

Shared Risks Bring High Returns for Both Credit Unions and Members

by Jim Jerving, Contributor

As financial margins continue to shrink, adding business loans to the credit union lending portfolio is becoming a well-traveled road. The risks are higher, but the yields on business loans typically outpace consumer loans.

Credit unions have several options. The first is to develop a business lending department which involves costly resources and an experienced staff. The second choice is to outsource the operation to a third party, much like a credit card provider or mortgage lender.

A third option is to join with other like-minded credit unions and form a credit union service organization (CUSO). A CUSO offers many benefits: risk is spread among partners, a diversified portfolio, and the opportunity to generate income within new geographical areas. And member credit unions have the ability to develop their staff's expertise in business lending without an expensive trial and error process. By partnering with others, the credit union can hold multiple small loans instead of several large loans, an enviable posture to maintain if a large loan goes sideways.

Wright-Patt Credit Union

Business lending CUSOs are not solely the province of smaller credit unions; larger credit unions are also taking advantage of this cooperative venture. The \$1.1 billion asset Wright-Patt Credit Union in Fairborn, Ohio is a case in point. Wright-Patt CU was one of the founders, along with six other credit unions, of the Cooperative Business Services (CBS) CUSO in August 2003. Currently, it is owned by eight credit unions and the Ohio Credit Union League Service Corporation.

"Joining a CUSO is a good way to share financial risk; business lending is expensive," said Doug Fecher, CEO of Wright-Patt CU. "You need to purchase underwriting, packaging, computer software and do the record keeping. If it doesn't work out you can have a significant loss."

Wright-Patt CU has between \$6 million and \$7 million in business loans on the books. There is value in taking part

in a venture that is unique in the financial industry. Banks participate in loans through a process of syndication, similar to credit union loan participations. But no other organization in the financial services sector has a cooperative business lending service similar to a credit union CUSO. The credit union cooperative nature is part of the reason.

"Credit unions can compete on car loans, but they come together for business loans," said Keith Reed, chief operating officer for CBS. "A number of the owners are in each other's markets, but we go out as a united front and develop opportunities."

Another advantage is information sharing. "We all learn from each other—business lending is quite a bit different from consumer lending," said Fecher. "And it allows us to say yes to the owner of a small business."

Shared Resources

Most business lending CUSOs have small staffs with partner credit unions usually employing one staff member to act as liaison. CBS has four staff members, which is typical for CUSOs specializing in business lending services.

The staff includes a controller, who handles the financing, loan servicing, financial records and statements. A compliance officer manages the loan closings, audits the credit files and ensures that all documents are in compliance. A third staff member completes the underwriting, structuring of the loan and provides credit training to participating credit unions. Keith Reed manages the CUSO and "does a little bit of everything" as can be expected in small operation.

The financial results for the CUSO have been notable considering it has been open for business just two years.

Over a two-year period CBS reached \$25 million in funded transactions and averages about \$1 million a month in business loans. The breakdown of loans is: 85%, commercial real estate, investment properties or small business offices; 10%, term finance, machinery or working capital; and 5%, lines of credit.

“Our approval rate is now averaging 55%, which is lower than I would like it to be,” said Reed. “We expected it would take three to five years to be profitable, but as of August 2005, we’ll be profitable. The first year we had a small loss, which was expected.”

Shared Risk

One of the tangible benefits of CUSO membership is the loan participations available to the owners. This allows the credit union to diversify its portfolio and spread the risk among all partners. Loan participations allow the owners to earn a higher rate of return with a lower cost of funds since the costs of the loan—like the risks—are shared. And since CBS offers floating rate products at prime, plus the spread, the lender is better protected against the threat of interest rate risk.

According to the ownership agreement, CBS requires that the lead owner credit union offer participation to the other owners for any amount over \$100,000. After the loan is approved and underwritten, each member credit union gets a chance to say whether they are interested in participating and at what percentage. The originator of the loan can keep up to 50% of the loan. The range of loans completed through CBS is from \$15,000 to \$7 million, with an average of \$500,000. If a loan participation exceeds \$500,000, CBS organizes a conference call with all participants to discuss the agreement.

Even though the loan participations are voluntary, most of the credit unions participate. The formula for participation was changed since the CUSO was formed.

“At first we based the loan participation on asset size; the larger the assets, the larger the participation,” said Fecher. “That worked well for us, but it was a disadvantage for the smaller credit unions. Now the originator has the option to keep up to 50% of the loan.”

Credit unions that are not owners of the CUSO can hire CBS to perform business loan functions for them. The “client” credit unions are able to partake in loan participations if the loan is not completely funded by owner credit unions.

Sound Infrastructure

The key to a successful business lending CUSO is a strong foundation. “Keith Reed is a very good leader; he insisted on a building a strong infrastructure,” said Fecher. “You need an effective underwriting system, a quality system and the assurance that each loan closing gets a thorough examination.”

Hiring staff with people and communications skills is also critical. “You need to invest in talent,” said Reed. “It is vital to have business lending in your arsenal. You need to cross sell services. The more services you offer, the more likely members will stay with the credit union. Business owners will expect their lender to provide all of their financial services.” ●

The owners of CBS CUSO, all located in Ohio, are:

AurGroup Financial Credit Union	Fairfield	\$154M
Chaco Credit Union	Hamilton	\$118M
Code Credit Union	Dayton	\$68M
Day Air Credit Union	Kettering	\$136M
Mid-First Credit Union	Franklin	\$197M
River Valley Credit Union	Miamisburg	\$126M
Wright-Patt Credit Union	Fairborn	\$1.0B
Kemba Financial Credit Union	Columbus	\$263M
Ohio Credit Union League Service Corporation		