Observations & Insights

from

Jeff Judy & Associates

Service to Members
vs.
Service to a Member

The Member Business Lending Conundrum

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Credit unions distinguish themselves by *serving members'* financial needs, rather than by *selling services to customers*. They share with other financial institutions the need to manage risk, particularly in the all important *credit* function that gives them their names. Members join together to pool their resources and, importantly, to spread risk across those pooled resources.

In the ongoing effort to maximize service to members, credit unions are rapidly adding and then expanding *member business lending*. While in some respects this is a natural extension of credit union goals and values, in others the addition of member business lending is a significant shift in the credit union model — and the magnitude of that shift is often incompletely understood when …

The Board Decides to Add Business Lending

As more and more credit unions get into member business lending, the decision to offer this service may seem like a slam dunk to the board of directors. It expands the range of services offered to members at the same time it may produce additional interest income that contributes to the financial strength of the credit union.

And risk management? The board may assume this is a straightforward extension of current credit practices, with the same risks that are already well understood from long experience. And that's where things can go seriously awry.

The simple fact is, the risk profile of a business credit is different than that of the traditional, non-business loans that credit unions have always made. After all, the risk associated with a credit is the product of:

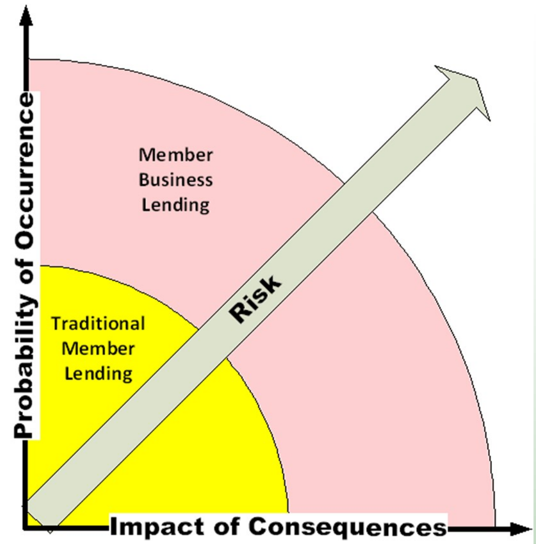
- the probability of a repayment problem occurring, and
- the impact on overall financial strength of that non-repayment.

Risk management can fail on a massive scale because basic human nature leads us to prepare for the most likely risks — the ones that are easy to think of — but to be much less prepared for the rare catastrophe. Consider the Titanic: the chances of that ship hitting that particular ice berg with that particular glancing blow were probably very small, but the impact of that blow was significant.

When it comes to member business lending, both components of risk — probability and impact — are higher than for non-business loans (See figure on next page). On the probability side, traditional lending has depended largely on the member's employment status and assets. Consistently generating profits from a business, however, has many more factors, and is considerably less predictable.

Meanwhile, the amounts involved in business loans mean that partial or complete failure to repay delivers a greater blow to the members' pooled resources, raising the risk due to magnitude of impact. After all, ask yourself these questions:

- What is the average size of a non-business loan, and how long will it take to make up a loss that size?
- What is the average size of a business loan, and how long will it take to make up that loss?



And there is an additional risk factor, perhaps stronger at credit unions than at banks:

The Individual Member Focus

Credit unions are highly committed to serving each and every one of their members. That can make it hard to decide when a member's business is not performing well enough to ensure repayment of the credit.

This is a problem at *all* financial institutions. Banks and credit unions alike often fail to react to problem credits until it is too late to control losses. But with the heightened member-service values of credit unions, the pressure to "stick with them" until things work out is even stronger. And as business credits are rapidly getting larger and larger at credit unions, the possibility of a mortal blow from a couple of defaults looms ever larger.

The Antidotes:

1. Think in terms of the entire membership of the credit union. You can't let your focus on serving one member blind you to the impact a default could have on the rest of the members.
2. Create rigorous definitions and an objective process for assessing probability of default and responding to problems in a timely manner.
3. Encode both of the above items in a clear, written member business lending policy that is understood by the board and by the credit staff.

Understanding and managing the risk profile of member business lending is crucial to upholding your core value of service to *all* of your members.

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.