DCU BULLETIN

Division of Credit Unions

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Structuring a Member Business Lending Program

This Bulletin is intended to share the practices examiners will be looking for as they review the elements of member business lending (also known as commercial lending) operations. It is intended to be consistent with the safe and sound examination standards as set forth by the FDIC in 12 CFR Part 364, Appendix A. All elements of this Bulletin may not be a requirement of all credit unions. Examiners will particularly be concerned with these guidelines when a credit union reaches $25 million or 5% of assets (whichever is less) in commercial loans. As the complexity and size of a credit union's commercial lending program grows, the credit union should enhance appropriate elements of the program structure, including its policies and procedures.

We acknowledge that size limits imposed by a credit union on individual loans and the overall program as well as certain lower risk types of commercial loans can ease examiner concerns. Credit unions doing million dollar construction loans have a very different risk profile from a credit union doing single family residence rental loans for less than $300,000. For the higher risk loans, examiners will be looking for stronger controls to manage that risk.

Research & Planning are Vital

Background research and planning are essential for a successful commercial lending program. Examiners will be interested in how you critically assessed your credit union's commercial lending abilities and resources against the needs of a sound program prior to making the decision to embark in commercial lending. The preliminary and on-going research and planning will be vital given the inherent risks in commercial lending and the initial lack of experience a credit union may have in this market. Both research and planning are crucial and should not be short-changed.

Examiners will be interested in how the credit union address these important questions regarding the credit union's research prior to implementing or significantly expanding an MBL portfolio.

1. What are the membership's business relationship needs?
2. Is there a commercial lending market that the credit union can penetrate and realistically service better (more than just price) than other local financial institutions?

3. What are the credit union's strategic, operational, and financial needs; and does developing a viable commercial lending program meet those needs?
4. Will developing a commercial lending program divert necessary resources from other key operational areas?

The due diligence process should fully analyze the different approaches for commercial lending given the personnel, operational, and financial resources of the credit union. Often, by starting small and increasing your credit union's commercial lending exposure in a measured way, management can incrementally assemble the resources and expertise to implement a comprehensive program without subjecting your credit union to undue risks.

<u>The main concern from both a regulatory perspective and a credit union point-of-view will be ensuring that appropriate commercial lending expertise is available to best mitigate MBL risk.</u>

If management determines this is not the right time to start a commercial lending program of material size (in excess of the lesser of 5% of assets or $25 million), management may want to explore other means to meet their membership's commercial lending needs. Here are two alternatives for serving their membership's commercial borrowing needs:

1. Setting-up a system whereby the credit union accepts a commercial lending application from its member and then sends it to an experienced commercial lender (for example, another credit union) to underwrite, originate, and to fund. The original credit union then purchases an interest (up to 100%) in this loan.

   It remains the responsibility of each credit union with MBL loans or participations to be able to demonstrate the capacity to analyze, approve, monitor, and manage the risk of each loan and loan type in their portfolio. Frequently the more complex MBL types will require special knowledge or skills for analysis, monitoring, and risk management.

2. Setting-up a commercial lending program, that is limited to only those types of MBLs for which the credit union has sufficient expertise, processes, and systems in-place. For example, the credit union may limit commercial loans to non-owner occupied 1-4 unit real estate properties or commercial vehicles or equipment loans.

MBL or Commercial Lending Expertise

It is critically important to the success of a MBL program that management find <u>and retain</u> individuals who understand the intricacies of commercial purpose lending. It is important to strive for a breadth of commercial lending expertise and knowledge suitable to the loan types provided for in policy. The experience required in WAC 208-460 is a minimum. The expertise factor becomes more important as the breadth of commercial loan products increases, as the size of the loans grow, and as the speed of the overall program growth increases. Experience derived through an entire business cycle is highly desirable for larger more complex loans and portfolios. If your credit union intends to grow the program gradually over a period of years, the credit union is more likely to be able to train staff in house.

The need for expertise includes knowledgeable commercial lenders on the Credit Review Committee if such a committee is to approve MBLs. The credit union may need to employ consultants to sit on this committee to provide a suitable breadth of expertise and to advise those who lack expertise.

When credit unions become involved in commercial lending, they find that borrowers often rely on them to provide "professional" guidance on the viability and structure for the project and loan. This responsibility is recognized by the courts as well. Often courts and juries assume financial institutions to be the expert and they are assumed to grant only loans that are financially sound viable projects.

The credit union staff must also be ordered to provide for adequate credit analysis, proper underwriting and loan structure to mitigate the risks of the loan, as well as ongoing loan administration. A candidate for a position in a credit union may have what looks like extensive experience but upon further consideration you may find the experience does not adequately provide for all aspects of the work you will be asking of the position.

Finally, if the loan or portfolio size is sufficiently large or if the loan type pursued by the credit union is higher risk, it is very important for the individual with the expertise to have adequate authority (and accountability) to guide the commercial lending program. It should be clear that expertise is of limited value if a more senior officer with no commercial lending expertise is to approve the loans simply based on the marketing plan for the credit union.

Elements of a Commercial Lending (MBL) Planning Process

A key element of success in starting or expanding the MBL program will be understanding and bridging the knowledge gap from not having performed commercial lending in the past. In order to bridge this gap, credit unions will need assistance from experienced commercial lenders. A word of caution here is appropriate. When the credit union management does not have experience in commercial lending, it can be difficult for them to recognize what they don't know and why it is important.

Successful sound MBL plans set program goals, establish limits, and determine resources to be allocated to the program. Plans should also develop policy requirements and guidelines for implementing the program. It is important that the MBL plans be realistic, customized to the credit union needs, and in compliance with safe and sound standards. Examiners will expect to see that the following general areas were considered in the MBL planning process:

1. List specific program goals
2. Identify resources (human and operational) to be allocated to the MBL program;
3. List responsibilities and appropriate delegation of authority for all individuals and committees involved in the commercial lending process
4. Identify program limits and restrictions, including but not limited to:
    - Aggregate MBL program limits,
    - Geographic area restrictions,
    - Industry and loan type limits, and
    - Unacceptable loan type restrictions
5. Determine the operating systems to be used and ensure they have the necessary flexibility and capacity (including loan documentation, cash flow analysis, tickler system, loan reporting, and accounting system)

6. Understand and provide for special legal expertise required for certain lending risks. For example, loan participations will require an attorney with extensive experience in that area.
7. Address how program weaknesses and limitations will be satisfactorily addressed
8. Identify program strengths and opportunities and how these will be leveraged to make the program successful
9. Address training needs for each individual and committee member involved in the commercial lending program

After these and any other critical areas are satisfactorily addressed, a project plan (including a timeline), budget, policies, and procedures need to be developed and approved by the Board of Directors. The timeline should include specific dates and responsible parties who are to be held accountable for achieving the desired program goals.

MBL Policies and Procedures

The need for detail and comprehensive MBL policies and procedures will be determined by the up front restrictions and limitations that the board and management put on the MBL program. For example, if construction and development (C&D) lending is approved, then the MBL policy will need to be expanded by adding a detailed C&D lending section. It is important that the MBL policy and procedures be customized to your credit union needs and that as your credit union's commercial lending program becomes more complex, the policy and procedures are revised accordingly.

A number of credit unions have adopted policies provided by CUSOs that focus on federal rules or mix federal and state rules. Such an approach will not work in Washington if the credit union ever intends to benefit from the advantages in the Washington Administrative Code (WAC).

Regulatory Policy Requirements

WAC 208-460-050 lists regulatory requirements that must be addressed in a credit union's MBL Policy. In addition, the regulatory requirements stated in NCUA Rules and Regulations 12 CFR 722 (Appraisals), the requirements for purchasing loans RCW 31.12.436(1), and NCUA Rules and Regulations 12 CFR 741.8 should be incorporated in the policy.

Key Policy & Procedure Considerations

Credit unions should focus on only those MBL industries for which they have knowledge suitable to manage the risks. They should then supplement that knowledge with suitable on site inspections and analysis of borrower capacity to ensure they understand the individual credit. Specific policy and procedure areas that require careful attention include:

- Cash flow analysis – Focus on drafting policies and procedures that provide guidelines for performing consistent and accurate cash flow. Also, address how cash flow will be used in determining the borrower's debt service coverage ratio and in approving credits.
- On site inspections, appraisals and appraisal reviews – Focus on drafting policies and procedures that ensure knowledge of the project (on site inspections). Ensure that well supported appraisal valuations are used for making credit decisions. Make certain that appraisal reviews are satisfactorily performed to determine whether the appraiser satisfactorily supported the appraisal assumptions, used appropriate appraisal

methodology, used appropriate market comparables, and whether the final reconciled appraised value is adequately supported.

- Geographic Risks – The credit union policy must restrict loans outside the market area of the credit union. Examiners will look critically at loans made outside the credit union's normal market area and will expect mitigations to be in place to compensate for the distance.
- Limits & restrictions – Ensure well thought-out limits and restrictions that sufficiently control commercial lending risks. These should including overall MBL portfolio, loan type limits, and geographic restrictions, as well as debt service coverage ratio (DSCR), loan-to-value (LTV) and other appropriate ratio limits (see WAC 208-460).
- Corporate entity, licensing and signing authority verification – Focus on verifying the good standing and proper licensing of the corporate entity as well as the signing authority of corporate officials representing the entity.
- Credit risk rating system – Establish a credit risk rating system that is in compliance with WAC and FAS guidance, understandable, and useful for staff. It is important to establish guidance on when credit ratings are to be updated and how risk ratings will be used to monitor overall portfolio risk. Also, establish risk rating reporting requirements to management and the board.
- Audit review and control – Focus on avoiding risks through both internal and external audits that verify that effective internal controls are in place. Independent third party reviews can be effectively used by most credit unions with material amount in MBLs. Credit unions below these thresholds could use independent third party reviews to help certify that program requirements are being met and validate that underwriting quality is satisfactory. Regardless of size, outside reviewers should be given sufficient time to analyze the major MBL program components.

Staffing and Organization Structure

As in every product and program, the Board of Directors is responsible for establishing the credit union's MBL policies including the broad limits on risk. The Asset – Liability Committee determines the cash availability and product pricing constraints for the credit union. The Credit Committee then works to build each product line in compliance with that guidance.

As a credit union builds the MBL program, they must also incorporate and balance three specific skill sets. Those skills are in business relationship development, credit analysis, and ongoing credit administration. These skills include the following duties and experience levels.

Business Relationship Development

The primary duty of a Business Relationship Officer is to develop and maintain business account relationships. Their role is to find opportunities where the credit union can serve the business interests of the member.

Experience level is often extensive (5-10 years) for all types of business deposit accounts and business lending products. An individual that most successfully builds relationships is very experienced with business relationship selling, recognition of quality of balance sheets, income statements and tax returns, financial information analysis, loan underwriting, loan structuring, business legal entities and business industry analysis..

Credit Analysis or Underwriter
The primary role of the credit analyst is to examine the borrowers' capacity to re-pay and to develop a loan proposal that both meets the needs of the borrower and ensures the repayment of the loan.

Each loan may have unique risks, differing collateral, borrowing entity structures, and recordkeeping expectations. Repayment expectations need to match the cash flow of the business.

The credit analyst needs to have expertise in several areas to be effective. Properly underwritten loans are specific and rarely formula driven. More than the WAC 208-460 minimum two years is recommended. This position will also require ongoing training in cash flow analysis, financial statement analysis, appraisal analysis, collateral analysis, loan documentation, and lien perfection.

Unlike consumer loans, business loans rarely have identical documentation or performance standards. For example, guarantees, cross collateralizations, periodic and regular financial, as well as inventory reporting requirements, sales reporting, regular reporting of rent rolls, assignment of rents, performance bonds, required deposits, pledge reports, and tax receipts are frequently found in the loan documents. They are enforced just like the required payments.

If required financial reports or rent rolls are not provided as required, the loan is considered in default and collection efforts or monetary penalties can and generally should commence. However, the credit union can enjoy these protections only if they are prepared in the underwriting step. The credit analyst also prepares the credit memo or loan proposal for approval by the Credit Committee.

A recommendation for the initial risk rating of the loan is contained in the loan proposal, with final risk rating grade assigned by the loan approval authority.

Once the loan is approved, this person also documents and closes the loan.

Loan Administration
Loan administration is responsible for managing the loan from closing to pay-off. Commercial loans are high maintenance. Loan administration is responsible for enforcing all loan requirements (covenants), monitoring the collateral to ensure no deterioration in loan quality, verifying on an annual basis that cash flows are still available to repay the debt, and assessing the credit quality of each credit. This position will understand when and how to implement collection of each loan given the multitude of factors in evidence. Collection practices will seldom be the same as those used for consumer loans.

Loan administration will determine if the risk rating classification continues to be appropriate for each loan and will recommend risk rating upgrades or downgrades to the loan approval authority, the Credit Committee and/or Board of Directors.

Many banks now have structures that separate those skill sets among three or more people. Such an approach may or may not work for your credit union but care must be given to incorporate each area of the credit union operation.

When hiring, credit unions must understand which area of expertise a potential staff member may bring to the credit union operation. **Understand the duties not just the job title of each candidate.** Clearly if your credit union has money for only one individual you will need to exercise great care in the hiring decision.

Summary

Adequate staffing accompanied by thorough research and program planning are the foundations for establishing a successful commercial lending program. Examiners will expect thorough due diligence to be performed before implementing a commercial lending program and to determine if the credit union has enough resources to effectively implement a commercial lending program.

After completing the due diligence process and approving the level of commercial lending to pursue – the credit union will begin the MBL planning process (including drafting policies and procedures) in earnest. Comprehensive MBL plans set forth program goals, establish limits and restrictions to be followed, determine resources to be allocated to the program, and develop requirements and guidelines for implementing the program. It is important that the MBL plans be realistic and customized to the credit union needs. As the credit union commercial lending program becomes more complex, the policy and procedures should be revised accordingly.

Finally, it is important the board and management recognize that a significant commercial loan program commitment is likely to be expensive and will alter the culture of the credit union. Thought should be given as to how that change in the culture of the credit union will be managed.

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