JULY 2003

SPECTRUM

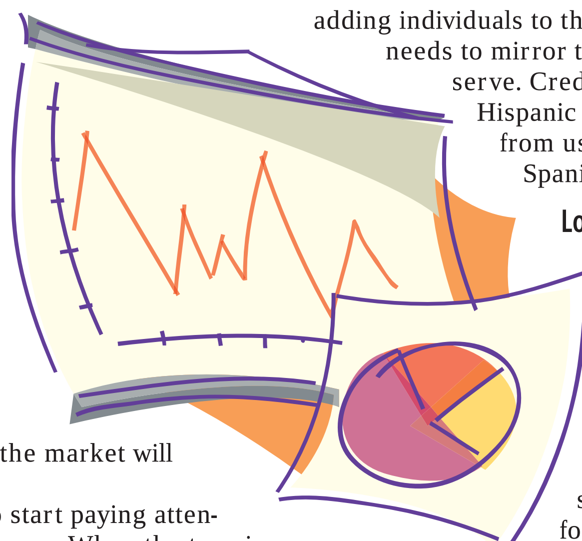
AN ELECTRONIC REPORT FROM THE CUNA LENDING COUNCIL

When Rates Rise...

How are you going to hold onto market share when rates begin to rise?

Interest rates will be going up—it's just a question of when. Most of us in the mortgage market are seeing record years. Many people purchasing and refinancing homes today have never seen rates so low. But as the saying goes, "all good things must end." So will the mortgage rates of today. What do we do?

We must have a strategy for the years ahead. That could range from timely acquisitions, to bulking up sales forces, to targeting high growth markets, to building Internet business. Thinking strategically and planning for the inevitable downturn in the market will be critical.



Credit unions need to start paying attention to their sales processes. When the turn in rates hits, the refinance loans will all but disappear. Ask yourselves:

- Who are we calling on and how are we cultivating relationships?
- Do we have a strong Internet presence?
- How are our relationships with our realtors and brokers?
- Do our members know we can handle their purchase as easily as their refinance?

Look to emerging markets

While the segment of the population classified as minorities is less than 20 percent of U S homeowners, it accounts for 40 percent of the homeowner growth over the past five years.

Home purchase rates by Hispanics, blacks and other ethnic minorities are growing at a much faster pace then they are by the Anglo-Caucasian majority. Credit unions will serve their members well, and be well served, by understanding the subtle differences in attitudes and motivations for home buying among various ethnic groups.

Marketing studies show that increased diversity in the sales force is important: Credit unions need a diverse candidate pool when adding individuals to their sales force, which needs to mirror the communities we serve. Credit unions in highly Hispanic areas would benefit from using documents in Spanish.

Look to the Internet

Now is the time to create access for your members and nonmembers via the Internet for mortgage loans. The Internet is extremely popular with consumers when looking for mortgage loans. Although most consumers want to talk to a person prior to closing their loan, they will not hesitate to shop and compare in the privacy of their home or office. This avenue gives lenders an advantage for leads.

Look to vendors

When rates start to increase one change likely to occur as the market slows is a switch from first- to second-mortgage (refinance) loans. Do you have a product that sets you apart in the second-mortgage market? Are you ready to attract that education, home improvement, or auto purchase through a second mortgage? ◆

Sharon Gaugler, Chair
CUNA Lending Council
Communications Committee

Sell or hold? The credit card portfolio conundrum

One of the most difficult questions facing credit union lenders today is whether to sell their credit card portfolios to third parties. Management may be faced with a difficult decision based upon cardholder use, marketing costs and profit margins.

Arguments in favor of selling a card portfolio include

- substantial immediate income a credit union captures when its card business is sold;
- marketing costs borne by the purchaser;
- additional benefits to credit union cardholders that larger organizations can offer;
- end of the costs associated with administering a card program.

On the negative side, credit unions may be concerned that

- the very people who purchase their card portfolios are or could become direct competitors, cross-selling their own products to the credit union's members;
- the credit union also loses control over rates charged to their members, rates that may be raised to bank levels without any control by the credit union;
- the credit union's relationship with its cardholder members, who are likely to be its most loyal and profitable segment, is eroded.

As management and lending operations considers whether to hold or fold the credit union's card portfolio, it must deal with a number of key questions:

- Is the card portfolio part of the credit union's core competency and strategic focus?
- Will the sale of the card portfolio result in a substantial loss of member relationships?
- Will members receive a higher (or lower) level of service if a firm specializing in cards manages the program?
- To what extent will the credit union retain the right to control access to its members under an agreement with a card buyer?

The value of a card portfolio lies not only in the card itself, but also in the value of the relationship the card confers upon the credit union. Each of the key considerations outlined above should be thoroughly evaluated in the process of determining whether a sale of the portfolio is in the best interest of the credit union and its members. ◆

CUNA launches *Credit Union Business Services Solutions*

A new on-line newsletter, Credit Union Business Services Solutions, *is now available at no charge at CUNA's Member Business Services web site. The following is a reprint of "Planning Requires a Process," in the premier issue, June 21, 2003.*

Since a rule change allows all credit unions to participate in SBA lending, many credit unions are pondering member business loans. It is important to have a well thought-out process, according to Glenn Strebe, CEO of the Air Academy FCU.

Air Academy FCU is planning to expand its member business-lending portfolio. The $244 million asset Air Academy was the 2001 winner of the CUNA Lending Council Excellence in Lending Award for mortgage lending; it increased its mortgage lending 185 percent from 2000-2001.

Strebe says that member demand is a major reason for moving into business lending, as well as demographic and societal changes. "As the banking industry has consolidated, banks are doing bigger loans and are not as interested in the small- to medium-size loans under $100 thousand. It is the same reason credit unions get involved in anything; there is a middle market that isn't served by banks."

Air Academy has been doing construction loans that builders use for developing speculative houses. After a strategic planning session two years ago, senior management notified the board that they wanted to get more involved in business lending.

"The board said go ahead, but get more information. We are finding out which credit union business models work. We are defining the core competency that we can do," says Strebe.

Member business lending brings financial advantages to the balance sheet, according to Strebe. Car loan terms are typically four-to-six years although they last about half that; mortgages, thirty years. Member business lending allows you to get an "intermediate asset" in your balance sheet since many have three-, five-, and seven-year balloon payments. And you can reprice the loans at current market rates as the balloons occur, says Strebe.

Understanding and analyzing cash flow is critical to success in business lending, according to Strebe. You need to determine whether the applicant's data and projections are accurate. If you truly understand cash flow, you won't need to know the businesses as intimately.

Capturing business deposits are also important to a successful business lender. "If you are a business lender, you'll want the cash deposits coming to you. This gives you an opportunity to monitor cash flow. A lot of lenders require compensating balances," says Strebe.

Air Academy plans to focus on commercial real estate. "As a follow-up we may make loans for furniture and equipment. Down the road, we may make loans for working capital for members who want to expand their business," says Strebe.

Article reprinted with permission from CUNA's Credit Union Business Services Solutions. To view this free electronic newsletter, which was launched June 20, 2003, visit www.cuna.org and click "Member Business Services." ◆

HEARD IT ON THE LISTSERV

The CUNA Lending Council listserv is an excellent resource for networking with fellow members. You must be a CLC member to gain access to the listserv. To join, click on the Community tab at the CUNA CLC web site, then on listserv, and follow the directions to subscribe. Following is a digest of popular subjects recently discussed by members.

Eighty-four-month financing on auto loans: What are the requirements and how do you price eighty-four-month financing on new auto loans? Members' credit unions offer:

- eighty-four-month financing on new autos over $35,000 for members with A credit only. The rate is .25 percent higher than the 72-month rate and .50 percent higher than the sixty-month rate.
- eighty-four-month financing for new and newer used vehicles and RVs. The longer term loan is priced 0.50 percent higher than the credit union's sixty- and seventy-two-month rate.
- eighty-four-month loans only on new vehicles with a minimum value of $25,000. These loans are priced at 200 basis points over the seventy-two-month rate.

Risk-based home equity pricing: Does your credit union offer risk-based fixed-term home equity/second mortgage loans? Members offer risk-based home equity loans as follows:

- range from base minus .5 percent for A+, to base plus 4 percent for E, with 1 percent increments from A to E;
- range from base minus .15 percent for A+, to the 18 percent maximum. They add .50 percent for B; 1.50 percent for C; and price all D & E at the 18% maximum.

Credit card use rate: What is your credit union's credit card portfolio use rate? Members respond that their credit union's credit card portfolio use rate is

- 33 percent (outstanding balances as a percentage of available credit lines);
- 32 percent. If they monitor the card portfolio using a ratio that includes accounts with a finance charge, the credit card portfolio use rate is 43 percent;
- 24-29 percent.

Loan approval ratios: Does your credit union have risk-based pricing? What are your current loan approval ratios? Some responses:

- "We run between 78 percent and 80 percent approval ratios. This does not include loans where the applications are cancelled, work-out loans, or any loans that are merely a change in terms or conditions. We do risk-based pricing on all our loans, with the exception of Visa and equity products."

- "We average a 78 percent approval rate on applications, and they make up an average of 93 percent of the total dollar amounts requested. That means most of our denials are for small loans. We are doing risk-based lending."
- "Our approval rate is in the 45-48 percent range. We have risk-based pricing and are looking at a risk-based sub-prime auto lending program."
- "We hired a credit planner about four years ago. This position has helped us develop loans that may initially appear to be denials. The position was so successful that last year we hired a second planner."

Residential rental property: Please advise on regulatory, compliance, and disclosure requirements for refinancing a loan from another institution secured by residential rental property. The loan will be to a sole proprietor who does not live in the property.

- NCUA requires that if the loan is $50,000 or more the credit union must have a business loan policy addressing it.
- Federally chartered credit unions are limited to a twelve-year maturity on rental property mortgages. The loan can be amortized over thirty years, but it must be paid off in twelve years. These mortgages do not require a three-day rescission period after signing documents before funds are granted.

Twenty-year HELOC: What is your experience with, and where can loan documents be found for a twenty-year HELOC program similar to this: a ten-year draw period and interest only during the first ten years, with the loan amortizing over the last ten years? Responses:

- "We started to offer this product seven weeks ago and are buried in applications." The credit union already has more than $2.5 million in balances on the product in a total loan portfolio of $98 million.
- "We have increased our portfolio by $2.2 million over a sixty-day period, using Loanliner documents."
- "We offer a draw period of 9.5 years to ensure the priority of the lien. The loan is priced at .25 percent under prime with interest only during the draw period." ◆

Bankruptcy concerns behind you? Think again

Assuming the Bankruptcy Abuse Prevention and Consumer Protection Act of 2003 is passed, signed and implemented, credit unions may believe that Congress has come to their rescue and solved the problem. But while legislation may close some of the more glaring gaps in federal bankruptcy law, it will not change member psychology or eliminate personal financial problems. That means lenders will continue to deal with members in financial difficulty.

The Filene Research Institute offers two excellent studies detailing the root causes of bankruptcy and outlining how credit unions can work to overcome the problems it presents.

Fresh Approaches to Bankruptcy and Financial Distress: Why Don't More People Declare Bankruptcy? includes an overview of the issues by Bill Hampel, chief economist for CUNA and Affiliates. Hampel provides analysis of credit union data compared to overall national data, and brings out important implications for credit unions. The report also includes a summary of key research findings by Professor Michele White, of the University of Michigan. Professor White is widely regarded in the academic world as the leading economic expert on bankruptcy, and her work has produced a number of surprising and important findings that have implications for credit unions.

The second Filene report, *Financial Stress and Workplace Performance: Developing Employer-Credit Union Partnerships,* offers ways in which credit unions can work with employers, financial counseling agencies and others to reduce employee financial stress. The report shows that financial education leads to greater employee awareness of financial control, and therefore fewer financial worries, less stress, better health, and stable personal lives. Dr. Flora Williams of the Purdue University School of Consumer and Family Sciences presents a model of a successful financial counseling program.

Copies of these and other Filene monographs are available free to Institute members. The cost is $100 for non-members.

For information about Filene studies call (608)231-8550 or visit on-line at www.filene.org. ◆

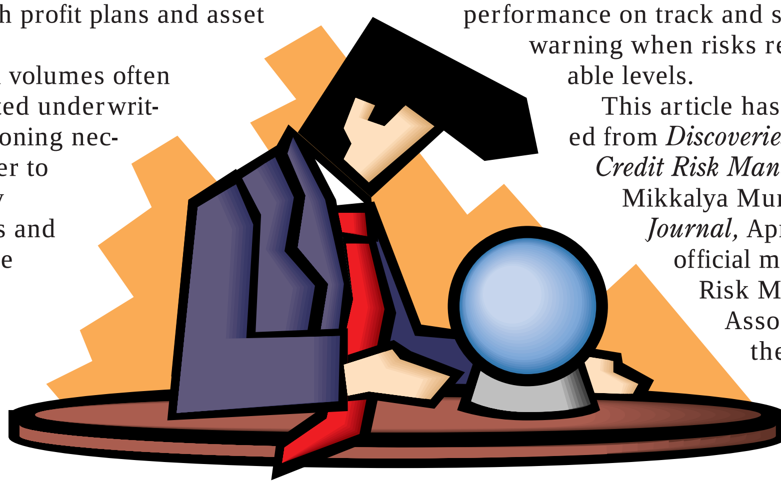
Credit risk management faces new challenges

In the ever-changing world of credit-risk management, credit grantors rely more frequently on analytical tools to adjust the composition and acquisition of new credits.

Writing in the *RMA Journal*, Mikkalya Murray points out that to use management by exception techniques in traditional risk elements, managers need to automatically track a wide array of exceptions and risk attributes using a core processing system or other databases.

Murray urges managers to carefully review each product line to determine if it accomplishes the profit plan and achieves volume and the desired product mix while maintaining asset quality. After measurable levels of risk are expressed in terms of volume, dollars, and/or number of loans by segmented product line, it is easier to track portfolio performance relative to both profit plans and asset quality.

Today's loan volumes often make automated underwriting and decisioning necessary, in order to achieve timely response rates and accuracy in the process. An automated application and decisioning process can be centralized in a loan center, or decentralized in the branches.



Record high levels of consumer debt also mean that the collections process must work smoothly to manage increased volume. Many lenders cope with increased volume by using risk-based strategies such as early, more proactive decisions on restructuring and rehabilitating high-risk borrowers.

At the same time, traditional risk management techniques still apply: Focused credit policy, underwriting procedures, approval steps, quality control, collection management and exception tracking are all important elements of the process.

Good management by exception processes start with quality control provided by the credit review process and measured through benchmarking. These processes keep portfolio performance on track and sound an early warning when risks reach undesirable levels.

This article has been excerpted from *Discoveries in Retail Credit Risk Management,* by Mikkalya Murray, The *RMA Journal,* April 2003, the official magazine of The Risk Management Association. Visit their web site at *rmahq.org.* ◆

The Point debuts

CUNA's online information tool has been renamed. In a grand opening on April 28, the former CU Executive Center was upgraded to *The Point for CU Research and Advice*.

Credit unions that don't already get the point can go to *The Point's* web site to try it out in a free thirty-day trial subscription. Revamped content includes in-depth articles with analysis and perspective, best practices, advanced search tools for operational questions, extensive archives for historical information, peer-group analysis, state-by-state rate comparisons for pricing decisions, and live chats.

Visit The Point for a free trial at cucenter.cuna.org/free_trial.html. ◆

Learn from the savings and loan crisis of the 80s

A white paper on the savings and loan failures of the late 80s, *The Savings and Loan Crisis: A Retrospective View,* is available now. The following summary is by the author, by Brian Hague, president and CEO, Corporate Network Brokerage Services, Inc, Overland Park, Kansas.

The original purpose of the thrift industry charter was to provide for the growth of home ownership in the U.S. through affordable financing. The interest rates that thrifts that could charge on loans and pay on deposits were regulated until 1980.

The deregulation of interest rates, coupled with unprecedented interest rate volatility, led to an earnings crisis throughout the thrift industry in the early 1980s. This crisis was due to the duration mismatch between thrift deposits and long-term mortgage loans.

In an effort to allow thrifts to grow out of their earnings problems and diversify their interest rate risk, Congress and the thrift regulator initiated a series of liberal regulatory practices including

- expanded lending and investment authority;
- relaxed accounting standards and regulatory oversight;
- broader ownership rules.

These factors only exacerbated the industry's problems. Early attempts to tighten regulation were thwarted by Washington's zeal for deregulation and the lobbying efforts of the industry's trade association.

Ultimately, widespread thrift failures cost U.S. taxpayers much more than would have been the case had earlier efforts to resolve the problems been successful. Failures resulting from inappropriate—or even criminal—activity received the most publicity.

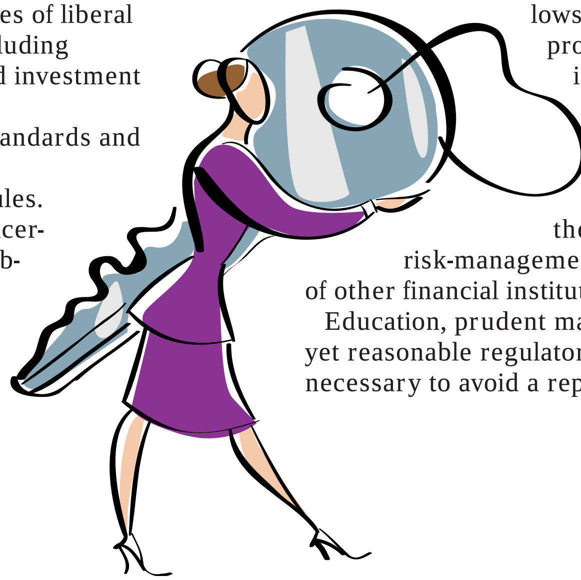
However, most of the failures resulted from thrift managers' lack of expertise to successfully implement the expanded powers granted them, or from overzealous regulators keen to prevent failures before they occurred.

This paper reviews the case of Franklin Savings Association—a classic example of the latter cause—in some detail.

As credit unions have dramatically increased long-term fixed-rate mortgage lending funded by short-term deposits, the credit union system could be poised for a similar scenario to the thrift industry's early problems.

Interest rates are at historical lows, and the NCUA has proposed expanded lending and investment powers to allow credit unions to diversify their balance sheets. At the same time, industry risk-management practices lag those of other financial institutions.

Education, prudent management, and strong yet reasonable regulatory oversight will be necessary to avoid a repeat of past mistakes. ◆



WELCOME NEW MEMBERS

Forty-four new members are on the CUNA Lending Council roster. Join us in welcoming these expert lenders who have demonstrated their commitment to promoting professionalism among credit union lenders. We look forward to networking, freely exchanging ideas, and improving the overall effectiveness of our credit union's lending operation.

Lisamarie Arden
VP Lending/Operations
Pacific Transportation FCU
Pasadena, CA

Todd Beasley
VP Savings & Loans
Broward Schools CU
Fort Lauderdale, FL

Thomas Berry
VP Lending
Bell Com CU
Grand Rapids, MI

Clint Bramlett
VP Lending/CLO
Charter Oak FCU
Groton, CT

Michael J. Brennan
Chief Lending Officer
Boeing Helicopters CU
Ridley Park, PA

Florence Brown
VP Operations
FORUM CU
Indianapolis, IN

Vicki Caldwell
Financial Services Manager
First Class American CU
Fort Worth, TX

John Cooke
SVP/Chief Lending Officer
University and State ECU
San Diego, CA

Jeanine M. Corpuz
VP Lending
Fiscal CU
Glendale, CA

Dennis L. Cottrell
Lending Officer
Pitney Bowes EFCU
Stamford, CT

John Ferstl
Director CL/Sales
Honeywell FCU
Minneapolis, MN

John C. Flanagan
Manager
Union County EFCU
Elizabeth, NJ

Cynthia A. Flora
VP Lending
Texas Dow ECU
Lake Jackson, TX

Donna L. Glockzin
Loan Manager
Family Financial CU
Muskegon, MI

Lori W. Hall
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American Airlines FCU
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Susan C. Hamilton
VP Lending/Collections
Southeast Financial CU
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CUNA Mutual
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SSA Baltimore FCU
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Consulting Director
Virginia CU League
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Highmark FCU
Rapid City, SD

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VP Lending
MemberSource CU
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President/CEO
Massachusetts State ECU
Boston, MA

Nancy K. O'Rourke
VP Lending
Y12 FCU
Oak Ridge, TN

Brenda C. Roberts
VP Member Services
Montrose FCU
Montrose, CO

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AVP Lending
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Vernon Hills, IL

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City CU
Dallas, TX

George F. Sessa
VP Lending
Stamford CU Inc
Stamford, CT

Trent Smutka
VP Lending
United Educators CU
Woodbury, MN

Jon J. Sonia
VP/CLO
Massachusetts State ECU
Boston, MA

Michael E. Stocker
VP Products/Development
Macomb SGCU
Mount Clemens, MI

Linda Summarell
VP Lending
Educators CU
Nashville, TN

Mindy J. Virgin
VP Lending
Beehive FCU
Rexburg, ID

Raymond D. Wade
VP Consumer Lending
American Airlines FCU
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Karen Walczak
VP Lending
Raritan Bay FCU
Sayreville, NJ

Joseph Whitaker
SVP Member Services
Truliant FCU
Winston Salem, NC

David L. Williamson
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Mutual Savings CU
Birmingham, AL

Mary H. Witt
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Members CU
Traverse City, MI

Kristen Yeager
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CUNA LENDING COUNCIL SPECTRUM

CUNA Lending Council SPECTRUM is a web-based newsletter published quarterly by the CUNA Lending Council at www.cunalendingcouncil.org. Send news and Lending Council information to:Sharon Gaugler, Austin Area Teachers FCU, phone: (512)302-6836, fax: (512)451-9569, e-mail: sgaugler@aatfcu.org. For Council information, contact Pamela Frey, manager council administration, phone: (800)356-9655, ext. 4141 or fax: (608)231-4061, e-mail: pfrey@cuna.coop