The CUSO Value Proposition: Mining Success in Member Business Lending

By Ted Goldwyn

Over the past few years, hundreds of credit unions have begun offering business loans to their members. In fact, over a third of all credit unions now have business loans on their books, an increase from just 18% a decade ago.

But much of this growth has come at the larger end of the scale—over 90% of credit unions with greater than $500 million in assets now offer business loans. Yet only about 20% of credit unions of less than $100 million in assets offer business loans to their members (Fig. 1). It truly is a tale of two cities.

But does it have to be this way? While it's true that jumping into the MBL marketplace can be a risky and expensive proposition, with the help of outside expertise such as that offered by a seasoned credit union service organization (CUSO), even smaller institutions can enjoy solid returns in this lucrative and exciting arena.

I recently had the opportunity to speak with John Hayes of CU Strategic Services, LLC, a member business lending CUSO based in Woodbridge, Virginia, along with executives at several credit unions across the asset size spectrum. In these conversations, we explored how partnering with an experienced CUSO can benefit your credit union's growth strategy and help you unearth opportunities in the business lending marketplace.

CUSO Helps Small Credit Union Dig Out From the Financial Crisis

Five years ago Jersey Shore FCU was looking for lending alternatives. Severely impacted by the recent financial crisis, the credit union's home markets of Atlantic and Cape May counties were economically hard hit by the resultant slowdown in the gaming industry in Atlantic City. The credit union wanted to explore other lending opportunities as it was becoming more challenging to put quality consumer loans on the books. The management team wanted to offer MBLs to help rebuild its loan to share ratio and take some pressure off its balance sheet. But the credit union had no commercial lending experience, and management didn't know where to begin.

"John Hayes came in and made a presentation to our board," says Jim Burns, current CEO of Jersey Shore FCU ($145 million, Northfield, NJ). "He told them that even though they didn't originate MBLs, they could still purchase participations and he could do the underwriting and all the necessary reviews to keep the credit union in compliance with the MBL regulations. This would relieve us of the burden of not having someone with experience on staff, which happens to be a big concern that small to medium size credit unions have."

Hayes helped Jersey Shore start off slowly, by purchasing loan participations in portions as small as $250,000. This allowed the credit union to get comfortable with the business lending process in a lower-risk fashion.

"Business lending has been a very good revenue source. We have looked to put as much into this lending source as we could, while keeping in mind the NCUA's regulatory requirements and our own policy and procedures for limiting risks," Burns says. "John takes a very conservative approach. He does not want anybody to go out on a limb, so when he underwrites a loan, 99% of the time it is going to be solid, otherwise he wouldn't put his stamp of approval on it.

"We've been very pleased with the results."

Benefits of Partnering with a CUSO

Jersey Shore's experience of working with CU Strategic Services illustrates one of the key benefits of partnering with an experienced member business lending CUSO: it allows you to start small and ramp up your operations slowly, commensurate with your appetite for risk while enabling the steady and gradual development of your internal staff. But a CUSO relationship also allows you to:

1. **Outsource High-priced Functions:** To start up a new business lending operation, you need to hire or develop staff for a variety of specialized functional roles, including originators to go out and get the business, credit analysts to spread the financials, and administrators and servicing specialists to support the myriad documentation and reporting needs. This expertise doesn't come cheap.

   "Building your own department is very expensive," Hayes says. "It will cost you several hundred thousand dollars before you even book your first loan. This is a huge commitment. Most credit unions can't start from scratch, in today's environment, with interest margins so tight."

   A better and less risky approach is to outsource some of these responsibilities. If you plan to originate new business loans organically, then you will need to have a locally-based loan officer to work the pavement and bring in new deals. But functions such as financial spreading and credit underwriting can easily be outsourced to an experienced business lending shop. Leading CUSOs also offer other support services including document generation, loan servicing, and concentration reporting.

   Another common service offered by business lending CUSOs is annual reviews. If your policy requires loans above a certain dollar amount or secured by specific types of collateral to be reviewed on an annual basis, you should establish a process for this right from the get-go, before you book your first loan.

   Additionally, even credit unions with a large and experienced in-house business lending team can sometimes use an extra hand.

   "It hits every shop at one time or another," Hayes says. "A credit union experiences turnover in staff. Your top lender gets sick or leaves the organization, and suddenly your staff of ten is down 2-3 people for a period of time. That's where we can step in; help you process and underwrite new credits, do annual reviews, and keep your loan quality up at the level where it should be.

"With a little help, your credit union can keep up the member service levels without hiring a new person, a process that could easily take three to six months."

2. **Build a Loan Portfolio:** Some credit unions may wish to take advantage of the business lending opportunity, but they don't serve an open field of membership in an attractive local business market, or they don't have the resources to build an origination pipeline and credit underwriting and approval structure.

   For such credit unions, purchasing member business loan participations may be a good option. It allows you to build a portfolio quickly with little of the initial overhead expense. But to minimize risk, partnering with an experienced CUSO is a crucial early step.

   United States Senate FCU ($575 million, Alexandria, VA) is the sole owner of CU Strategic Services. The credit union started the CUSO as a way to begin adding business loan participations on its books.

   "U.S. Senate has a government-based field of membership," says Susan Enis, President/CEO. "Since we're not community, business doesn't really fall our way so traditionally we've not been into business lending. The good news is that we've got this affluent, financially savvy membership. The bad news is that they have the wherewithal to not borrow unless they need to and a lot of times they don't need to.

   "A lot of credit unions are in the same boat that we are in. They need to grow their loan portfolio, and they don't want to do it recklessly. They need to do something else, and that something else is member business loans, but they don't have the expertise on staff."

   U.S. Senate did have John Hayes on staff, and John brought thirty years of commercial lending experience to the table. So Enis and her board decided to start up CU Strategic Services as a CUSO, with the intention of offering its services to other credit unions with similar balance sheet woes.

   "John is doing two things," Enis says. "He's analyzing and reviewing the loans, acting as that independent review factor to supplement the Credit Union's review process. But he's also finding loans and helping credit unions like us that need to diversify our portfolio and bring up our loan-to-share ratio."

3. **Train Your Staff:** Top business lending CUSOs hire the best and brightest commercial lenders from the credit union and banking industries. Often, staff have decades of experience working in the field as commercial lenders, credit underwriters, and analysts. Some even bring a workout or collections background, so they're familiar with the common warning signs of bad credits.

   With this type of expertise on staff, it's no wonder that training and development is a core competency of many of these firms. CU Strategic Services is no exception. Hayes, along with his well-seasoned senior team of Eric Kirn and Astrid Csida, offers hands-on training to his credit union clients. This training is often offered as an additional benefit of an onsite consultancy engagement. Or it can be provided in a more formalized and structured multi-day workshop setting.

"John and his crew were on site with us for a week doing annual reviews," says Cathy Benson, chief lending officer at CFCU Community Credit Union ($955 million, Ithaca, NY). "During that time, we had just brought a new staff member on board, and they trained him for three days while doing the annual reviews. He was able to sit with them and learn the process.

"It really was a priceless situation because not only are they helping us get through our workload, but they brought their expertise in house to train our staff."

4. **Assist with regulatory and compliance challenges:** Without a doubt, business lending is a risky business. Some credit unions get in too deep, too fast, and need help digging out. This happened to one larger credit union that Hayes worked with recently. Although the organization was considered generally safe and sound, once it started originating business loans, its portfolio grew very quickly, and the lending operation had a tough time keeping up.

   As a result, staff training was put on the back burner, annual reviews began stacking up, and delinquency began to rise. During a regularly scheduled NCUA exam, examiners discovered some compliance issues and noticed that annual reviews were not getting done. The agency issued a cease-and-desist order to the credit union, requiring them to obtain outside help to clean up the portfolio before taking on any new business loans.

   Fortunately, the credit union hired CU Strategic Services to help get them out of this jam.

   "We met with the management team, interviewed their staff, and put a project plan together," Hayes says. "We put together a development plan for their staff, and helped them get caught up with their annual reviews. Within six months, NCUA came back in and saw that we were making good progress. Within nine months of the original exam period, they released the cease and desist order and the credit union was back on track."

5. **Connect You with a Participation Network:** At some point, all credit unions that get heavily into business lending, unless they are exempt, will bump up against the statutory 12.25% of assets business lending cap. Digital FCU ($6.5 billion, Marlborough, MA) found itself in this situation about five years ago.

   "We started off working with CU Strategic Services mainly because of the cap," says Stephen Mackowitz, senior vice president of business lending at Digital. "Participating loans also helps us manage our concentration risk in terms of type of industry, as well as loans to one borrower.

   "John's group adds an audience for our participations. We have some credit unions that we deal directly with, but I am always looking for new credit unions to buy participations. John's group basically opens up the market for us; they provide another 20 or 30 candidates to take a look at our deals."

Choosing the Right CUSO For Your Credit Union

So, you've decided to engage a CUSO to help your credit union start up or grow an MBL program. What now?

Conducting thorough, up-front due diligence is critical for ensuring a smooth and beneficial working relationship with a CUSO. Credit unions with experience in this area offer a checklist of items to consider before entering into a relationship with an MBL CUSO.

Here's where to start:

1. **Investigate the CUSO's track record and lending philosophy—**In your earliest conversations with the CUSO's management, you'll want to ask some probing questions, such as:
    - How many loans has the CUSO underwritten?
    - How many have gone delinquent?
    - How many, if any, have resulted in a charge-off loss to the originating or participating credit unions?
    - What has the CUSO learned from these experiences? Have they changed their lending philosophy or underwriting policies and procedures?

    It is important that your credit union's lending philosophy and risk profile is in line with the CUSO's. Otherwise, you're asking for trouble. Compare your policy and procedures with those of the CUSO before you sign on the bottom line, and ensure that your general approach to risk is compatible.

2. **Interview the staff—** Hayes recommends that you treat the due diligence period of vetting a new CUSO, or any vendor, as if you were conducting the hiring process for a new employee.

    "Interview the staff of the CUSO like you would any new hire," Hayes says. "The CUSO will be working for you now. Do they have the necessary expertise, as well as mindset, to be a good fit with your organization? Or will you be butting heads at every turn?"

3. **Check references—** Ask for references up front. If a CUSO is reluctant to provide them to you, that is an obvious red flag. But don't just file the references away in a drawer; you can learn a lot by speaking with a CUSO's clients. Ask questions like:
    - How long have you been a client?
    - How has the CUSO helped you to meet your organizational goals?
    - Do they meet deadlines consistently?
    - What is your business lending risk appetite?
    - What is your lending philosophy?

4. **Size matters –** CUSOs don't need to be huge to be effective. In fact, a small company is more likely to provide personal service, and the CEO will likely be intimately involved in every engagement. However, the CUSO should be large enough to have multiple business lending

experts available to serve your specific needs. Consider it as a form of succession planning; if your engagement lead becomes unavailable for any reason, someone else with comparable skills should be available to step in, in a pinch.

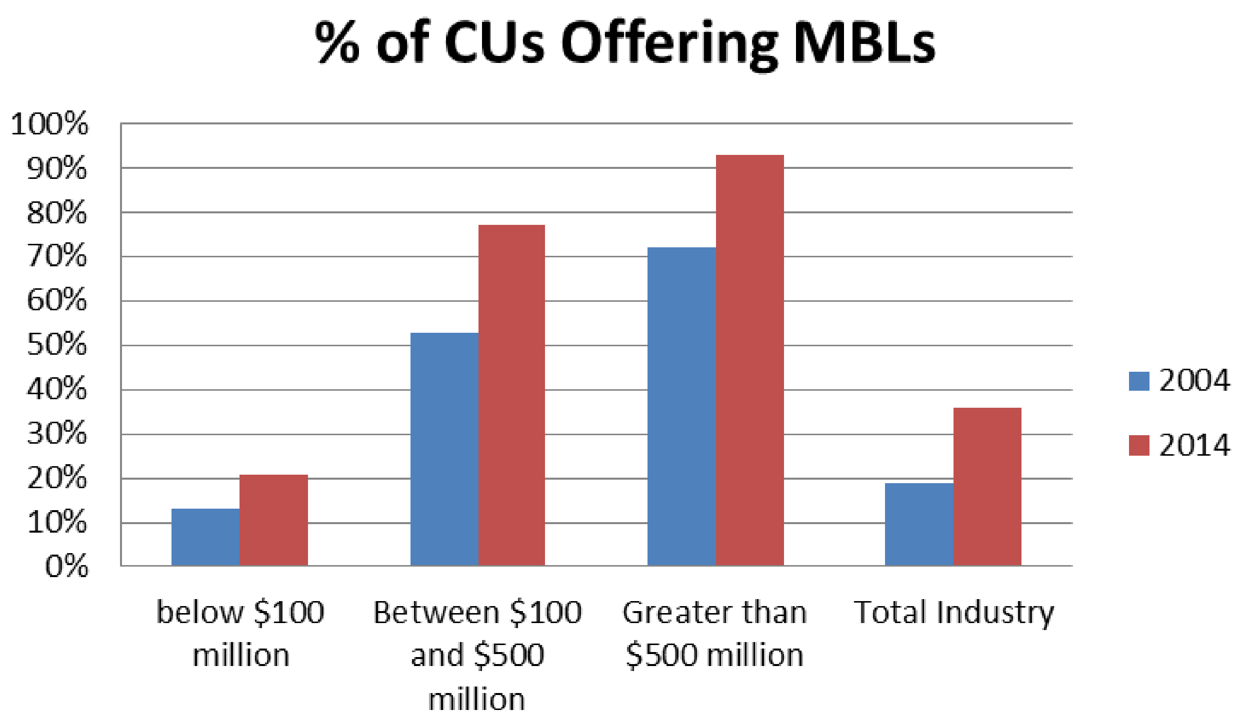
5. **Do they inspect every property personally?** This is critically important if you are considering purchasing participation loans through a CUSO. Surprisingly, not all MBL CUSOs do this as part of their due diligence process. If the CUSO is underwriting the loan for their credit union client, or even re-underwriting it for sale and putting their stamp of approval on a loan, they should have a good, solid understanding of the local market where the loan originated. And they should actually go and visit the property as a standard part of the underwriting process.

   "I like the fact that John's group personally inspects each property," says Stephen Mackowitz, of Digital Federal Credit Union. "Of all the people that I have sold loans to, John's group is the only one that personally inspects the property. If I were using a group like John's I would hope that an inspection would be part of the due diligence."

Dig Deep for Nuggets of Business Lending Gold

Industry experts agree that if your credit union is ready to explore the member business lending goldmine, you should first consult with an experienced CUSO to help you get started. It is a cost-effective and low-risk way of entering the market, allowing you to scale up your operations in accordance with your available resources and appetite for risk. With years of experience and specialized expertise on staff, top MBL CUSOs are in the business of helping you select the richest veins of opportunity, while guiding you away from the riskiest and most costly mineshafts. Happy digging!

Fig. 1:



Source: National Credit Union Administration. Data includes all federally-insured credit unions in U.S., including unfunded commitments, as of 3Q 2014.