same time, the percentage of total credit unions that had MBLs on their balance sheets nearly doubled from 18% in 2004 to 34% in 2014, showing a growing acceptance of member business lending as a driver of growth across the credit union movement.

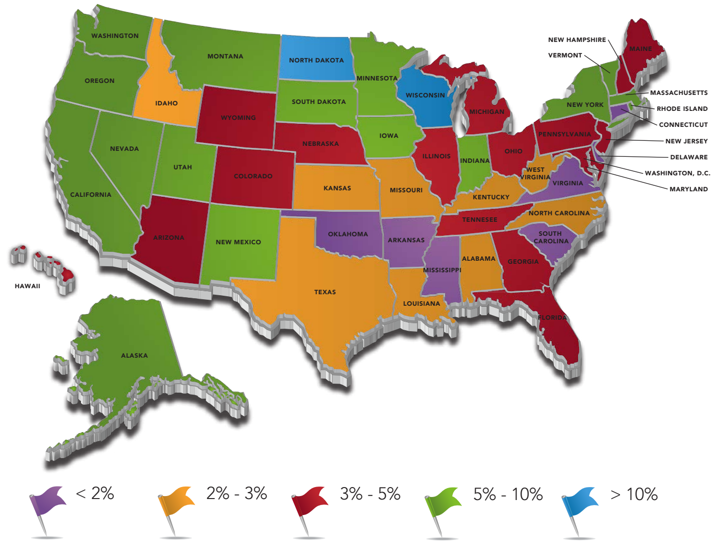
Member Business Lending
(Billions of Dollars)



Source: U.S. Small Business Administration. Note: Excludes unfunded commitments.

States with the largest member business loan portfolios as a percentage of total assets are centralized primarily in the Northeast, Midwest and West Coast of the U.S. As of the third quarter of 2014, credit unions in Wisconsin (31.9%) and North Dakota (10.2%) led the way with MBL portfolios representing over 10% of assets. Both states have long traditions in agricultural business lending.

MBL as a Share of Assets
Third Quarter 2014



Source: U.S. Small Business Administration

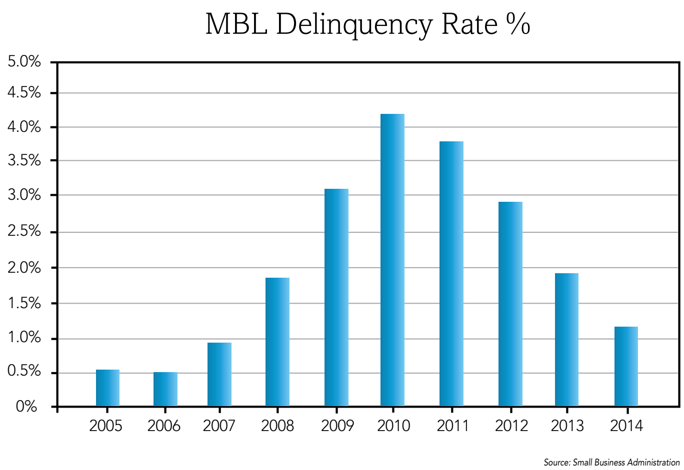
Member Business Lending is Another Way to Put the Member First

Offering a suite of small business loan and deposit products fits with a credit union's members-first philosophy. If a credit union member who owns her own business has a mortgage, share savings account, retirement account, and primary checking account all with the credit union, adding small business services is a convenient and complementary way to satisfy that member's total financial needs.

For the credit union, a successful business services program results in loyal members, profitable growth, a diversified loan portfolio and positive involvement in the local community.

According to the Small Business Administration, there were 28.2 million small businesses in the U.S. in 2011, defined as companies with fewer than 500 employees. Such businesses comprise 99.7% of the U.S. employer base. Plenty of growth opportunity remains for both established credit unions and new entrants into the market. The time is ripe for credit unions to take their share of the pie.

Credit unions have also demonstrated over time their ability to grow and manage member business lending assets in a responsible way. Despite an uptick in both delinquency and charge off ratios immediately following the start of the recession, MBL loan quality ratios have since stabilized to pre-recessionary levels.



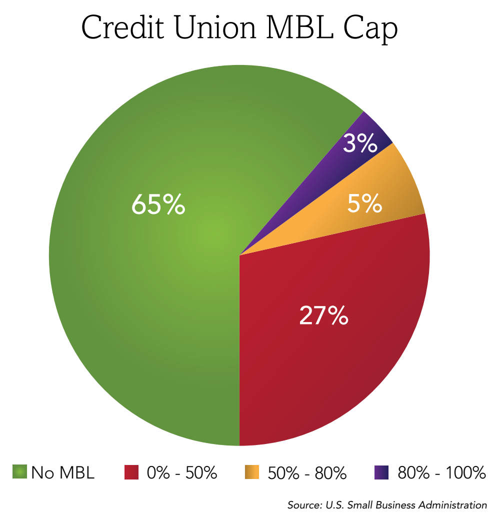
An Industry Challenge: The Member Business Lending Cap

Credit union business loan portfolios are limited by statute to 12.25% of total assets (or 1.75 times net worth, whichever is less), where business loans are defined as a loan for business purposes over $50,000 (with certain exceptions). This regulation limits the overall market size available for credit unions. However, the majority of credit unions are well below this limit.

Industry-wide just 3% of credit unions are at or approaching their statutory member business lending cap. A majority of credit unions (65%) report no member business loans. And despite significant increases in the annual volume of business loan originations and in the number of federally-insured credit unions offering MBLs over the past 10 years, this sector still represents a small share of credit unions' assets and loans outstanding. As of the third quarter of 2014, MBL represented only 4.3% of total credit union assets and just 6.8% of loans.

Despite these statistics, it is important to note that the existence of the MBL cap has imposed an artificial limitation on growth. It presents a barrier to entry for many smaller credit unions, where the financial investment in experienced business lending personnel is prohibitively expensive, considering that the credit union can foreseeably hit its asset-based cap within just a few short years. Additionally, many larger credit unions strategically manage their cap position by participating portions of their loans to keep a self imposed "cushion" beneath their statutory cap level.

Regardless, for individual credit unions, small business lending represents a significant opportunity to provide more value to members and to grow their balance sheets in a fiscally responsible trajectory. Through the implementation of smart, leading edge technology and operational efficiencies, credit unions can enter this market, serve their members and local communities, and manage their business loan cap position in a profitable way.



The current cap allows credit unions to make member business loans over $50,000 up to 12.25 percent of assets.

Loans under $50,000 do not count toward the business lending cap.

Credit Unions with exemptions to the current business lending cap have not been included.

Do's and Don'ts for Successful Small Business Lending

The transition into small business lending can be particularly challenging for inexperienced credit unions. Business loans are fundamentally different than mortgages or other consumer loan products, the traditional markets for credit unions. Studying the best practices of the banking industry and of those credit unions with a successful track record in member business lending can help credit unions just getting started to accelerate the learning curve and avoid many pitfalls.

DO use technology to improve processes, lower costs and improve the customer experience. Most credit unions will find technology to be the key to effectively implementing and transforming their business lending processes. Modern loan origination systems and portfolio management tools can quickly be configured to any credit union's specific needs, and by utilizing secure, cloud-based technologies, reports and applications can be accessed on the fly in the office, at home, or on a tablet or smartphone. Beyond helping to manage risk and performance, these tools can speed up approval times, improve the member experience and create back office cost efficiencies.

"More technology provides better portfolio monitoring, and less time touching the same document or form. It has helped us to improve our risk management and efficiency, as well as allows us to provide better and timelier service to our members."

Todd Strong
Supervisor of Commercial Credit
Corning Credit Union

SAFE Credit Union recently implemented technology to help improve its business lending processes. Karen Banda, business lending manager at the $2.1 billion credit union said of the nCino end-to-end business loan origination system, "The relationship with nCino has been transformative. I live in the system; my team lives in the system… things are moving much quicker than when we had paper files."

And Collin Patterson, AVP Commercial Lending at SAFE has been "most impressed with the openness and transparency of nCino. nCino has been a big time saver and made the loan process more efficient. The length of time from lead to loan closing has dropped significantly."

Dana Sumner is president of DFTC, Inc., a consulting firm that provides credit unions with contract underwriting, portfolio reviews and risk analysis services. He adds, "An integrated platform will be tremendously helpful. Credit unions have one system here and an Excel spreadsheet there. This opens up the potential for errors and mistakes. Systems can plug those holes; and provide an easier path through the process from origination through closing and servicing. For us at DFTC, having all the data in the cloud is hugely helpful from an efficiency standpoint, for us and our clients."

DO listen to your members. In October 2013, the *Credit Union Times* reported on a survey of small business owners' requirements to consider doing business with a financial institution. At the top of the list are robust offerings in online and mobile banking. Business members expect the ability to check balances, transfer funds and pay bills all online. To be clear, these functions are not on a member's "wish list," they are requirements. To truly "wow" a member, a credit union's mobile and online products must exceed the basics.

The simplest approach to acquiring these functions is through a third party vendor. These firms make a living by developing, maintaining and delivering the cutting edge products and features demanded by the small business owner. These tech companies have expertise in data security and cloud technology, as well as experience in best practices by serving a broad sampling of the industry.

SAFE Credit Union listened to its members and then partnered with nCino to improve their experience. Through improved process management and efficiency, Henry Wirz, CEO, says that "nCino has given SAFE's employees the tools needed to better serve their members, which has increased business and overall member satisfaction." SAFE's experience with nCino is a great example of a well-managed and well-designed back office having a very positive impact for the front lines.

DON'T try to learn business lending on the fly. For many banks and credit unions with long histories in the mortgage business and consumer lending, the transition into business lending can be rocky. Business loans must be monitored routinely. This may mean gathering and analyzing financials annually (or more frequently) for covenant tracking, reviewing collateral positions quarterly or monthly for borrowing base purposes, and routine on-site collateral inspections. Originate a mortgage or car loan and the work is done. Originate a business loan and the work is just beginning.

DO strategically select the right market. Many credit unions enter the business lending arena deciding to focus only on commercial real estate (CRE) lending or 1-4 family residential rental properties, ignoring the opportunity to lend to operating entities. According to Dana Sumner of DFTC, Inc., this is a mistake.

"Credit unions have a great opportunity if they are willing to shake off the focus on collateral lending, especially in the area of CRE," Sumner says. "Real estate loans do not have the same impact on a credit union's local community or the membership as a whole as does a loan to an operating business. If you help a business with a working capital line of credit or loan to purchase a new piece of equipment, it may result in that firm being able to create two or three new jobs. In addition, the pricing on these types of loans can help increase your return on portfolio exponentially."

DO understand the risks and expectations going in. It is important for senior management to fully grasp the unique nature of business lending and how dramatically different it is from traditional consumer and mortgage lending. Without CEO and senior management buy-in and engagement, your member business lending program is doomed to fail.

According to DFTC's Dana Sumner, making sure everyone at all levels of the organization buys in to the program is critically important. "You need to have realistic expectations – it is a business of risk, there will be charge offs. Many senior management teams and boards simply do not understand the resources required to make member business lending successful. Credit unions have a tendency to avoid staffing their business lending shop appropriately, and make the mistake of setting up for origination, not risk management."

DO hire experienced business lenders to lead the effort. It can be easy to underestimate the importance of the expertise and experience needed to successfully navigate the myriad of business lending risks, such as credit risk, portfolio risk, operational risk, compliance risk, rate risk, and so on. In general, it's a mistake to transition a career mortgage or consumer lender into a role in business banking until the program has matured and the credit union has developed institutional knowledge and experience. A more advisable approach is to hire outside staff with extensive business lending experience. This early step alone will help a credit union avoid a number of pitfalls.

"For credit unions looking to enter into this market," says Jason Bierman, CAO of Corning Credit Union, "it is important to gain the experience by hiring seasoned commercial lenders and credit analysts and/or utilizing the services of an outside consultant or CUSO [credit union service organization]."

It is important to note that the National Credit Union Administration (NCUA) specifies that a credit union must use the services of an individual with at least two years direct experience with the type of lending the credit union will be engaging in. "But this is not sufficient for most credit unions to manage the risk," says Bierman. "Don't trust the future of your organization to a junior loan officer from a bank who has just two years of actual experience."

DO familiarize yourself with credit union business lending regulations. Even for experienced commercial lenders, credit union member business lending is different. The NCUA and state regulators have established very specific requirements for MBL programs that are generally more restrictive than those of commercial and community banks. In addition to the statutory cap on a credit union's total MBL portfolio, NCUA has imposed maximum loan-to-value (LTV) and length of term requirements, limits on total construction and development and unsecured lending, and single-borrower limits. Personal guarantees are required in most cases, and credit unions are not allowed to charge pre-payment penalties. Waivers are available for some of these requirements, but not all.

DO write a business loan policy. It is difficult to implement the processes and systems necessary to properly monitor and manage a portfolio of business loans. Doing it without an overarching, well-thought out strategic vision is impossible. The regulatory and accounting treatment of business loans can be markedly different than consumer loans, and new processes are absolutely critical to successfully building the portfolio. Layer on credit risk and the need for proactive concentration management, and you can quickly overwhelm existing systems designed for consumer lending. Write a policy specific to business loans, make a detailed strategic plan and get it approved by the board of directors. This is not just good practice as the NCUA requires a federally insured credit union to adopt a board-approved written policy with very specific elements before it can make its first business loan. The board of directors must review its policies at least annually.

DO pay extra attention to credit risk. The business of lending money is predicated on one key principal above all others – borrowers must pay back their loans. Credit unions should allocate resources to ensure that credit risk comes first as the new business loan programs are rolled out across the franchise. Business loans underwritten and managed properly can be safe, profitable and valuable to the borrower; again, it's well worth the expense to hire an experienced commercial lender to lead this portfolio.

DON'T forget about checks and balances. The credit union should also ensure that management is able to appropriately review and monitor the new business portfolio on an ongoing basis. Using reporting from the credit union's core system, its origination system, and its customer relationship management (CRM) solution, management should be able to quickly, easily and regularly review metrics pertinent to the size and complexity of the portfolio. It is important to hire experienced business bankers to manage this business line; it is also important to properly monitor and supervise those individuals. No one gets a blank check!

DO use SBA Lending programs. Many credit unions have built their business loan portfolios by taking advantage of credit enhancement programs. The U.S. Small Business Administration (SBA) has a variety of programs designed to reduce credit risk and increase credit availability to small businesses. In fact, in early 2015 Chairman Debbie Matz of the National Credit Union Administration announced a new three-year partnership with the SBA on a series of initiatives aimed at helping small businesses connect with local credit unions to get better access to capital. The educational initiatives include webinars, training of NCUA examiners on SBA programs, increased availability of data resources, as well as outreach through the media. For fiscal year 2015, the SBA has also extended several borrower incentive programs, including waiver of the guaranty and annual service fees for loans up to $150,000, and the popular Veterans Advantage Program.

The 7a loan program is the SBA's flagship, but opportunities exist in the 504 program as well as the SBA*Express* small business program. The SBA's programs can be highly effective; however some require a substantial amount of paperwork and add time to closing. The use of technology is the most efficient and effective method to quickly build these processes to successfully grow an SBA portfolio. Implemented correctly, these programs can be a cornerstone for effective credit risk management. And as a bonus, the guaranteed portions of SBA loans do not count against the credit union's 12.25% of assets business loan cap.

Business Lending Can Be a True "Win-Win" Proposition for Credit Unions

Most banks' mission statements include platitudes about shareholders and returns, whereas most credit union mission statements focus instead on their member owners and fiscal responsibility. It's a distinction that consumers have known and understood for years. And it's a distinction that the business community is just beginning to learn.

Credit unions across the country are entering the business loan marketplace, and they're winning business. The trend has been growing for at least 20 years, but it accelerated noticeably as a result of the financial crisis. Members appreciate the culture of doing business at credit unions and see business banking products as a desirable value added service. Credit unions are seeking to diversify the loan portfolio, increase wallet share, and of course, provide first-class financial products to their member base.

For many credit unions, member business lending is a new market that requires new processes, people, and ways of thinking. Successful credit unions will hire experienced business lenders to design and lead the portfolio, and they'll put to use efficient and cost effective technology to provide the infrastructure. The small business loan market is robust, and a significant amount of growth opportunity remains for both established credit unions and new entrants into the market.

About the Authors

About Ted Goldwyn

Ted Goldwyn is principal at Ted Goldwyn Writing. Ted specializes in marketing, communications and thought leadership for the credit union and financial services industry. His prior experience includes over eight years in senior management as Director of Business Services at Corning Credit Union in Corning, NY, and nearly 10 years in branch management and as Vice President, Product Manager for Small Business Services at The Bank of New York in New York City. Ted holds a B.S. in Applied Economics and Management from Cornell University, and an M.B.A. in Finance and International Business from New York University's Stern School of Business. Ted may be contacted at ted@tedgoldwyn.com and at www.creditunionwriter.com.

About Jonathan Rowe

Jonathan Rowe is the Vice President of Marketing and Research at nCino, the leader in cloud banking, based in Wilmington, North Carolina. Jonathan has been studying and analyzing the community bank industry for over seven years including previously as a business professor at the University of North Carolina Wilmington. His doctoral research at the University of Auckland was on private equity investment practices in Pacific Rim countries and his MBA is from Babson College. Before beginning his academic career he served as a project manager at IBM for enterprise software integrations in the United States and Europe. Jonathan can be reached at jonathan.rowe@ncino.com.

About nCino

nCino is the leader in cloud-based operating solutions for the financial services industry. Through its Bank Operating System, nCino leverages the power and security of the Salesforce platform to deliver a comprehensive enterprise solution. Dedicated to transforming financial services through innovation, reputation and speed, nCino's technology enables financial institutions of all sizes to expand market share, adapt to meet regulatory compliance, drive profitability and optimize operational transparency. Founded in 2012, nCino is headquartered in Wilmington, N.C.