Observations & Insights

from

Jeff Judy & Associates

Member Business Lending:

Are Your Sources of Repayment Riskier Than You Think?

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Credit unions have long experience with collateral-backed lending. They are experts in auto loans and in residential real estate, in mortgages and other home equity products.

But long experience with any given approach is a two-edged sword, particularly when that experience is extended to new situations. In other words, all that auto- and home-lending leads to habits and assumptions that may cause problems, especially if they are applied to member business lending without some examination and adjustment.

While the fundamentals of sound credit and member service remain the same, both primary and secondary sources of repayment need a fresh look when you get into member business lending.

Cash Flow, Monitoring, and Agreements

A great deal of the lending credit unions have traditionally done is based on income from employment. A steady wage produces an income record with few surprises or variations.

Once the member is qualified for the credit, monitoring may be minimal. For example, the first sign that the member has become unemployed may be when a payment is missed.

With a business credit, however, the cash flow generated by the business is the primary source of repayment. Given that member business loans can be much larger than your typical auto loan, you don't want to wait until they miss a payment to realize there are issues.

That means that your agreement with the member needs to provide for regular reporting and monitoring. But it doesn't matter if members faithfully provide information if no one at the credit union pays attention to it! Many credit unions do not have much experience with monitoring ongoing cash flow, and they will have to take steps to set up explicit monitoring practices. The best agreements monitor more than just financials, they also track things like changes in key personnel in the member business or major developments in the member's industry.

One other difference with business credit: cash flow fluctuates. Unlike the employer's paycheck that is the same month after month, your member's business may be quite cyclical. Perhaps a revolving credit line makes sense, or some other structure. But that can be hard to see if the credit operation is too tightly bound to a history of term loans for specific purchases.

Can You Count On Secondary Sources of Repayment?

Think "secondary sources of repayment" and "collateral" is the first word that comes to mind. Even though seizing the collateral rarely makes you whole, it's a good backstop for things like auto and home loans. Credit unions have the experience and access to needed expertise to liquidate that collateral when needed.

What happens, though, when you provide a member with the credit needed to buy a printing press, or other specialized equipment? It will be much harder to liquidate something like that, and it is impossible to be an expert in every type of business.

Then there is the personal guarantee from the owner of the business, sometimes seen as the gold standard of small-business lending. The problem there is that the very assets, the savings and property of the business owner, derive from what the owner earns from the business. If the business is failing, not only is the member's income cut off, the member may actually drain savings (another good thing to monitor!) and liquidate assets to try to save the business. There may be little left to serve the guarantee when default occurs.

Early Detection

The best protection for both primary and secondary sources of repayment, then, is to set up strong monitoring requirements and practices for member business lending. By the time the member business misses a payment, it is often too late to recover much from the relationship. Much better to take action when the business misses, say, a reporting requirement.

But simply writing new procedures or carefully structuring member business credits isn't enough. A culture of early detection and rapid response is at the heart of safe and successful member business lending.

And that requires a common understanding of that culture throughout the credit union, from the loan officers to the board.

Jeff Judy's booming voice and unique instructional style have been enjoyed in classrooms and auditoriums across the globe. Jeff is in demand as a trainer for individual financial services institutions as well as regional and national trade associations. His practical, down-to-earth approach consistently wins him high ratings from participants in his seminars and workshops. Jeff also educates audiences through his frequent interviews and articles in trade journals and more general financial media, as well as through his own biweekly electronic newsletter, Jeff's Thoughts. For information about Jeff's work with credit unions, visit www.JeffJudy.com/creditunions.html.