The Filene Research Institute is a non-profit organization dedicated to scientific and thoughtful analysis about issues affecting the future of consumer finance and credit unions. It supports research efforts that will ultimately enhance the well-being of consumers and will assist credit unions in adapting to rapidly changing economic, legal, and social environments.

Deeply embedded in the credit union tradition is an ongoing search for better ways to understand and serve credit union members and the general public. Credit unions, like other democratic institutions, make great progress when they welcome and carefully consider high-quality research, new perspectives, and innovative, sometimes controversial, proposals. Open inquiry, the free flow of ideas, and debate are essential parts of the true democratic process. In this spirit, the Filene Research Institute grants researchers considerable latitude in their studies of high-priority consumer finance issues and encourages them to candidly communicate their findings and recommendations.

The name of the institute honors Edward A. Filene, the “father of the U.S. credit union movement.” He was an innovative leader who relied on insightful research and analysis when encouraging credit union development.

The Center for Credit Union Innovation, LLC, is dedicated to identifying, refining and developing innovative ideas of commercial importance to credit unions and others. The Center works closely with the Filene Research Institute to deliver promising product and service strategies emerging from Filene research and from many other contributing sources. The Center provides a link between the world of ideas generated by Filene and their application in the marketplace. It gives credit unions a powerful tool to explore the relevance of new concepts in a rapidly changing financial services industry.

*Progress is the constant replacing of the best there is with something still better!*

— Edward A. Filene
The author wishes to thank David Coggins, President, Business Lending Group, along with Banta Credit Union, Menasha WI; CitizensFirst Credit Union, Oshkosh, WI; and Fox Communities Credit Union, Appleton, WI; Robert Hoefer, President, and the business lending staff of Dupaco Community Credit Union, Dubuque, IA; Robert Familant, Treasurer, Progressive Credit Union, NY; Kevin Bates, Participation Loan Coordinator, Evangelical Christian Credit Union, CA; Kevin Zakus, Regional Manager of Business Services, Vancouver City Savings Credit Union, BC; and Axel Christiansen, Investment Manager, VanCity Capital Corporation, BC. These credit union executives have made a substantial contribution to the knowledge and understanding of the opportunities available to credit unions in the business services arena, and we thank them sincerely for their time and effort.

We are also grateful to Mike Riley, of D. Michael Riley & Associates, Middleburg, VA, for his work on NCUA’s approach to regulating small business lending and services.
# Table of Contents

**Executive Summary** ............................................. 1

**Part I: Dimensions of Business Lending** .................. 7

Large Numbers .................................................. 9
A Vital Component of the U.S. Economy ................. 10
The Job Growth Engine ................................. 10
Loan Market Large, Relatively Low-Risk ............... 11
Credit Cards ................................................. 12
Banks Dominate the Small Business Market .......... 13
Small Businesses Prefer Community Banks .......... 14
Using Other Financial Institutions ................. 15
Fresh Perspectives ........................................... 15
Why Small Companies Choose Nonbanks .......... 16
Why Small Businesses Discontinue Business With Their Bank ................. 16
Service Strategies ........................................... 17
Banking Relationships Are Durable ................. 17
Deposit Products A Key Part of Product Portfolio ...... 18
Online Opportunities ........................................ 19
Small Business Insurance Opportunities .......... 20
Small Business and Women and Minorities ........ 20

**Part II: NCUA’s Approach to Small Business Lending and Services** .............. 23

Regulatory Environment History ......................... 23
Federal Credit Union Act .................................. 25
NCUA Rules and Regulations ......................... 26
Examiners Guide/Informal Level ....................... 27
Summary ...................................................... 27
Part III: Profiles of Credit Union Business Lenders . . 29

Business Lending Group
Neenah, Wisconsin ........................................... 30
Dupaco Community Credit Union
Dubuque, Iowa ...................................................... 44
Progressive Credit Union
New York, New York ........................................... 53
Evangelical Christian Credit Union
Anaheim, California ............................................. 61
Vancouver City Savings Credit Union
Vancouver, British Columbia .............................. 66
VanCity Capital Corporation ......................... 71

About the Author 77

The Center for Credit Union Innovation, LLC
Board of Directors 79

Filene Research Institute Administrative Board/
Research Council 81

Filene Research Institute Publications 85
As credit unions enter the 21st century, they have vastly expanded their powers to serve members in terms of products, services, and fields of membership. However, this broadened capacity does not guarantee the future. Credit unions must continue to evolve if they are to survive to serve future generations of members.

The current environment in the financial services industry is particularly demanding. Competition is fierce, and most product offerings are mature. Margins for first mortgage lenders are slim. More and more institutions are becoming involved in indirect lending, making this a difficult competitive arena. The big players in the game are appropriating credit cards. The profitable components of a credit union’s loan portfolio have therefore been limited to used autos, home equity loans and personal lines of credit. Overall, margins are shrinking and consumer product lines are becoming commodities in which the sale typically goes to the lowest bidder. Meanwhile, the area of business services continues to offer significant opportunities.

Credit union members have also evolved. They now possess much more diversified lives. No longer do young people seek employment with a single firm and work for that company for the rest of their professional lives. Today’s members are increasingly mobile and entrepreneurial. Individuals in many professions have both the time and the energy to engage in self-employment activities, in addition to their regular jobs. Individuals downsized from major corporations find a demand for their services. And early retirees increasingly embark upon second or third careers as business owners.

These members need and deserve financial services beyond the traditional range of credit union products. In addition to auto loans, home mortgages and vacation or education loans, they need the financial backing that will help their business grow. On the deposit side, they need not only passbook savings and checking accounts, but cash receipt depository, lock box, estate planning and trust services as well. And growing businesses need payroll processing services, merchant credit cards, and insurance.

Changes in the financial services industry have also created opportunity. According to the FDIC, from 1990 to 1999 there were 5,047 bank mergers. These mergers tended to result in poor relationships with small business customers, protracted decision-
making, and loss of local control. These changes have created an excellent opportunity for new entrants in the market.

Over the same 10-year period, 1,315 new banks were chartered. These banks were formed primarily to capture local relationship opportunities. Merger activity also placed thousands of qualified people on the streets and made experienced staff available to new players in the business services market, including credit unions.

In Part I of *Small Business: The New Frontier* we look at the size and scope of the potential for member business services, and examine the statistics behind some key findings of this research:

- A broad range of sources confirms that the market of small businesses totals millions of units.
- The small business market is a major component of the U.S. economy.
- One half or more of U.S. job growth is in small businesses. This growth has been generated across many industries.
- The market for small business financial services is large and profitable. A substantial portion of the market is low-risk.
- As small businesses grow, they increasingly look to community banks for financing.
- Service is the key competitive issue in the small business market.
- Deposit products satisfy a key small business need, providing the main source of financial institution profit in the relationship and help with the financial institution’s risk management program.
- There is growing potential to provide financial services to women and minorities who own small businesses.

Serving small businesses gives credit unions five distinct opportunities to create new revenue streams:

1. Business loans can accelerate the overall growth of the credit union.

2. Successful businesses generate deposits and require an array of fee generating cash services.

3. The owners and managers of small business firms are likely to handle their personal financial affairs through the same institution that handles their business account.
4. Business services create an opportunity to offer select employee group services to employees of the business partner.

5. The credit union may grant loans to retail customers of its businesses partners, including financing for durable goods and other consumer products.

All five of these avenues present substantial opportunities for growth. Yet most financial institutions have not taken advantage of the strategic opportunities presented by small business relationships. Those who step up to the plate and construct a workable overall program to serve the needs of these firms are sure to reap an important competitive edge.

Part II of this paper provides guidelines for credit unions planning to offer business services to their members, based upon the NCUA’s regulatory approach to small business services. Certain rules must be observed by credit unions entering the small business market, but these rules are by no means prohibitive. The Federal Credit Union Act contains enough enabling language for a credit union to involve itself in virtually any small business lending or services undertaking, but NCUA regulations are much more restrictive.

Part III of the paper examines five credit unions whose small business service programs serve as models that others can use in designing their own approach to small business services. The credit unions profiled here each feature a unique approach to business lending and other services, because each has a specific vision and mission that drives its service to members. Still, their combined experience provides a platform for others to use in developing a strategy to reach out to this exciting new market. While each credit union’s mission and membership is unique, the cases presented here are sure to provoke creative thinking regarding your own opportunities for member business services.

These are actual case histories of credit unions that have been successful in the business services arena. Each of the five cases presented here has its own distinguishing characteristics:

• Business Lending Group (BLG) is a CUSO formed by three central Wisconsin credit unions that felt they lacked the critical mass necessary to enter the market on their own. The three credit unions combined have assets of a little
more than $500 million and serve the seven counties comprising the Fox River Valley. All three credit unions have community charters. Their major reasons for entering the business lending arena are 1) the potential for diversification, and 2) the expanded opportunities for member service that it offers. Under a CUSO, each credit union can purchase one third of any particular loan, rather than taking on the entire risk itself. Each of the three credit union owners has an image in the marketplace as a consumer lending institution. BLG has tried diligently to build a new image for itself as a business services provider.

• The $280 million Dupaco Community Credit Union has carved out a niche for itself in the Dubuque, Iowa business community, and is recognized as a formidable competitor in small business lending. As a community credit union, Dupaco perceived a need to broaden its business charter, and look at new ways in which to serve its community. Bank competitors claimed that the credit union did not serve the needs of the community because it did not reach out in ways that they were required to do under the Community Reinvestment Act. Dupaco has found that business services is an area where the margins are still reasonable. On the non-financial side, more small businesses are being formed, people are leaving corporate life and striking out on their own, and the opportunity to serve members in this area is growing at a rapid rate.

• Progressive Credit Union, New York, has both a unique field of membership and a unique business lending opportunity, serving its members with loans that make it possible for them to enter into business on their own. Today, approximately 75 percent of Progressive's total loan portfolio is in taxi medallions and vehicles. In addition, the credit union provides mortgage loans to members, and offers participation loans to other credit unions. Progressive Treasurer Robert Familant's rationale for offering business loans is simple: “Credit unions should acknowledge that members need these loans,” he says. “You’re serving your members’ basic interests by providing them with a small business program. You may even be protecting your membership base. If a member is forced to go to a bank for
a small business loan, the bank is likely to cross-sell accounts already held by the credit union."

- Evangelical Christian Credit Union, Anaheim, California, matches its spiritual mission with financial advice and counsel to help build churches and schools throughout the country and around the world. Since 1964, Evangelical Christian Credit Union has been serving the financial needs of the evangelical Christian community including churches, schools, ministries and individuals. Its members reside in all 50 states and in more than 100 countries around the world. The credit union’s mission is to assist ministries and the ministry-minded in doing their jobs better. The overall objective is to increase the effectiveness of members through biblically based, value-driven financial services. The credit union stresses the fact that its core beliefs are coupled with disciplined action, resulting in a chemistry that differentiates people and organizations. While the values, mission and objectives of prospective borrowers may be foreign notions to traditional banking institutions, they are shared by ECCU. In terms of both fundamental principals and staffing, the credit union understands how churches operate, and what their aspirations are.

- Vancouver City Savings Credit Union, Vancouver, British Columbia, is the largest credit union in Canada, with assets in excess of $7.3 billion Canadian and 39 branches. VanCity offers a wide range of business services to members, from a unique peer review program to for-profit lending and socially responsive loans to nonprofit groups. VanCity’s business lending division represents $580 million Canadian ($370 million U.S.) in loans outstanding, and about $760 million ($485 million U.S.) in deposits. The business lending staff manages more than 6,000 loans for the 22,000 business members with accounts at the credit union. In addition to its business lending division, VanCity also created a wholly owned subsidiary called VanCity Capital Corporation, that provides subordinated debt, a risk oriented financing product that combines features of both equity and debt, to small and medium sized businesses that need growth capital. VanCity Capital Corporation makes investments in the $100,000 to $1 million range. Its portfolio now stands at about $9 million.
Small business lending and the business services that surround a small business are an important and profitable undertaking for credit unions. The market is enormous, and competition is less intense than in consumer markets. Small business services fit credit union operations very well, they have the potential to bring in many new members, and they constitute a tremendous community service. It can be a fairly safe business with high margins, but it does require considerable effort and expertise. Additional information on providing service to small business is provided in Management Enrichment Training Program (MERIT) module M 29, Providing Loans to Small Businesses, by Sue Eckenrode, CUNA & Affiliates, 2000.
PART I: Dimensions of Business Lending

For more than a century, credit unions have served the saving and borrowing needs of consumers. Credit at reasonable rates, along with safe and secure savings options have been hallmarks of credit union operations. More than other financial institutions, credit unions have built a reputation as advocates for their consumer members, and have become champions of financial independence for people of modest means.

As we enter the 21st century, credit unions have vastly expanded their powers to serve in terms of products, services, and fields of membership. However, this broadened capacity does not guarantee the future of the institution. As businesses, credit unions must continue to evolve and find new sources of revenue if they are to survive to serve future generations of members.

In that context, we currently find margins shrinking and consumer product lines becoming commodities in which the sale typically goes to the lowest bidder. Serving small businesses gives credit unions a number of opportunities to create new revenue streams. First, businesses need loans to fund their growth. Second, successful businesses generate deposits and need fee generating cash management services. Third, the owners and managers of the firm are likely to do their banking with the same institution that handles their business account. Fourth, the credit union has the opportunity to reach out to employees of the business with select employee group services. And fifth, at least one credit union has developed an additional opportunity. It generates loans to retail customers of some businesses. For example, it may provide financing for the purchase of washers and dryers from a white goods retailer. All five of these avenues present substantial opportunities for growth. Yet, as reported by Jack Hubbard in “Small-Biz Banking Requires a Targeted Strategy” in American Banker, August 2, 2000, most banks have not seized the total business opportunity.

Margins for first mortgage lenders are slim. More and more institutions are becoming involved in indirect lending, making this a difficult competitive arena. The big players in the credit card game are consolidating the market. The profitable components of a credit union’s loan portfolio therefore are narrowing to used autos, home equity and personal lines of credit. Meanwhile the area of business services still has some significant opportunities.
For their part, credit union members have developed much more diversified lives. No longer do young people seek employment with a firm in their hometown and work for a single firm or two for the rest of their professional lives. Today's members are increasingly mobile, and entrepreneurial in their financial lives. Firefighters, teachers, and other professionals take on self-employment in addition to their regular jobs. Individuals downsized from major corporations in the technology and other fields find niches for their services within the same or another industry. And early retirees increasingly embark upon second or third careers as business owners.

These members need and deserve financial services beyond the traditional range of credit union products. In addition to auto loans, home mortgages and vacation or education loans, they need the financial backing that will help their business grow and prosper. On the deposit side, they need not only passbook savings and checking accounts, but cash receipt depository, lock box, estate planning and trust services as well. And, their growing business may need services like payroll processing, merchant credit cards, and insurance.

Changes in the financial services industry have also created opportunity. According to the FDIC, from 1990 to 1999 there were 5,047 bank mergers. These mergers often lead to poor relationships with small business customers, protracted decision-making, and loss of local control. The changes have created an opportunity for new entrants in the market.

Over the same 10-year period, 1,315 new banks were chartered. These banks were formed primarily to capture the local relationship opportunity created by the mergers cited above. Ironically, the mergers also placed thousands of qualified people on the streets and made experienced staff available to the new banks (and to some credit unions).

This paper gives credit union managers and board members an insight into 1) the size and scope of the potential for member business services, and 2) a snapshot view of five credit union programs designed to take advantage of business service opportunities. The credit unions we feature here differ in their approach to business services, providing a platform for others to use in developing a strategy to reach out to this exciting new market.
While each credit union’s mission and membership is unique, the cases presented here are sure to provoke creative thinking regarding your own opportunities for member business services.

In Part I of *Small Business: The New Frontier*, we set the stage for the magnitude and diversity of the small business market. We look at the role small businesses of varying sizes and shapes play in the overall economy, the financial service package entrepreneurs expect of their providers, and the income their banking partners realize in return for providing those services. We also examine the competitive issues, the durability of banking relationships, and the portfolio of services required by small business.

LARGE NUMBERS

Let’s start with an accounting of the size of the market for small business loans and other financial services to the credit union community. There are large numbers of small businesses in America. The estimates vary by source, but they all agree that there are many millions of small businesses that need financial services. According to the rating firm Dun & Bradstreet, 11 million small businesses in the U.S. have less than $10 million in annual revenue. That figure underestimates micro-businesses, including single proprietor in-home businesses and similar cottage industries.

Some 20 million micro-businesses take in less than $1 million in annual revenue. This segment of the market comprises 90% of all small businesses, says Oxford Information Technology, reported in the publication *Federal Reserve Bank of San Francisco: Community Affairs*, Winter/Spring 1999. This is the segment of the small business market that is most accessible to credit unions, and the area in which members are most likely to need business loan and deposit services.

The U.S. Census Bureau also reports a robust small business community in the U.S:

- 5.8 million establishments had less than 20 employees
- 741,000 businesses had 20 – 99 employees
- 138,000 firms had 100 – 499 employees

**Finding:** Multiple sources confirm that the market of small businesses totals millions of units.
A VITAL COMPONENT OF THE U.S. ECONOMY

Individually, these businesses are small, but in the aggregate they are a large and vital part of our economy. Reporting on 1999 business activity, the Small Business Administration (SBA) said that small businesses with fewer than 500 workers:

- Contributed 47% of all sales in the country
- Were responsible for 51% of the total private gross domestic product
- Filed 99% of all business tax returns. About two-thirds of these organizations are full-time businesses, the rest are operated part-time

Finding: The small business market is a major portion of the U.S. economy.

THE JOB GROWTH ENGINE

In recent years small businesses not only accounted for half the total U.S. economy – they have provided the lion’s share of new job creation. Job creation is especially relevant for credit unions because members historically tend to join a credit union when they enter the work force. The SBA notes that businesses with fewer than 500 workers:

- Created 76% of net new jobs from 1990-1995
- Employed 53% of the total private non-farm workforce
- Created virtually all new net jobs from 1994-98. Micro-businesses with 1-4 employees generated 60% of net new jobs over this period, and firms with 5-19 employees created another 18% (Cognetics, Inc., reported by SBA, 1999).

The greatest concentration of jobs is in the services and retail trade sectors, according to U.S. Census Bureau data.

However, SBA data shows that small business is also a vital component of the technology economy, since it produces 55% of U.S. innovations, and generates twice as many of both product innovations and other significant innovations per employee as large firms. Small businesses also are granted more patents per sales dollar than large firms. They employ 38% of U.S. workers in
high technology occupations such as scientists, engineers, computer programmers and analysts.

**Finding:** One half or more of U.S. job growth is in small businesses. This growth has occurred across many industries.

**LOAN MARKET LARGE, RELATIVELY LOW-RISK**

The small business credit market is $460 billion in loans, with associated revenue of $60 billion. The small business loan market is very large. The SBA reports that the dominant lenders to small businesses are commercial banks, with $371 billion in small business loans outstanding, including commercial and industrial loans and mortgage loans under $1 million, as of June 1998. Total loans under $100,000 by banks were valued at $112 billion. A breakdown of bank loans by magnitude is shown in figures 1 and 2.

| Figure 1: Number and Dollar Amount of Small Business Loan by Banks, 1998 |
|-----------------------------|-----------------------------|-----------------------------|
| Loan Magnitude              | Total Outstanding           | Percent of Total*            |
| Micro-Low-Loans under $100K | 111.5 billion               | 10.9%                       |
| Dollars                     | 8.02 million                |                             |
| Number                      |                             |                             |
| Mid-Size Loans under $250K  | $187.8 billion              | 18.4%                       |
| Dollars                     | 8.67 million                |                             |
| Number                      |                             |                             |
| Small Business Loans under $1M | $370.8 billion             | 36.4%                       |
| Dollars                     | 9.22 million                |                             |
| Number                      |                             |                             |
| Total Business Loans        | $1,020 billion              |                             |

* Percentages do not total 100% because not all lending categories are not included.

The number of small business loans under $100,000 by banks is growing faster than the numbers of larger loans. This is due to a marketing drive by large banks, such as Wells Fargo, to penetrate this market using credit scoring. This has also broken down some of the geographic barriers in serving small business.
Small business annual spending on financial services totals approximately $206 billion. However, total dollar value of small business loans under $100,000 by banks is growing slower than the total value of larger loans. Another study estimates the total market for micro business financial services is $2.5 billion to $6 billion.

**CREDIT CARDS**

The small business credit card market is growing. Small business cards account for 16% of American Express’ card revenues. One expert says revolving small business accounts generate $155 in revenue per account. A 1998 survey of entrepreneurs found that 47% had used credit cards for financing their businesses in the previous 12 months. “The new figures show that more business owners financed with cards than with commercial bank loans (45%), leasing (36%), or vendor credit (19%), says Miriam K. Souccar in the American Banker.

Eighteen percent of small businesses use company cards for financing equipment or inventory. 4% use personal credit cards for financing, according to PSI Global 2000 Small Business Survey. The same survey reports that 28% of Small Office/Home Office businesses (SOHO) used personal credit cards for business financing, 62% for business travel, and 71% to buy office supplies and equipment.

Firms with less than $10 million of sales are a surprisingly profitable source of bank profit. On average, they are much more profitable than household accounts. Bank revenue from micro-

---

1 1998 data, Financial Institutions Consulting (FIC) reported in Commercial Lending Review, Spring, 2000
business ranges from $1,000 to $5,000 per annum per business account. Combined, small businesses and the households of their business owners frequently represent 50% or more of a retail bank’s profits. For U.S. banks as a whole, the small business sector accounts for about a third of total market value. A nd studies using 1994-1996 banking data show that banks that are small business friendly are more profitable than those that are not.

There is a general perception that a large percentage of small businesses fail. However, failure of the business is not the same as financial loss to the lending institution. Of every seven businesses that shut their doors, only one actually leaves unpaid obligations. The remainder close for voluntary reasons, such as a desire to enter a new field, or for personal health or other reasons.

Finding: The market for small business financial services is large, profitable and low-risk.

BANKS DOMINATE THE SMALL BUSINESS MARKET

The SBA notes that overall, small firms rely more on owner capital and less on external debt capital than larger firms do. Small firms are also more dependent on short-term debt relative to long-term debt than are large firms. And most small firms use external financing only occasionally. Less than half of small firms borrow once or more during a year. However, small firms experiencing rapid growth or those with high volumes of receivables require frequent external financing.

The cost of borrowed funds is typically higher for small firms. Interest rates on bank loans for small firms average two to three percentage points above the current prime rate.

---

2 “Doing It Their Way” by Peter Carroll, BAI, July/August, 1999
As firms grow, their reliance on the commercial banking system increases. Of the small firms that borrow from traditional credit sources, most obtain financing from commercial banks, as shown in Figure 3.4

<table>
<thead>
<tr>
<th>Employees</th>
<th>% Bank Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>59%</td>
</tr>
<tr>
<td>1-4</td>
<td>64%</td>
</tr>
<tr>
<td>5-9</td>
<td>68%</td>
</tr>
<tr>
<td>10-19</td>
<td>73%</td>
</tr>
<tr>
<td>20-99</td>
<td>84%</td>
</tr>
<tr>
<td>100-499</td>
<td>86%</td>
</tr>
</tbody>
</table>

It is important to note that while not all small businesses need loans, all need transaction accounts. So all small businesses are a potential source of deposits. Small businesses still consider banks their “primary provider” of financial services by a huge margin.5 Eighty-eight percent of businesses consider commercial banks their primary financial services provider. Only 3% consider savings and loans as their primary provider.

**SMALL BUSINESSES PREFER COMMUNITY BANKS**

Small business firms appear to prefer community banks to larger banks. This could be because community banks are more familiar with the businesses of small firms and are more willing to develop a relationship with the customer. “The fact that smaller businesses are less likely to utilize larger banks, even in urban markets, suggests that financial capital access from larger banks is more difficult for smaller business.”6

**Finding:** As small businesses grow, they increasingly look to community banks for financing.

---

4 “Small Business Lending in the United States” U.S. Small Business Administration, 1999
5 American Banker-FIC survey reported in Small Business Banker, August, 2000
6 “Small Business Borrowing from Large and Small Banks” SBA
USING OTHER FINANCIAL INSTITUTIONS

While banks dominate the market, most small businesses have relations with non-bank institutions. This suggests that the market is not closed to new entrants. More than half of small businesses have relationships with a non-bank provider:7

- Leasing company—25%
- Brokerage—16%
- Insurance company—15%
- Commercial finance company—13%
- Mutual fund company—8%
- Savings and loan—5%
- Credit union—3%
- Investment bank—1%
- Other—4%

FRESH PERSPECTIVES

Alternative providers are tackling the small business market from a variety of fresh perspectives. These alternative providers include brokerage houses, card companies, online firms and others, including:8

- Merrill Lynch
- American Express
- Intuit
- Administaff and other local advisory firms
- Capital One Financial Corporation
- E*Trade (offers employee stock option plan administration)

---

7 Payment Systems Inc, reported in American Banker, September 9, 1996
8 “Doing It Their Way” by Peter Carroll, BAI, July/August, 1999
WHY SMALL COMPANIES CHOOSE NONBANKS

Small companies choose to meet their financial needs through nonbanks primarily because the provider either deals in specialized services or offers lower prices or greater access to credit. Small companies opt for nonbanks for the following reasons:

- Specialized services—26%
- Pricing—18%
- Credit—15%
- Provider—6%
- Service—5%
- Account officer—3%
- Don’t know/refused to answer—15%
- Other—15%

WHY SMALL BUSINESSES DISCONTINUE BUSINESS WITH THEIR BANK

Nine percent of small businesses reported changing their financial services provider during the past year, and 2% say they are considering a change. Why do they change? More than half the reasons given by businesses for leaving their financial institution can be broadly attributed to poor service. Product, price, and convenience were significantly less important.

- Poor service—32%
- Lack of product—10%
- Inconvenient location—9%
- Impersonal service—8%
- Credit availability—7%
- Fees too high—7%
- Merging—6%
- Lack of knowledge—5%
- Account officer left—4%
- Other—12%

9 ibid.
10 Payment Systems Inc, reported in American Banker, September 9, 1996
SERVICE STRATEGIES

Personal selling and personal contacts are the keys to serving this market. Sixty-six percent of small businesses apply for credit in person, and 9% apply over the phone. Forty-four percent say they get information about credit rates and fees in person, and 22% say they use the phone, according to the PSI Global report.

BANKING RELATIONSHIPS ARE DURABLE

Most banking relationships endure for many years. The length of banking relationships prior to terminating service follows:11

- 10 years or more—29%
- 4-9 years—30%
- 1-3 year—37%
- Less than 1 year—2%
- Don’t know—2%

Clearly, good service builds long-term goodwill.

The strongest tool available to smaller banks in the small business market is proximity to customers. Good customer relations are labor intensive. “When the playing field is level in terms of services offered and competitive pricing, personal contact will win over direct marketing every time,” says Maggie Scarborough in the ABA Banking Journal.

Ninety-two percent of bankers say the branch is one of their most important distribution channels in serving the small business market. Eighty-seven percent say the same about the dedicated sales force.12

Finding: Service is the key competitive issue in the small business market.

---

11 ibid.
DEPOSIT PRODUCTS A KEY PART OF PRODUCT PORTFOLIO

Deposit and cash management products are important for credit unions to consider in reaching out to small business. First, deposit and transaction product pricing is often less competitive than loan pricing. Deposit products often generate the profit in the relationship, while loans are only marginally profitable. Second, for risk management purposes, a lender often wants to be able to monitor transaction accounts to gauge the success or failure of a business enterprise.

The seven most important financial products (in no particular order) that small businesses use according to the Manhattan Consulting Group in a study for the Applied Research Institute, California Credit Union League, include:

- Operating accounts (checking and money market)
- Basic cash management
- Merchant card processing
- Payroll processing
- Credit (secured and unsecured)
- Retirement and other employee benefit plans
- Casualty and key employee insurance

Credit unions must be prepared to meet a range of product needs for small business. Simply offering a loan product won’t satisfy most business members. Small businesses most frequently use the following deposit services:13

- Money market deposits—15% (Bank share: 65%)
- CD’s—11% (Bank share: 76%)
- Money market mutual funds—7% (Bank share: 36%)
- Sweep accounts—7% (Bank share: data not provided)
- Commercial savings—5% (Bank share: 88%)
- T-bills—1% (Bank share: 45%)

Small-business owners are less likely today to keep money tied up in poorly paying deposit accounts. In response, small banks say they are adding cash management services like sweep accounts, automated clearing house services, and merchant services.14

13 ibid.
14 Community Banking: Today and Tomorrow, Grant Thornton, 1999
ONLINE OPPORTUNITIES

Internet loan delivery looks promising to some experts.

• The majority of small businesses are hooked to the Internet. One recent estimate is that over 80% of small businesses have Internet access, and 40% have their own Web sites.\(^{15}\)

• However, only 1% of small businesses apply for credit online, and only 2% use the Internet to do research on credit options. The high-touch aspect of obtaining credit actually appears to be increasing in importance, says PSI Global.

In a study of nine large banks, 17% of small business customers with less than $10 million in annual revenue did their banking online. But they maintained demand deposit account balances that were 2.7 times higher, on average, than other small businesses did.\(^{16}\) Wells Fargo recently announced the launch of the online Wells Fargo Resource Center for Small Business Owners. The Integrated destination site will provide Internet banking and bill payment and will link small businesses with services, both online and off.

The following list shows the percent of small businesses using each cash management product. More than 90% of each of products listed are provided to small firms by banks.\(^{17}\)

- Wire transfers—32%
- Corporate-to-corporate ACH—22%
- ACH direct deposit—15%
- Preauthorized ACH debit—14%
- Coin/currency processing—9%
- Controlled disbursement—8%
- Zero-balance accounts—7%
- Check imaging—6%
- Lockbox—4%
- Cash concentration—4%

Finding: Deposit products offer a key small business need, the main source of profit in the relationship, and help with risk management.

\(^{15}\) “Become a Portal for Small Businesses Or Watch The Draft Away to Nonbanks” by Bill Currie and Dave Dawson, American Banker, October 20, 2000

\(^{16}\) “Reasons to Get Small-Biz Customers Online” by Megan J. Ptacek, American Banker, June 9, 2000

\(^{17}\) ibid.
SMALL BUSINESS INSURANCE OPPORTUNITIES

Sixty-nine percent of companies with fewer than 100 employees have no group life insurance. There is also a need for property and casualty, liability, health, workers compensation and business interruption insurance. Banks – and a few credit unions – are just beginning to include insurance in their package of services.

SMALL BUSINESS AND WOMEN AND MINORITIES

The number of businesses owned by women and minorities has grown significantly and is a potential market opportunity.

The number of women-owned businesses increased 89% from 1987-97:

- 8.5 million women-owned firms operated in 1997.
- They generated $3.1 trillion in sales, up 209% over 10-year period after adjusting for inflation.
- They employed 24 million workers.
- 4.7 million women will be self-employed by 2005.
- More than 60% of women-owned businesses were first operated in the home.

The number of minority-owned businesses increased 168% over the 1987-97 period.

- 3.25 million minority-owned firms operated in 1997
- They generated 495 billion in sales, up 343% over 10-year period after adjusting for inflation.
- They employed 3.9 million workers.
- Of all firms in existence in 1992, 75.2% were still in existence in 1996. This compares with...
  - 74.3% of Hispanic-owned firms
  - 68.9% of Black-owned firms
  - 79.2% of Asian and other minority-owned firms

18 1995 LIMRA data reported in American Banker, November 29, 2000
19 U.S. Small Business Administration, 1999
Data for 1993 shows that 75.7% of all small firms used credit, 77% of Hispanic-owned, 63.3% of Black-owned, and 67% of all minority-owned firms used some type of credit. Commercial banks were a business credit source used by:

- 36.9% of all firms
- 32.6% of Hispanic-owned firms
- 15.4% of Black-owned firms
- 26.6% of all minority-owned firms

**Finding:** There is growing potential to provide financial services to women and minorities who own small businesses.

Business lending is an excellent opportunity for credit unions to diversify their loan and deposit portfolios. Small business services offer a large and diverse market. The market values local service. It provides access to businesses, owners, employees and customers. However, to capture the market credit unions need to offer a broad package of products, develop specialized and experienced personnel, and invest in significant operations and technology tools.
Credit unions must consider their regulatory environment when implementing strategy. Even CUSOs are constrained to an explicit set of activities. The regulatory environment for a particularly credit union involves the formal laws and regulations that it is subject to as well as informal examiner guidelines and practices.

The following is based on a review of NCUA written material and discussions with credit union industry participants. It gives a general overview of the federal regulatory environment for business services. It is not designed to provide guidelines for individual credit union actions. Also, state credit union and non-credit union regulations have not been examined.

**REGULATORY ENVIRONMENT HISTORY**

Reviewing the evolving regulatory environment assists in understanding how legislation, regulation, and enforcement of regulations affects the way in which an activity such as small business services provided by credit unions is affected. There were several distinct regulatory environments from 1970 until 2002.

- Under General Nickerson (1970 –1975), there were numerous pushes to expand credit union authority, most notably in “pilot programs” involving share drafts, credit cards, and shared branching. These were launched with little direct statutory authority. Small business activity was a relatively minor part of credit unions and was generally relegated to situational lending such as buying tools or a truck for a business but still treated as a personal loan.

- During the Connell era (1975 –1980) a whole series of new statutory authorities were received by credit unions (increased lending including mortgages; certificates; dividend flexibility; etc.) and numerous regulatory changes were made to accommodate these new authorities. Commercial lending, although still a very minor part of credit union activity, was increasing, mostly in state chartered credit unions. Most regulatory control in business lending was exercised through the examination program.

- The Callahan era (1981 –1984) represented very liberal and progressive deregulatory actions. There were numerous regulation streamlining efforts and the reduction of
operational restraints on credit union activities. Member business lending increased a fairly substantial amount but it was still concentrated in state chartered credit unions. It was mostly collateral based (real estate) commercial lending.

• The Jepsen era (1985 –1994) involved a series of implementation efforts and defensive strategies because of the unfolding S&L disaster. There were a whole series of new and more restrictive laws passed (FIRREA and FDICIA) that involved directly or indirectly financial institution activity. Due to substantial NCUSIF losses, a member business lending rule was created that restricted credit union activity in this area. By the early 1990’s the safety and soundness of credit unions was unquestioned and a series of modest regulatory relief actions were taken, not only in the member business loan area but other areas.

• The D’A mours era (1995 – 2000) became caught up in the CapCorp debacle and a whole series of regulatory and informal restrictions were applied to credit unions, their investments, their lending and their activities in the small business arena. Small credit unions generally received positive regulatory treatment but not in the small business area. The passage of HR1151 further restricted credit unions and provided statutory restrictions on member business lending. Attempts at regulatory relief were not successful.

• The Dollar era (2001 –) has been notable be efforts to reduce the regulatory burden on well capitalized and well managed credit unions. These efforts include the passage of Section 721 Incidental Powers. These efforts, however, have not notably changed the environment for business services.
FEDERAL CREDIT UNION ACT

The Act, in many different ways, provides fairly broad authority for credit unions to pursue business services needs. There are at least nine key sections that need to be viewed as a group and related to business services activity.

Applicable Sections of the Act

Section 101(1) states what a Federal credit union was created to be. Section 109 addresses who may be a member. Section 107(5) addresses who may receive a loan. Section 107A addresses limits on member business loans. Section 107(7), 107(5)(D), and 107(17) provide alternatives via the creation of organizations, service centers, CUSOs or the exercise of incidental powers to carry on a credit union’s business. Section 108 specifies that Bylaws must be issued by NCUA. There are no specifics required by 108 but Article XII of the Bylaws has been written to restrict business lending. Section 216 on prompt corrective action has to be factored in because the agency’s PCA rule includes member business lending as a specified risk element.

What do the sections of the Act mean?

In very simple terms, the Act allows virtually all types of entities to be members of a credit union: persons and incorporated and unincorporated organizations are specifically mentioned in the Act. Sole proprietorships, partnerships, corporations, and limited liability companies could all be considered legitimate entities for a credit union to provide service. It would appear to be easier for a community charter or a SEG-type charter to have business members but that’s all in the interpretation.

Business lending is restricted in the Act via the member business loan section. The prompt corrective action section, its corresponding regulation and the Bylaws section and the way in which the bylaws were written also place limitations indirectly.

Other business services that would support business activities include checking accounts, deposits, night drops, payroll, coin and currency, etc are not specifically prohibited and appear to be allowable either under a CUSO or under the incidental powers section of the Act.
Although an exhaustive analysis was not done, legal opinions and interpretative rulings in all of the above areas are extremely conservative and do not necessarily come to the same conclusion.

**NCUA RULES AND REGULATIONS**

There are four Parts of the Rules and Regulations that deal with business activities. None appear to address the ancillary business services but stick primarily to business lending. In all cases they are more restrictive than the Act.

**Applicable Parts of the Regulations**

Part 723 outlines the requirements for member business lending. Part 712 is the CUSO regulation. Part 702 is Prompt Corrective Action. Part 721 is about incidental powers.

**What do the Parts of the Regulations mean?**

The member business lending regulation essentially deals with what is allowed and what is not allowed. It also restricts the amount of what is allowed. In essence, it identifies what is a safe and sound way to make a business loan and then says even if they are good loans you can’t make many of them.

The CUSO regulation is very restrictive and does not allow much leeway for credit unions to involve themselves in so-called incidental activities. It requires pre-approval for non-enumerated activities. In all likelihood, any small business activities other than lending would need to be specifically approved.

The Prompt Corrective Action includes member business loans as one of the items singled out as having additional risk and for which additional reserves may be required.

The recently revised Rule 721 on “incidental powers” did not explicitly expand the ability of credit unions to serve business members. However, it does have a three-pronged test that credit unions can use to judge whether a proposed activity qualifies as an “incidental power.” In addition, there is an application process for credit unions to follow for activities that do not clearly meet the test. These changes increase the likelihood of credit unions being permitted to offer services that are important to business members.
EXAMINERS GUIDE/INFORMAL LEVEL

The Guide provides basic information and procedures for the examiner to follow. It is typically left to the examiner to define the actual scope of the examination. Most examiners do not scale back an examination in any area. The scope is often increased in areas perceived to be high risk. In areas of business or commercial activities, special examiners will probably be called in. These areas are considered by most regions to be high-risk areas and most examiners will try to discourage business lending and other business activities or they will examine it so minutely that most credit unions won't think it's worth the trouble.

Regions are concerned by any scrutiny from Washington and will generally exercise great care to avoid being spotlighted. This often results in higher standards (informal) for what are perceived to be risky areas. If the regulation allows up to 12.5% in Member Business Loans, informally the Region will try to keep credit unions under 10% or an even lower threshold.

Any area that has caused losses in the past, no matter how long ago, will remain under close scrutiny. Any new area is always treated as high risk. This is particularly true when the NCUA Board and Washington Office raise frequent concerns about the area.

SUMMARY

The Act contains enough language for a credit union to involve itself in virtually any small business lending or services undertaking. There are places in which it would be helpful if the wording in the Act were a little different.

The regulations are almost uniformly restrictive on small business activities. NCUA legal opinions and interpretive rulings are even more restrictive on business activities. Changes in these areas could materially ease the burdens faced by credit unions that want to pursue this market.

The Examiner’s Guide and the informal enforcement are generally skeptical toward business lending and will only change after it is perceived by the examiners that the NCUA is not opposed to credit unions undertaking small business activities in a
reasonable and safe and sound way. Clearly individual credit unions have a challenge in educating their respective examiner on the opportunities in business services and the soundness of their particular operation.

There is considerable opportunity to work with the NCUA to review regulations, opinions, interpretive rulings, the examiner guide and examiner training to allow credit unions to more effectively offer the products and services small business members require.

The federal legislation that governs credit unions has restrictions that may inhibit individual credit unions from fully meeting their member needs by restricting the maximum amount of loans that can be made. This restriction is not a major movement constraint given the low level of current activity in this area. Indeed, if the regulatory attitude is not altered the legislative constraints will not come into play.
PART III: Profiles of Credit Unions Business Lenders

Having looked at a range of statistics relating to financial services for small business, let’s next turn our attention to actual case histories of credit unions that have chosen to enter the business services arena with some success. Each of the five cases presented here has its own distinguishing characteristics. Business Lending Group, for example, is a CUSO formed by three central Wisconsin credit unions that felt they didn’t have the critical mass necessary to enter the market on their own. Dupaco Community Credit Union has carved out a niche for itself in the Dubuque, Iowa business community, and is recognized as a formidable competitor in small business lending by the area’s commercial banks.

Progressive Credit Union, New York, has both a unique field of membership and a unique business lending opportunity, serving its members with loans that make it possible for them to enter into business on their own. Evangelical Christian Credit Union, Anaheim, California, matches its spiritual mission with financial advice and counsel to help build churches and schools throughout the country and around the world. And VanCity Credit Union, Vancouver, British Columbia – the largest credit union in Canada, with assets in excess of $7.3 billion (Canadian), offers a wide range of business services to members, from a unique peer review program to for-profit lending and socially responsive loans to nonprofit groups.

Here we examine the lending programs of each of these organizations, in the hope that their experience will benefit many other credit unions as they strive to serve their members beyond the traditional scope of consumer lending and savings services.
The Business Lending Group (BLG) is a CUSO formed by Banta Credit Union in Menasha; CitizensFirst Credit Union in Oshkosh; and Fox Communities Credit Union in Appleton, Wisconsin. The three credit unions combined have assets of a little more than $500 million and serve the seven counties comprising the Fox River Valley. All three credit unions have community charters.

The impetus for developing a CUSO to provide business services began in 1996, says David Coggins, Business Lending Group president. Several credit unions in the area approached the subject, realizing they needed to expand their services. The initial group decided that cooperation offered a better chance for success than each credit union building its own portfolio. The initial group later disbanded, but Banta, CitizensFirst and Fox Communities came together again in the fall in 1998. The three had been engaged in other cooperative efforts, and found they had a common philosophy and a good working relationship. They trusted each other, and each had a geographical niche.

The credit unions hired a consulting firm to help develop a business plan, and an attorney to assist in filing articles of incorporation for Business Lending Group, Inc. That was March 1999. Next, they hired Coggins to run the operation, as well as another commercial lender and one administrative staff member.

The credit unions had done some focus group research, had many members who had left larger companies and gone into business on their own. The trend nationally is to entrepreneurial, self-employed business people rather than to concentration of employees in large companies. Employees are leaving larger companies and going into business for themselves, both at their own discretion and as a result of re-engineering and downsizing at larger companies.
**Strength in Numbers**

The major reasons for getting into the business lending arena were 1) the potential for diversification, and 2) the expanded opportunities for member service that it offered. Today, thanks to BLG, they don't have to send members seeking business services to competing financial institutions, and threaten the relationship between credit union and member.

These credit unions chose to form a CUSO for a number of reasons. They realized it would take substantial commitment and capital to make the operation a success. First, they knew that on their own they might not have the critical mass to accomplish what they wanted to do, but together they were in a much better position to succeed. A CUSO gave them the opportunity to share the risks involved in startup.

Second, they wanted to undertake the venture with adequate resources from the start. “Offering business services with a staff of one is a tough assignment,” says Coggins. “It’s difficult to find the talent to do everything, and to fit that person into the daily operation of the credit union. Business services require a significantly different mindset than do consumer services, and it takes a strong person to push the business services agenda through.” Coggins suggests that an individual may be good at many aspects of commercial lending, but may lack the capacity to champion the program with the credit union’s internal stakeholders - the board, management, and staff.

Third, there is a dynamic of risk sharing involved in the CUSO organization. With a CUSO, each credit union can purchase one third of any particular loan, rather than taking on the entire risk itself. In a million dollar deal, risk-sharing considerations can be a significant factor. Along with the risk considerations, each credit union is able to consider larger loans, because it has partners with whom deals are shared. Each of the players has more capacity and more clout in the marketplace.

Image is a fourth consideration. Each of the three credit union owners has an image in the marketplace as a consumer lending institution. BLG has tried diligently to build a new image for itself as a business services provider. “We send the message that we’re serious about business lending,” says Coggins, “and that we’re in
this business for the long term. We’re not dabblers, and our prospects know it.”

BLG also makes a point of letting business people know that it has the strength of three credit unions behind it. There are people who have a fierce loyalty to the credit union, and want to do as much business with the credit union as possible. Ties with the credit unions give BLG a competitive advantage in the marketplace because it’s part of the credit union family.

**Competition**

Coggins uses consolidation trends in the banking industry as an advantage in seeking out business relationships. “We’ve had lots of mergers in this area, and we emphasize the local ownership of our sponsoring credit unions. Business people who deal with us can be sure they’ll continue to deal with local people, and not have their banking relationship sent off to a big money center bank next week or next year.”

Bank consolidations have had a very real effect on small business owners in the Fox River Valley area. With the mergers have come changes in operations and personnel. Decisions that once were made locally are now made in Chicago, Columbus, or Minneapolis. What used to be excellent community banks are now mere afterthoughts for the regional and national banks headquartered hundreds of miles away. As a result, local business people have become frustrated, and that frustration has translated into good business opportunities for BLG. The cooperative nature of credit unions assures borrowers that local control will continue.

**Part of the Community**

Becoming involved in community activities is a real challenge for Coggins and BLG, because the CU SO serves perhaps a dozen communities in its market area. Some of its best opportunities are in outlying communities, but the organization can’t focus on one specific community. At the same time, many leads come from being present and visible in the community, and letting business know that BLG is there to serve them.

“There’s no substitute in business lending for face-to-face contact,” says Coggins. “We’ve joined the Oshkosh and Fox Cities Chambers of Commerce. Those are the two largest business organizations in the area. We are also members of local service
clubs, and we’re building our presence in the communities we serve. At the same time, we have to be careful not to spread ourselves too thin.”

Executives of BLG’s sponsoring credit unions are also very active in community affairs. Many of them have excellent business contacts, and are able to help with referrals and other support. They serve on community non-profit boards, typically made up of local business people, which serves to enhance BLG’s image in the community. A community chartered credit unions, these executives understand the need to raise awareness of their services within the community.

**Governance**

The credit unions are equal partners in the business lending venture. Each made a one-third initial equity contribution. Large amounts of capital weren’t necessary, since BLG serves as a kind of pass-through cost center for each of its credit union owners. All that was needed was some leasehold improvements, furniture, and software, along with startup costs such as legal advice and business consulting. Every month expenses are totaled, and each credit union is invoiced for one-third of the total. BLG collects loan fees, and nets them out.

The BLG board of directors is comprised of its owner credit union CEOs. The loan committee, made up of BLG officers and two representatives of each credit union, meets once each week to review loan applications. Loan policies state that every loan requires at least one business lending officer and at least one other credit union officer to sign off on it before the deal is approved. BLG does not have lending authority, by regulation. Its loan committee needs to sign off on each loan, but it’s the credit unions that make the loan decision.

**Loan Procedures and Participation**

Every Thursday BLG faxes or e-mails the packages it has put together that week – new loans, amendments to existing loans, servicing actions – to participating credit unions. Then the loan committee meets on Friday morning. If it’s a new deal, each of the three credit unions can choose to participate or not. If one credit union declines and the other two agree to participate, the two take on the loan. If only one credit union likes the deal, that credit
union can take the loan on its own. “We try to reach consensus on the majority of the deals,” Coggins says, “but we didn’t want to find ourselves in a situation where one party had veto power over a particular deal that another partner wants to make.”

A credit union may choose to limit its participation because it has liquidity concerns at the moment, or one party may have excess liquidity and be willing to be a bit more aggressive than the others in going after loans. Pricing might be right for one credit union, but not for the others. The decision for each credit union depends upon both credit considerations and price.

BLG does all preparation and underwriting with the prospective borrower, and puts the package together. The credit unions then sign off on the proposal, and BLG takes the appropriate steps to close the loan. BLG is the ongoing servicer of the loan, collects interim financial information, monitors collateral, conducts all business contacts with the borrower, and builds the borrower/lender relationship.

The CU SO does not maintain loan accounting software. Loans are booked at one of the participating credit unions, and that credit union is the lead player for the loan. The lead credit union then makes payments to the other participating credit unions for the life of the loan.

The decision concerning which credit union will be the lead on a loan is made in one of two ways. If the referral came from one credit union and the business owner is already a member of that credit union, that credit union becomes the lead. If the referral comes through BLG or some other avenue, the business owner decides which credit union is most convenient. The three credit unions operate a total of 16 branches to which business owners can be referred. Almost everybody who comes to BLG for a loan is within 10-15 minutes of one of those branches.

Deposit and other business relationships arising out of a particular loan are assigned to the lead lender. This is a simple, workable way to handle the additional business relationships that might arise out of a loan. Each of the three credit union owners has agreed that each will get its share of origination opportunities over time. The lead credit union may get additional business arising out of a loan, but it can also expect to incur additional expense associated with servicing the loan.
Once the business owner is enrolled as a credit union member, that owner can establish other service relationships, use the credit union’s online banking services, and access other benefits.

The lead credit union collects all payments and handles disbursements. Typically, disbursement requests come through BLG, which notifies all parties by fax, and clears transactions through the credit unions’ accounts at Wisconsin Corporate Central Credit Union. The accounting is easily handled with the Corporate Central by e-mail. Participation accounting is done behind the scenes, settling once a month.

New privacy rules make that access troublesome. However, making a request by telephone and receiving the information the CUSO needs by fax is very efficient.

Whenever the credit unions’ collections departments send out delinquency notices, they fax a copy to BLG. Coggins expects that as BLG grows, it will want to be able to monitor deposit activity such as irregularities, NSF checks and the like, to provide an early warning for potential loan payment problems.

Because the loan accounting systems and back room operations of the credit union was not built for commercial lending, BLG has adapted these systems to make them appropriate for business purposes. BLG has chosen not to purchase a commercial lending program, reasoning that from a member’s perspective it would create unnecessary complexity. The member would be using one system for personal accounts and another, incompatible system for business accounts. “We can deal with back room considerations without affecting the member,” says Coggins, “and we’d rather do that than causing problems for the member.”

The Marketing Plan

BLG’s marketing plan targets efforts to work with its owner credit unions and their people on the front line to help those employees identify and refer potential loans. Two of the credit unions have business development representatives whose job it is to market to SEG groups and attract business deposits and members. BLG works with these people, referring potential business to them for deposit accounts, and they refer loan opportunities to BLG. About 60 percent of all leads come from frontline credit union staff or from business development representatives.
BLG has been successful on 20-30 percent of the leads it receives. It places heavy emphasis on high-touch in developing leads, through contact with potential business borrowers. CU SO representatives almost always meet potential clients at their business rather than at the BLG offices. “That means driving,” says Coggins, “but in the long run it’s worth the effort. It’s what many larger banks have forgotten to do. Because we’re not in each of our communities on a day-to-day basis, we need to go out of our way to be local for those business people.” Meeting at the client’s business also gives BLG an insight into their business. And they appreciate the effort to make life easier for them.

BLG also works to build and maintain relationships with accounting firms, realtors, and attorneys as part of its marketing effort. Referrals are likely to come from activities such as service club meetings. Now the CU SO is beginning to get referrals from its existing members as well, people who believe they’ve treated them well and can recommend the organization to other business people.

**The Loan Portfolio**

BLG’s loan portfolio is heavily weighted toward real estate loans, which comprise a little more than half the total. Because the organization is relatively new in the commercial lending business, people are more likely to refer a real estate project than an entire banking relationship. Real estate is often a project business, and relatively uncomplicated. But BLG is already seeing this kind of transaction build into larger relationships in which it becomes a total business services provider.

The three owner credit unions are also more comfortable with real estate collateral than with the less tangible assets such as line of credit relationships. Like most lenders, BLG tends to be more discriminating with some categories of loans than with others. However, BLG does consider lines of credit, inventory and accounts receivable financing, and term debt on equipment.

**Participations**

Early on, BLG purchased participation loans as a way to create an immediate portfolio, and cover overhead costs. A participation relationship also allows BLG to be a seller of participations to other lenders if circumstances warrant. The long term goal is to
make participation loans fill-in at times of excess liquidity, but not as a basic marketing strategy.

There have been a significant number of church projects in BLG’s market area, and the group has been successful in obtaining a share of that business. Currently, it has half a dozen church projects on its books, and is bidding on others. As the staff becomes proficient in a particular type of business lending, such as church loans, it is able to increase its success rate in that niche category. “And from a risk standpoint,” says Coggins, “these are good loans. Churches have low delinquency and low charge off ratios.”

**Underwriting, Decision-making**

BLG takes a close underwriting look at all loans it bids on. The first step is to tell the borrower what kind of information is needed: the most recent three years of personal and corporate tax returns; three years of income and expense statements, and balance sheet data; a business plan; and a personal financial statement. That's the starting point. Some borrowers provide everything in advance, so that BLG is able to review the data and make an underwriting decision relatively easily. Others are not so well organized, and the underwriting meeting is a challenge.

The next step is to request a credit report on the borrower, and perform a software analysis that compares the applicant with industry key financial ratios. BLG’s program shows these ratios in terms of the lower third, middle third and top third of the operators in the particular industry, to assess where the borrower fits in.

Robert Morris & Associates (RMA) provides a CD-ROM into which BLG plugs its data. The data is updated annually to reflect current business practice by industry code. All users feed data back to RMA for future releases. The service costs $400 per year.

Next, if the staff feels comfortable in recommending the loan to the credit unions, a detailed report is prepared for consideration by the loan committee. This report addresses key issues, risk concerns, spreads, and personal financial information. The document includes a signature page, and goes into the file when authority is received to proceed on the deal.
The applicant then receives a commitment letter outlining the terms and conditions under which BLG will provide credit. The applicant signs the agreement, giving BLG authority to proceed and incur costs such as an appraisal, title insurance and the other things needed to place a loan on the books. This protects the lender in the event the applicant later recants.

The commitment letter is worded: “The Business Lending Group, on behalf of Fox Communities Credit Union and its other owner credit unions, offers the following commitment...”

Closing and Servicing

BLG uses a software program by Bankers Systems for compliance and loan document preparation. The note and a worksheet is forwarded to the credit union to advise that a loan is about to close. That information is faxed to the lead credit union a day in advance of closing, with copies to the other two credit unions to advise them that there is funding to be done. The credit unions set the loan up on their accounting system, and cut any checks needed for the closing. BLG also does the followup work, recording mortgages through a title company, handling lien perfections and other activities.

Each May BLG sends out requests for updated financial information, and analyzes the information provided by borrowers. For loans of $300,000 and under, BLG does the analysis and determines whether the loan is still properly risk-rated. For loans of $300,000 to $1 million, a spreadsheet analysis is performed, and a report is prepared for the loan committee. In loans of this magnitude, if problems are emerging BLG may do a collateral review, a lien search, and possibly order a credit bureau report. For loans of over $1 million, and those rated substandard, BLG creates a full report for the loan committee to review.

Coggins reports that servicing functions now constitute a large part of the BLG staff’s job, now that the organization has about 150 loans on its books, as shown in figure 1. Staff time allocation overall has gone from nearly 100 percent of time spent on originations two years ago, to about 60 percent on originations and 40 percent on servicing today. Recently, another person was added to the staff, to handle some of the servicing activities.
Coggins also finds that many loan applications coming through the BLG loan committee are existing loans with new actions on the original deal. In one recent week, three of the five loans the committee considered were related to existing loans, and only two were new deals. With traditional credit union lending, this kind of ongoing servicing is not necessary. But in commercial lending, loan servicing becomes a substantial part of the overall operation. That requires the staff skill to monitor a portfolio on a continuing basis. The business loan is much more complex from a servicing standpoint than a typical consumer loan.

“To enter the business lending and service arena,” says Coggins, “the credit union must be totally committed. It can’t be a sideline, or an afterthought. A good relationship with a single real estate developer who now wants to develop a neighboring subdivision, for example, does not constitute a compelling rationale for a business loan program. The practice of dabbling is a sure recipe for failure in this business. It’s not mysterious, but it does take experience.”

**Building Relationships**

BLG works very hard to try to build deposit relationships with its clients. Issues such as retirement planning, succession planning, and investments are all important issues. Many small businesses can use help in these areas, and BLG tries to be aware of areas beyond lending where its owner credit unions can be valuable to business people.

BLG may refer borrowers to a second CUSO operated by its owner credit unions. Marketing materials also list some of the other services that BLG offers, as shown in figure 2. The credit

---

**Figure 1: Business Lending Group Servicing Activities**

- Financial analysis
- Risk assessment
- Monthly and quarterly analyses on some loans
- Changes in the borrower’s business status
- Title transfers by the borrower
- Changed entity names and structures
- Sale of property
- Requests for additional advances
unions also employ business development people, so when BLG makes a business loan those individuals follow up and solicit the business as a SEG or for other services. For example, the churches BLG counts as commercial borrowers with could benefit greatly from offering automatic deductions for their parishioners who contribute regularly to church building funds. It makes giving easy for everyone, and secures the loan at the same time. One of BLG’s credit unions has contacted churches with some success. Today, with automatic payment systems part of consumer lifestyles, the churches themselves have had some success with that idea. It’s convenient for the individual and provides security for the church building fund.

Each of BLG’s three credit unions has its own collections department. They notify BLG if a loan becomes 14 days past due. The credit union sends a notice to the member, and faxes a copy of that notice to BLG, which then contacts the member to learn

---

**Figure 2: Business Lending Group Services**

**Loans**
- Commercial loans
- Commercial lines of credit
- Equipment and vehicle financing
- Commercial Real Estate Lending
- Multi-family and rental property loans
- Purchase of existing businesses
- Other customized loan programs

**Deposit Services**
- Business checking
- Business checking with interest
- Money market accounts
- Business savings accounts
- Automated payment programs
- Wire transfers
- Business MasterCard and Visa

**Other Specialized Services**
- Retirement planning
- Insurance
- Investment services
what the problem is. So far, there has been only one loan with chronic delinquency that has created problems. All other instances have been momentary misunderstandings. BLG has had no loans in which the business is failing and the borrower is unable to pay for that reason.

**Regulation Limitations**

Regulation presents some unique considerations for credit unions. Coggins suggests that a few changes in regulation it would make BLG more competitive in the business lending field. “Loan to value limits sometimes tie our hands,” he says. “Any change in regulation would involve both our state office of credit unions and the NCUA. We’d like to see existing regulations changed where possible, to be a little friendlier to business lending.”

By regulation, any loan over $50,000 must be secured, and carry no greater than an 80 percent loan to value ratio. There are many smaller loans in the $50-$200,000 range that a bank would be interested in because the business shows a strong cash flow but has intangible assets. One good example is a dentist’s practice. It’s likely to have good cash flow, and be located in a rented building. The dentist might need a $100,000 loan to make leasehold improvements, purchase equipment, and pay off dental school bills along with startup costs. Technically, this loan may have only $50,000 of hard collateral, but the dentist has a tremendous ability to pay.

Yet technically, the credit union can’t make the loan unless it supplements the collateral with personal real estate. BLG finds itself taking more personal real estate as collateral on a loan than a commercial bank would. Service businesses are difficult for a credit union to lend to. Many of these businesses are excellent risks, with good cash flow but with limited hard collateral.

Another regulation that handicaps credit union business lending is the requirement that every loan except those to non-profit organizations must be personally guaranteed. There is a good reason to ask for a personal guarantee, but there are times when BLG has an opportunity to lend to strong companies, and personal guarantee requirements work against making the loan. For example, a firm may a senior partner owning 70 percent and a junior partner owning 30 percent. Any principal in the loan must be a guarantor. But if the senior partner is a father who wants to
leave the business, he's not likely to want to personally guarantee a loan.

A third regulatory issue is the business regulations themselves, which do little to facilitate the lending process. Coggins believes the regulations would benefit from a review and revision by an experienced business lender.

**The Case for a CUSO**

BLG’s credit union owners believe that they can be much more effective working together in an area as demanding and as complex as business lending than they could working on their own. But it takes more than simply creating the CUSO structure. It takes a high level of trust, mutual respect, and common vision among the participants in the venture. These three credit unions had prior experience in working together.

These credit unions have an ownership stake in the commercial lending business. That gives them a commitment that’s missing under some other possible structures intended to address business lending. Because these credit unions have risk capital involved in BLG’s success, they are motivated to do everything they can to make sure the enterprise succeeds.

When a liquidity crunch occurred late in 1999, for example, BLG had many deals in progress and many prospects to follow up on. The credit unions were obliged to find funding for these projects. Each week, in loan committee meetings, the participants considered whether they should slow down on prospecting and be more selective. But the credit unions consistently told BLG that they were prepared to manage their way through these bumps in the road. They knew that if the organization waffled on business lending, it would do irreparable harm to their image in the marketplace, and erode the goodwill of the business community.

More recently, the market has been at the other end of the spectrum, and the credit unions could relax standards to attract more loans. But they are determined to be consistent in applying underwriting standards, and to consider the long-term relationships they’re trying to build. They are looking at long-term asset/liability management issues, not at temporary conditions.
Fox Communities, Banta Community and CitizensFirst credit unions, along with many consultants in business, believe that the business model of the future involves cooperation. To be effective, they need to work together. CU SOs are one way to achieve the kind of cooperation credit unions need in today’s business climate. Says David Coggins: “We don’t see our CU SO as simply a service to which we refer people. It’s an integral part of the larger business strategy of each of our owners. We have three partners who are willing to sit around the table and make decisions in the best interest of all concerned, and leave their egos at the door. That’s what the cooperative model is all about.

“We also believe there’s value in cooperating and working with other credit unions, to develop the ability of all credit unions to offer business services. By promoting the concept of business lending, we secure our own future as well. If credit unions are serious about providing lending and other services to business, we’ll all be in a better position to encourage the cooperation of regulators and legislators. We want to see all credit unions succeed in this arena.”
DUPACO COMMUNITY CREDIT UNION
Dubuque, Iowa

Dupaco Community Credit Union is a $280 million organization dedicated to serving the financial needs of individuals and businesses in the Dubuque, Iowa community. The credit union began business lending about 17 years ago. “At the time,” says President/CEO Bob Hoefer, “we’d moved from a single-sponsor credit union to a community charter. That was brought about as a result of a plant closing by our original sponsor, the Dubuque Packing Company. As a community credit union, we needed to broaden our business charter, and look at new ways in which to serve a larger community. Our bank competitors claimed that we didn’t really serve the needs of the community because we didn’t reach out in ways that they were required to do under the Community Reinvestment Act.”

Hoefer points to both financial and non-financial reasons for entering the business lending arena. On the financial side, margins on traditional consumer products are becoming smaller and opportunities for income are fewer. Business services is an area where the margins are still reasonable. On the non-financial side, more small businesses are being formed, people are leaving corporate life and striking out on their own, so the opportunity to serve members is growing at a rapid rate.

“Those were essentially our reasons for undertaking a business services program,” says Hoefer. “Our members want us to provide these services. Many of our members were employed by corporations for years, and used the credit union for personal financial services. Now these members are changing occupations, forming their own businesses, and finding that they need a new range of services. They trust their credit union, they own it, and they want it to grow with them.”

Dupaco Community Credit Union’s mission is to be its members’ lifetime home for financial services. That mission requires some diversification in product line. In the Midwest, businesses that are growing most rapidly are one, three, and four employee enterprises. Large company expansion has been minimal, at best. People who once worked in the technology areas for large companies are finding niche markets to serve through their own
businesses. These entrepreneurial individuals are a growing segment of the economy.

Many emerging entrepreneurs get their start with home equity loans, an area where credit unions can excel. In working with larger businesses, credit unions are more likely to be collateralized lenders.

The relationship between Dupaco and its business clients begins with lending services, but it typically goes farther than that. Business lending is an opportunity for credit unions to help people realize their dreams. As an example of the interest in business lending on the part of credit unions throughout the nation, CUNA’s Renaissance Commission reports that it received more requests to change the rules for business lending than any other area of their investigation. Credit unions asked for changes in the rules for personal guarantees, risk factors, and regulatory requirements, as well as other areas of business lending.

Hoefer counsels that the first thing a credit union needs in setting up a business lending operation is the staff experience and talent to undertake the operation. That probably means hiring a business banker who knows how the process works. A fledgling operation needs an individual who has experienced business cycles, including economic booms and busts. The key is to recruit a business lending expert who knows whether a business plan shows potential or not. Most credit union staffs have not had the experience necessary to launch such an operation, and the human resource in this area is critical.

Beginnings

Following the plant closing by Dupaco’s original sponsoring organization, many of its members were seeking new careers, and many of them chose to organize their own businesses serving the community on a freelance basis. When these members came to the credit union looking for loans to support their new businesses, the lending staff often had to turn them down because the credit union wasn’t organized to do business lending. Hoefer and the Dupaco board of directors saw both a challenge and an opportunity in these developments. They wanted to continue to be a part of their members’ financial lives, but they needed the expertise and programs that would help them to continue a growing relationship with the credit union.
Dupaco decided to become a small business lender on a gradual basis, and to do that in a way that would help meet the mission of the organization. The objective was to provide money to the community in every way possible, to help it grow. Hoefer recruited John Koppes, a former banking executive with business lending experience, to head up the new operation. Koppes has been with the credit union for 17 years, and is now its Senior Vice President, Business Development.

Experience is so important because a good business lender needs to be able to identify both good accounts and bad accounts, and devote time to the good accounts. That means building relationships, getting them to give the credit union an opportunity to bid on a new loan when the time comes.

A knowledgeable staff is another key ingredient of a successful business lending program. The manager is likely to be out making contacts, but the foundation for the business is back at the office where the staff makes sure everything runs efficiently.

Initially, regulators were hesitant about the viability of a business lending program, and demanded a number of things during the early years of Dupaco's entry into the market. They required extensive documentation, along with more detailed paper trails than Dupaco was used to doing for its consumer lending programs. Hoefer says that even real estate lending, for all its complexity, is relatively simple compared to business lending. Commercial lending is much more labor intensive, involving credit analysis, accounting skills, reading financials, inventory reports, accounts receivable and other special functions.

"Business lending requires a firm, long term commitment," says Hoefer. "You need to either be in it, or get out entirely. There's no halfway. Written policies, safeguards, a professional staff, and resource allotment are essential, as is a full product line." Dupaco's business committee analyzes all loans over $100,000, in order to take some of the pressure off its business lenders in the decision-making process.

The results of the program speak for themselves. Dupaco has achieved better margins in its commercial lending business than in all other lines of business combined. Business lending has been a builder of reserves, added significantly to margins, and helped to build the credit union's long-term future.
Dupaco currently has about $35 million outstanding in business loans on its books. That volume is handled with a staff of five employees, plus the business development officer. In addition, this staff originates real estate and consumer loans amounting to $15 million. The credit union increases its outstanding loans by $2-4 million each year.

The credit union encourages its business clients to bring all their business to Dupaco, personal and business. The objective is to have a complete knowledge of the client’s total cash flow. To that end, Dupaco seeks the entire household’s financial business for its business clients. That helps attract both consumer and commercial business, including credit cards, investor’s choice money market accounts, and business checking accounts. With this kind of total financial relationship, the credit union can work with the member to be the asset needed to promote the business and make it successful.

Business accounts typically have much greater assets on the deposit side of the business than does a typical consumer. There’s greater cash flow, and successful business people grow and bring more business to the credit union.

Once the account is secure, business owners are likely to need financial planners to help them, and trust services for estate planning. Dupaco recently opened a trust department.

“With a trust company in place,” Hoefer says, “we have a facility in house that will never compete with us for deposits, and will never lend money to our accounts. They are our partners. All these services benefit both our business members and the credit union.”

Dupaco seeks out businesses that have the potential to be positive cash generators. In fact, the credit union often receives a better return on the deposit side than on the loan side over the life of the business. One goal is to move the client from the lending side to the deposit side.
Building Relationships

Attracting and retaining a good professional staff is key to a business services operation, so the relationships staff forms with client members can flourish. Turnover is more dangerous in a commercial lending operation than it is in a consumer lending operation, because so much of the business depends on personal relationships.

Those relationships develop from a number of sources. Dupaco is active in a variety of community involvement programs, and encourages members to tell others in the community that it's a good place to do business. Community involvement generates interest, and builds awareness of the credit union both as a business partner and as trustworthy people. The credit union also engages in image-building activities. It has not done formal marketing campaigns on its commercial services, however. The process is largely a word of mouth process, very much one-on-one communication.

The credit union’s best advertisement is a recently-satisfied client. When the business lending staff meets with that kind of client, they ask the client to pass the word about Dupaco Community Credit Union to their friends and business colleagues, and let them know that Dupaco has good people to do business with. And they ask these clients to call the credit union and let the staff know when they’ve referred someone, so they'll be prepared.

With a business client, the relationship is ongoing. It’s not like a real estate deal, for example, where the transaction is completed, and the credit union may not see the client again for several years.

Dupaco gets very little of its business leads through walk-in traffic. The banks probably have already turned down that kind of borrower before they walk into the Dupaco lobby. However, Hoefer suggests that a credit union undertaking a business lending program train staff on the consumer side of the business to cross-sell business loans. This should be an automatic part of the credit union's cross-sell program, when the opportunity arises.

Dupaco’s community involvement program even involves participation loans with some banks in the area. Dupaco takes its share of funding to help the community on projects. It is currently putting together a deal involving a sister credit union in which
Dupaco will be the lead lender, and the participating credit union will take part of the loan.

**Competitive Considerations**

Hoefer reports that many banks in the Dubuque area have merged in recent years, purchased by larger, out-of-town organizations. Some of the tension that accompanied passage of the Credit Union Member Access Act, H.R. 1151 is gone, but bank competition is still very formidable.

One of the weaknesses of credit unions is their data processing systems, which do not have the capability to analyze business checking accounts – how many deposits are being made, how many foreign checks have cleared, what’s the clearing time on checks, cash-coin-currency activity, and lock-box service usage. Because Dupaco’s ability to analyze these factors is limited, so is its ability to institute fees for those services. The credit union depends on the deposit and lending relationship to provide the margins to be successful.

Another data processing need in the business lending area is to find a system that can print all collateralized documents and assignments necessary in commercial lending. Dupaco uses Bankers Systems programs, so that it can be sure the documents are accurate and enforceable.

**Professional Service Providers**

Dupaco has a corporate counsel who determines what must be done to effect a collateralized instrument and provides advice on other business documents. Accounting software was purchased to support business services. A retained CPA consultant examines the credit union’s operations, and also brings in an outside consultant to take a look at the operation. The consultant analyzes Dupaco’s business loan portfolio, and offers advice on specific loans, improvement and workout suggestions. “An outsider can give us advice on loans that might be a little outside our normal range of business,” says Hoefer. “That gives us another point of view upon which to base our business decisions.”

Hoefer compares the process to doing one’s own due diligence on loan decisions. That means the credit union needs to use all the tools available to make intelligent decisions. Business lending differs from typical credit union operations. On real estate loans,
for example, much of the business is sold into the secondary market, and the buyer takes a second look at the loan. And in consumer lending, tools such as credit scoring help in the decision-making process. But in business lending, the lender is on his own, and additional points of view are welcome.

Another consideration is the concentration of loans. Dupaco is wary not to make too many loans in a particular category or a particular business, in order to spread the risk. An economic downturn might put extreme pressure on a loan portfolio that's concentrated in one particular area. The NCUA is a formidable resource, since the agency has lots of experience in this area.

**Governance**

Dupaco’s five-member business lending committee is made up of John Koppes, who presents each case; the credit union’s vice president of finance; Hoefer; and two directors. The two current board representatives have extensive expertise in business, having owned businesses themselves. One board member owned two independent insurance agencies; the other was co-founder of a business that eventually went public. These individuals know how to read statements, and how business operates. Hoefer counts it as a major advantage to have business-savvy individuals on the Dupaco board. And he advises credit unions thinking about initiating a business lending program to consider recruiting individuals with a business background.

Hoefer says identifying qualified candidates was not a difficult task for the Dupaco board. “One of these directors was involved in the first SEG group Dupaco recruited, and was a longtime member of the credit union. He is also a very active community leader, and was an obvious choice when a board position became available. The second individual is an insurance agent that handled a number of the credit union’s member accounts, and is also an active volunteer in the community.”

**Working Together**

Dupaco’s business lending staff works closely with the credit union’s vice president of Business Development, Leo Costello. In his calls on business owners, Costello routinely asks what services the credit union can provide to both employees and the business itself. And whether it’s Costello or John Koppes, they explain that
Dupaco offers all the services that a bank offers, from card programs, to corporate credit cards, lines of credit, and trust services. The credit union’s business lending services are shown in figure 3.

**Figure 3: Dupaco Community Credit Union Business Services**

- Business loans and line of credit accounts
- Interest-bearing business checking
- Savings, money market and certificate accounts
- Commercial mortgages
- Corporate Visa credit cards
- MasterCard and Visa Merchant processing
- Expressway indirect lending
- IRA and SEP accounts
- Employee net check, ACH and payroll deduction services
- Safe deposit boxes
- Debit card, online branch and telephone teller account access

A number of years ago Dupaco decided to bring all the services it provides to businesses and owners to a single department because business clients were becoming frustrated when they called the consumer department and were asked to provide the same information they’d already given to the business department. A business relationship depends on a single source for all financial services. If a business client, for example, wants an auto loan, the client now calls the business department. The same is true of real estate transactions.

The relationship also gives the business department an opportunity to cross-sell other credit union services, both commercial and personal. That lowers future risk, because the credit union has the individual’s complete financial history and circumstances at its fingertips. Bank competitors do not always have that advantage. Bank loan officers focus on commercial lending, and pay little attention to other services the bank may be able to offer their business clients.
Business lending requires a complex infrastructure in terms of loan documents and accounting systems. It is a labor intensive business, with a high level of documentation required. At Dupaco, a loan analyst is charged with providing spreadsheet information from tax returns and other information. Like Business Lending Group, it uses Robert Morris & Associates to provide industry comparison data. The staff performs cash flow analysis in Microsoft Excel, and writes the analysis in Microsoft Word.

Dupaco does background checks on the business people it deals with, in order to better understand who they are and how they run their business before closing a deal with them. In this way, the credit union determines whether a prospective client is a good credit risk or not.
An American Story

The year was 1918. In the Bronx, New York City, small business owners in the garment industry, many of them immigrants, were having a difficult time raising the capital needed to participate in what was rapidly becoming a thriving industry. Banks were unwilling to lend money to people of modest means, and few garment industry workers, despite their considerable skills, had the collateral to attract the attention of traditional financial institutions.

These budding entrepreneurs decided to band together and form an institution through which they could access affordable credit, and Progressive Credit Union was born.

The credit union was formed well before enabling legislation passed state and federal legislatures. Minna Levine was the secretary to the small, part-time Progressive Credit Union. Later, her husband Louis, uncle to the father of current treasurer Robert Familant, became a volunteer board member of the credit union, serving for many years as its president.

Progressive Credit Union grew, providing the capital its members needed to purchase sewing machines, fabrics and other necessary business supplies. The credit union was both similar to and different from the credit unions that would follow it in the wake of the 1934 Federal Credit Union Act. Like its brethren, it provided low cost credit to people of modest means so that they could improve their quality of life. Character, rather than collateral, was the basis for those early loans, and the foundation for a growing organization.

But unlike most other credit unions that were to follow, the focus of Progressive Credit Union from its very beginning was on business lending. The credit union’s founders knew that without the means to make a livelihood in the garment industry, its members would be hard pressed to achieve the American Dream. Business lending and other services therefore became the cornerstone of the credit union’s operations.
The Familant family had a date with the destiny of the credit union. In 1959, the credit union’s assets were approximately $500,000. The operation was becoming too complex to be handled on a part time basis. The board of directors pondered whether to continue on a limited service basis, or to hire a full time treasurer/manager and seek additional business opportunities.

Enter Robert Familant’s father, Aaron. When he had come back from World War II, he was recruited by his Uncle Louis to become a member of the credit committee. An accountant by training, by 1959 he had become controller of a company in New York, but was required to spend much of his time traveling in the Midwest. He agreed to leave that post and take on the full time duties of a credit union manager. Thus, a family tradition in credit union work was continued.

In 1961, the credit union recognized a market need in the New York area. Taxi drivers eager to become owners of their own businesses were hard pressed to raise the substantial sums necessary to purchase medallions and automobiles. In the dynamic world of the Big Apple, the opportunities were there, if only these entrepreneurs could get the credit to enter the transportation business.

Progressive Credit Union considered the cab drivers opportunity to be a window for its own growth. At the time it appeared that the players had a win-win situation, and subsequent events proved that both the taxi drivers and the credit union were correct in their assessment.

From its modest beginnings, Progressive has grown to become a vital organization with more than $225 million in assets, $218 million in loans, and $113 million in deposits. Today, Progressive serves the taxicab communities not only of New York, but also of Chicago, Boston, Miami and Atlanta. It is a thriving organization built on a market niche closely aligned with business lending. And it exhibits all the characteristics of traditional credit union principles.

Robert Familant says that in order to serve their members’ complete needs, credit unions need to understand that many people have diverse interests that may require financial services. “Those credit unions that are common bond oriented need to recognize that their members may have other sources of income.
that the credit union needs to address. Progressive’s borrowing members are small business people who depend on the credit union for the wherewithal to make their living. That’s when the credit union can step in and help them to achieve their dreams. It’s what we at Progressive have been doing for nearly a century.”

The credit union brings cooperative principles to the markets it enters. When Progressive began providing loans to members in Boston and Chicago’s taxi fleet, for example, it effectively reduced loan rates by 25 percent. In Atlanta, the rate was reduced by 40 percent. That amounted to a savings of millions of dollars in interest payments for the owners.

Today, approximately 75 percent of Progressive’s total loan portfolio is in taxi medallions\textsuperscript{20} and vehicles. In addition, the credit union provides mortgage loans to members, and offers participation loans to other credit unions. Familant sees the role of the credit union as central to the lives of its members. “In one sense, it’s difficult to separate consumer loans from business loans,” he says. “When a member comes to us to obtain funding for his business, he may very well offer home equity or a personal vehicle as collateral. We try to look at our members’ needs as a whole, and help them to make the most of the assets they own. We think that’s consistent with credit union and cooperative principles, and it’s the way we can serve our members best.”

\textbf{How It Works}

Want to drive a taxi in New York City? It’s not an easy process, but it is fairly straightforward. Familant explains that the first step is to obtain a taxi and chauffeur’s license from the city. That involves educational sessions as well as certain fees.

Next, the prospective cabbie needs to purchase a medallion to operate a cab. The usual procedure is to buy the medallion through a broker, who trades in the business on a market supply and demand basis. New York City issues two classes of medallions, individual and corporate. Recently, an individual medallion was worth approximately $190,000. That’s down from the $250,000 range a few years ago, but fluctuations in the value of medallions are not unusual. New York City currently has 12,000 medallions issued. Corporate medallions, operated by cab companies that

\textsuperscript{20} A medallion is an emblem of registration for a taxicab.
keep their vehicles on the road for double shifts, are valued at $460,000, which covers two medallions.

It's rare for a prospective owner to have the capital necessary to purchase a medallion, pay the associated 5 percent sales tax, as well as purchasing a vehicle and paying the costs associated with that purchase, without credit. Therefore, the medallion broker refers the applicant to various lending sources for a loan. “Here, too, the referral is likely to be based upon market conditions,” says Familant. “A broker knows where owners can obtain the best rates and service on financing, and bases his referral on those rates and services. It’s a very competitive business, and we’re gratified to know that we’ve been able to provide some of the best rates available to our members over the years.”

Another channel through which members find Progressive is referrals by other members who have their loans with the credit union. “A prospective borrower also may already know about Progressive, through his contact with other cab drivers or depositor members.”

A typical loan on a medallion and vehicle, plus associated fees, licenses and taxes, is made at up to 80 percent of loan-to-value, but in some cases loans can go to as high as 90 percent of loan-to-value.

When the owner makes application to Progressive for a loan, the credit union proceeds with its due diligence activities. It requests a credit report on the applicant from the local credit bureau, and makes its decision based on that report. “We are in an enviable position with respect to the collateral we receive on our taxi loans,” says Familant. “In the rare instance where a delinquency becomes untenable, we can rely on the value and liquidity of the medallion to make the credit union whole on its loan.”

Progressive does not rely on scoring systems and risk-based lending in making lending decisions. “Character is still the most important element of a borrower’s credentials for us,” says Familant. “Character and collateral secure our loans in ways that traditional scoring systems cannot measure.”

Taxi loans are subject to rules under the Uniform Commercial Code, and the applicant signs a security agreement when the funds are disbursed. The first payment on a loan is due 30 days from the
date of the loan. The credit union encourages its borrowers to make their loan payments each week, if possible, because that is their cash flow cycle. “We show them how they can save money by paying weekly on an open loan,” Familant reports. “That’s another one of our advantages. Not all lenders will do that.”

Borrowers use a variety of methods to make payments on their loans. Some members use ACH payments, while others come into the credit union with three months’ checks at a time dated every Friday or Monday. Payment methods are as individual as the members to whom the loans are made.

Loans are amortized over a period of 15 to 20, and even 25 years, but the loan typically is made for three to five years, with a balloon payment and modification at the end of that term based on current rates.

Like credit unions that focus on consumer loans, Progressive does have a collections employee who works three days per week to help delinquent members find ways to bring their loans current. “We monitor delinquency in much the same way as other credit unions do, but our delinquency ratio is historically very low,” says Familant. “Because we grant loans based on the character of the borrower, we’ve been able to keep charge-offs and loan losses at a minimum. We might place people who are habitually delinquent in making loan payments on an involuntary weekly payment plan to help them catch up. For those who have health or family problems, we work to overcome the problem and maintain this important asset.”

If foreclosure becomes the only viable alternative for the credit union, Progressive either repossesses the taxi with the medallion on it, or takes the medallion from the car and sells it. One of the things that makes the taxi industry an excellent lending opportunity is the ability to foreclose and sell the asset without suffering a loss on the collateral. And, says Familant, Progressive has never suffered a loss of principal on the foreclosure of a taxi loan.

The Progressive staff consists of 16 employees. Taxi lending is headed by a vice-president for taxi lending. She has two full-time loan processors working exclusively on medallions. Progressive also grants loans for “black cars,” or corporate limousines. One employee is dedicated to commercial business loans and Small Business Administration loans, along with
residential mortgages. Progressive's member service area includes its tellers and member service support. There's also a chief operating officer and an office manager.

In cities other than New York – Chicago, Boston, Miami and Atlanta – Progressive's presence is limited to a marketing representative. In each case, these marketing representatives are former New York City medallion owners who moved to other cities.

Progressive's core business systems are tied to the software provided by its data processor, EDS. It uses the EDS loan origination system. However, it does design and use some organization-specific forms for its own use as well. In May, 2002, the credit union will switch to a new system by WESCO, which promises to enhance productivity and provide additional services.

The credit union also offers participation loans to other credit unions, having struck deals with approximately ten others around the country. Of it's total $285 million in loans, approximately $67 million is shared in participation arrangements, for a net loan portfolio of $218 million. Progressive also sells its SBA loans into the secondary market for a fee. When the credit union needs additional liquidity, it relies on the resources of New York State's Empire Corporate Federal Credit Union.

**Attracting Funds**

On the deposit side, Familant says the credit union succeeds primarily by offering very competitive rates on savings. “Our depositors are not the same people as our borrowers,” he explains, “but there is a strong feeling of membership among the various segments of our credit union.” Progressive boasts a very healthy $40,000 average deposit per member.

Progressive's annual meeting attracts more than 200 members, or five percent of its total membership. “It's an indication of the level of interest our members have in the business of the credit union,” says Familant.

“We've always been at the top end of the dividend structure. When rates go down in the industry, ours go down too. But we’re always at the top end of the range. People realize that, and become part of our loyal core of depositors. We rely on word of mouth communication.” Progressive does not rely on media advertising,
although it does publish a newsletter to keep current members informed. The credit union offers the typical range of savings products, from share accounts to IRAs.

The Future

While Progressive Credit Union intends to grow in the future, management and the board does not set specific growth goals. Currently, assets are at $223 million. The board has not given marching orders to grow to a specific target goal by year-end. Familant suggests that the credit union wants to be where its members take it. Shares have grown recently because members have taken money out of the equity markets. Progressive took these deposits and paid down its loan with Empire Corporate, and didn’t grow all that much, but Familant says that’s fine. “We don’t believe in growth simply for growth’s sake.”

Familant’s advice for other credit unions thinking about moving into the commercial lending market? “A common perception of credit unions is that their members don’t need small business loans. That is not true. People do more than just go to work every day. They have other business interests and opportunities. Credit unions should develop the expertise to help their members pursue these interests.”

“Credit unions should acknowledge that members need these loans. You’re serving your members’ basic interests by providing them with a small business program. You may even be protecting your membership base. If a member is forced to go to a bank for a small business loan, the bank is likely to cross-sell accounts already held by the credit union.”

At the same time, a healthy concern for the complexities of commercial lending is a good thing, according to Familant. “Current loan officers are not likely to have the expertise to deal with commercial loans. If the credit union plans to enter the business lending market, it must either give its current staff the kind of training necessary to make commercial deals, or it must recruit professionals with business lending experience. The additional income earned by providing business loans should cover the additional expense.” In fact, NCUA rules require a certain level of due diligence before a credit union can offer these services.
Familant points to the Small Business Administration program as very helpful. The SBA helps with the underwriting, because they’re another set of eyes looking at the loan. It’s a worthwhile investment for credit unions to do the extra work required to get an SBA license. The SBA has been proactive in helping credit unions to get licenses. That’s a good first step. Not only do they help with the underwriting, but part of the loan is guaranteed.

Familant also encourages credit unions to look at additional collateral available on business loans. It’s not uncommon to take a home or a vehicle as collateral on a business loan. There’s an opportunity for credit unions in the business lending area to provide additional service to their members in a safe way. It also gives the credit union a slightly higher yield than it may be getting on its consumer loan portfolio, so it should be able to pay for itself.

**Figure 4: Progressive Credit Union, New York, NY**

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Members</td>
<td>4,548</td>
</tr>
<tr>
<td>Assets</td>
<td>$226,408,155</td>
</tr>
<tr>
<td>Shares</td>
<td>$116,866,279</td>
</tr>
<tr>
<td>Gross Loans</td>
<td>$283,797,476</td>
</tr>
<tr>
<td>Net Loans</td>
<td>$221,682,427</td>
</tr>
<tr>
<td>Capital</td>
<td>$102,123,489</td>
</tr>
<tr>
<td>ROA (2001)</td>
<td>4.25%</td>
</tr>
<tr>
<td>Capital/Assets (2001)</td>
<td>45%</td>
</tr>
</tbody>
</table>
How to Build a Church

Evangelical Christian Credit Union (ECCU) is a $347 million organization with 13,000 members, located in Anaheim, California. Of its total $287 million loan portfolio, $276 million is invested in member business loans, and another $11 million is held in other real estate loans.

Since 1964, Evangelical Christian Credit Union has been serving the financial needs of the evangelical Christian community including churches, schools, ministries and individuals. Its members reside in all 50 states and in more than 100 countries around the world. The credit union’s mission is to assist ministries and the ministry-minded in doing their jobs better. The overall objective is to increase the effectiveness of members through biblically based, value-driven financial services.

ECCU was formed by a merger of two Christian credit unions that had historically provided service to both individuals and churches. Over the years the credit union has changed its focus from providing lending and deposit products for individuals, to concentrating on business services for churches and church-related organizations such as schools. Today, ECCU focuses extensively on business services. The transformation from consumer to business services was an evolutionary process based on the credit union’s perception that its greatest service opportunities lay in loans to churches. The transition from consumer to business lending was made smoothly and without controversy.

Loans to churches are a very specialized lending segment. Often, local bankers do not understand the special needs of churches. Commercial banks may not understand how to apply underwriting standards to church loans. And they are often reluctant to lend to a church, in the remote possibility that they may have to foreclose on the loan at some point in the future, and thereby lose the goodwill of the community.

The lending experience of ECCU’s expert staff, on the other hand, arms the credit union with the wherewithal to counsel and advise church leadership in the design of a good loan. As a result of this experience, ECCU has never had a charge-off on a
mortgage loan made to a church. The credit union has found that if it makes a good loan, the congregation tends to grow and become more financially secure. In time, the church may even need another loan to continue its physical expansion to accommodate increased membership.

The credit union’s membership consists of Christian churches that are usually controlled locally by a church council, board, or elders. This assures that decision-making rests in the hands of the group to which the loan is granted, and avoids hierarchical policy changes that may affect the integrity of the loan. The credit union also asks the church membership to either ratify or publicly affirm the loan. This underwriting policy is intended to make sure that everyone in the congregation is aware of the loan plan, and that the plan has the public support of the church membership.

The credit union also requires the church board or council to be independent of the clergy serving the congregation. In one case, for example, a prospective borrowing church was governed by a six-member council comprised solely of the minister and his immediate family members. As a condition of making the loan, the credit union required the church to diversify its board to include non-family members. The purpose for this underwriting standard is to avoid becoming enmeshed in projects that play to the personal agenda of clergy.

The target loan ratio for ECCU is 65% of loan-to-value of a building project. The credit union examines the number of members in the congregation, the average annual contribution per member, and historical income records in its due diligence process. The credit union expects the total annual loan payment to be no more than 30-35% of the church’s total annual budget.

The fact that churches don’t engage in multi-million dollar building projects on a regular basis gives ECCU a distinct competitive advantage. The credit union positions itself as an expert in the field of church construction loans. Credit union loan officers - themselves evangelical Christians - consult with the church board. Many of the credit union’s staff have served in ministry and/or missions, and are familiar with the requirements necessary for a successful building project. They provide their expertise to church boards that may not have the same depth of experience in the field. In essence, the credit union serves not only
as a lender, but also as a trusted advisor to church boards during the lending process.

ECCU’s business strategy relies on the savings and checking accounts of ministry and individual members to provide the deposit base from which to grant loans. They solicit both sides of the church’s business activity – both loans and deposits. In addition, ECCU relies on a network of participating credit unions to provide funds.

The credit union is chartered to make church building loans anywhere in the U.S. It has nine regional representatives around the country, who talk to church boards and supervise loan projects. A total of 43 people are involved in the credit union’s lending department activities, from credit investigations to closing and servicing. As its loan portfolio grows, the credit union has turned to participating some of the loans it grants. It has made $750 million in total loans, and has kept two-thirds of those loans on the credit union’s books. The remainder has been sold to other participating credit unions.

In 2001, ECCU originated $250 million in loans. Of that amount, ECCU offered approximately $130 million to participants.

ECCU has customized its lending software to book loans that are accounted for differently than are consumer loans, and has written programs to handle its participation fees. When the credit union receives payments from its borrowers, it needs to pass-through a certain percentage of the payments to its participation partners. Investor reporting is also required for participation loans.

Typical investors are other credit unions seeking sound lending opportunities. In fact, some credit unions that began their business lending strategy by participating in loans with ECCU later began offering business services on their own. It’s one way to test the business services climate, and learn more about the opportunities in the business community.

Marketing is handled through a variety of traditional communications channels. The credit union advertises regularly in the religious trade press. Trade shows are another effective marketing channel, along with church leadership conferences and conventions. The credit union relies on direct mail advertising as well. Word of mouth is a compelling marketing tool. In effect, the
credit union uses the same marketing techniques employed by
natural person credit unions in reaching out to its target audience.
It’s business-to-business marketing on a national level.

Because ECCU has only two brick and mortar branches, it reaches
out to serve its members through a variety of interactive remote
channels, including the Internet (www.eccu.org), where churches
can access information regarding the scope and breadth of its
services. In addition, ECCU offers the access paths shown in
figure 5 to maintain contact with members.

A Staff Of Experts

ECCU is staffed by individuals with broad experience in
commercial real estate. The differentiating factor between it and
other lenders in the church building arena is that these experts

<table>
<thead>
<tr>
<th>Figure 5: Evangelical Christian Credit Union Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Toll-free person-to-person service nationwide</td>
</tr>
<tr>
<td>• Internet delivery of online, real-time banking</td>
</tr>
<tr>
<td>information and transactions</td>
</tr>
<tr>
<td>• Phone*Link 24-hour toll-free telephone account</td>
</tr>
<tr>
<td>access</td>
</tr>
<tr>
<td>• Affordable electronic payment services</td>
</tr>
<tr>
<td>• Worldwide monetary transactions including currency</td>
</tr>
<tr>
<td>exchange, wires and foreign drafts</td>
</tr>
<tr>
<td>• An extensive ATM network for cash withdrawals and</td>
</tr>
<tr>
<td>deposits</td>
</tr>
<tr>
<td>• Check card access worldwide</td>
</tr>
<tr>
<td>• Point-of-sale locations at supermarkets and grocery stores</td>
</tr>
</tbody>
</table>

typically are also evangelical Christians. The staff has been
recruited from among the ranks of evangelical Christians, people
who believe in the mission of the churches the credit union serves.
Employees are active in their own local churches, so they
understand not just the financial need of the churches that come
to the credit union for loans, but the church’s overall purpose and
call as well.

“When we sit down with a minister or a church board of elders,”
says Kevin Bates, ECCU Participation Loan Coordinator, “our
first questions are not about the building project. The first thing we’d like to know is how the congregation is developing. We want to know about the underpinnings of faith and the commitment of the membership to achieving the overall purpose of the church. We serve as a kind of peer review, to probe whether the foundations of the church are secure, before moving on to discuss financial details.”

The credit union stresses the fact that its core beliefs are coupled with disciplined action, resulting in a chemistry that differentiates people and organizations. While the values, mission and objectives of prospective borrowers may be foreign notions to traditional banking institutions, they are shared by ECCU. In terms of both fundamental principals and staffing, the credit union understands how churches operate, and what their aspirations are.

This gives Evangelical Christian Credit Union a tremendous competitive advantage in its niche market. It also allows ECCU to examine prospective loans from a point of view that is not available to other lenders, and further secures the overall loan portfolio. “In a case where five or six financial institutions are bidding for a project,” says Bates, “our connection by faith often allows us to make the cut to final consideration by the church board. Everything else being equal, our spiritual ties give us the kind of differentiation required to carry the day.”
VANCOUVER CITY SAVINGS CREDIT UNION
Vancouver, British Columbia

Vancouver City Savings Credit Union is a giant in the credit union world, boasting assets in excess of $7.3 billion Canadian and 39 branches placed strategically throughout Greater Vancouver and the Fraser Valley. Membership in VanCity, as it is familiarly known, is open to all residents of British Columbia, although both membership and service facilities are concentrated in Vancouver and surrounding areas. The credit union also operates a branch in Victoria, the provincial capital, and in recent years has expanded its services to other areas of British Columbia.

VanCity has provided business loans to members at various times during its history, but over the past seven years the organization developed a number of innovative new programs that reach out to the business market. These programs were developed when the credit union realized that many of its members operate businesses and have business needs that it can be instrumental in fulfilling.

VanCity’s business lending division represents $580 million Canadian ($370 million U.S.) in loans outstanding, and about $760 million ($485 million U.S.) in deposits. The business lending staff consists of front office sales and service representatives, and a back office staff of credit approval, security and documentation specialists. The total employee count in these two areas is approximately 75. These employees manage more than 6,000 loans for the 22,000 business members with accounts at the credit union.

VanCity operates a number of lending programs as part of its community business services area. These are special programs operated by the credit union’s business lending group, as alternative lending programs for specific populations. The programs are supported by the Canadian federal government under various loan loss contracts.

The Peer Lending program, for example, provides loans to groups of four, five, or six people who agree to support each other through the loan process. Individuals within the group may apply for a loan for business purposes. When the loan is repaid, they can come back to the credit union for future loans in a stepping-stone process. The program is designed to serve new immigrants and marginalized residents who have difficulty accessing traditional
credit sources. Most of these people do not have a credit rating, or may have a poor credit rating. The support of the peer group allows them to create economic self-reliance, and develop their business idea.

Once a peer group is established, each member can receive an initial loan for $1,000. When the group pays that loan back, it is eligible to apply for a new loan for $2,000, and up to $5,000 in thousand dollar increments. Each loan is dependent on the peer group maintaining its repayment schedule. Loans are made to individuals, but the group is responsible for each loan.

When peer group members demonstrate good repayment habits and reach the loan limits under the peer group program, they may move on to participate in VanCity's Self-Reliance Lending program, which has been in place since 1997. Under the self-reliance program, the credit union has made over 600 loans ranging in size from $5,000 to $50,000. The program includes a loan loss provision, also supported by the federal government. The Self-Reliance program is a way to move peer group borrowers into the mainstream of business services, and has been a very successful program for both the credit union and its entrepreneurial members.

One of the concerns VanCity had in initiating these small business loan programs was the amount of administrative work required to make smaller businesses loans. At the same time, the credit union wanted to give members access to credit in cases where they normally wouldn't have it. The Self-Reliance loan program does not require collateral, but does require the borrower to make an investment in their business, have a solid business plan, and provide two character references.

A third loan program for small business is a Credit Scored small loan program that provides funds up to $35,000 for business purposes. Both the Credit Scored and Self-Reliance programs feature a streamlined underwriting process that minimizes the cost of loan administration. The Credit Scoring program gives VanCity a way to shorten the application and approval process, and minimize up-front expenses. Followup is also automated, with the centralized staff handling back office operations. The loan renewal process is also automated, so that loans can be renewed as long as the borrower lives up to loan terms and conditions.
“We only look at loans that may be experiencing difficulty to request additional information and followup,” says Kevin Zakus, Regional Manager of Business Services. “The operating efficiency of our small loan portfolio has improved tremendously as a result of these procedures.”

**A Streamlined Approach**

On loans in these special initiative categories and up to a $35,000 loan limit, VanCity deals with its business members within its retail branches. Branch representatives screen loans of this magnitude. If the loan application is for an amount in excess of $35,000, it is handled by one of three Business Solutions Centres. Each of these centers has a staff of 12-15 business lending experts, including account managers, credit analysts and business solutions coordinators, who provide administrative support.

The idea was to create a team to manage the overall relationship with business members. The account manager is the key contact, maintaining the relationship and building new sales. The analysts and coordinators support the work of the account managers.

The back office component of the business lending team is a centralized credit approval, security and documentation operation. In a typical loan process, the account manager visits with the member, gathers information, and completes 20-30% of the necessary credit underwriting data, then passes that information along to the credit analyst. The credit analyst does the numbers-crunching, and a detailed analysis of the deal. Once the business solutions center is ready to recommend the deal, it is sent to the credit approval team. This team of risk managers reviews applications and makes the lending decision.

Once the loan is approved, the credit union produces a commitment letter which the member signs, thereby accepting the terms and conditions of the loan. The loan then goes to the back office for security documentation and legal work, to make sure the credit union is secured for the loan.
Emphasis on Deposits

VanCity’s business services do not end with loans, however. There’s also an emphasis on attracting deposit business, which often provides greater margins than do loans. “We have a focus on non-profit organizations,” says Zakus, “and as a co-operative we feel an affinity for those types of organizations. We’ve been very successful in attracting deposits from these organizations. For example, many labor unions feel comfortable in dealing with us because we share many of their principles. The same is true for community organizations, which understand the values by which we operate. Those philosophical links have been very valuable to us in attracting deposits from the people and organizations we deal with.”

The credit union offers a community service account to non-profit organizations. These entities can perform up to 40 transactions a month, free of service charges. Most of these accounts operate with no fees at all. They may not be large accounts, but they aggregate to meaningful deposit amounts.

For larger accounts, VanCity has a cash management manager to support the pricing of deposits, setting up of accounts, and arranging of functions such as electronic funds transfer. The credit union is very competitive in pricing deposits, especially for non-profit organizations. It makes a concerted effort to get those balances on the books. The cash management manager is a large part of VanCity’s support strategy to service larger deposit accounts.

The credit union has also created pooled funds to maximize the return to organizational depositors. For example, a local rental housing association maintains a pooled account with VanCity. The association is made up of smaller organizations that require funds for emergencies and maintenance. The buildings belong to the association, and VanCity has an arrangement with them whereby each of its members gets the top level return on deposits. A single organization might have a fund of $50-100,000 on deposit, earning less than optimum return. But 50-100 of those accounts add up to a very large balance that qualifies for the best rates.

As a result, these pooling arrangements benefit both parties. The credit union gets a large deposit balance, and the pooling organizations get the highest rate of return in the marketplace.
Marketing Business Loans

Over the past two years, VanCity has stepped up its marketing of business services with full spectrum marketing campaign. “Our members told us they didn’t realize we offered services in the business services arena,” says Zakus. “That told us we had a challenge to increase awareness. In response, we conducted a very successful campaign for our small business loans. Those are loans up to $35,000, generally underwritten through a simple credit score. Our campaign emphasized a 24-hour response process.”

For more substantial loan deals, the credit union is currently focusing on three specific audiences. One is a health care professional financing package. A second campaign speaks to non-profit organizations. And the third focus is on larger business loans. In its large business loan campaign, the credit union emphasizes the local approval process, explaining that its loans don’t need to go to Toronto for approval by an out-of-town loan committee.

Zakus reports that the campaign has been very successful. The print campaign uses community newspapers throughout the greater Vancouver area, as well as two local business newspapers. It also employs posters in credit union branches, direct mail, and radio commercials. The direct mail campaign is directed at both members and non-members. In its member survey, VanCity discovered that about 65% of its members were willing to recommend the credit union as a business services partner to their colleagues. “We were very encouraged by that response,” says Zakus, “since it is an indication of the kind of service we’re providing to existing business members.”

An Experienced Staff

VanCity’s core group of business lenders came from a banking background. Many senior positions – risk managers and account managers – come from banks. However, account managers and business solution managers have also been promoted from within, through training of individuals with the talents to be successful in business lending. In junior positions, most of the staff has been promoted from within, creating additional employment opportunities in the organization. The current account management staff of 22 is equally divided among those from outside, and those promoted from within.
**VANCITY CAPITAL CORPORATION**

In addition to its business lending division, VanCity also created a wholly owned subsidiary called VanCity Capital Corporation, that provides subordinated debt, a risk oriented financing product that combines features of both equity and debt, to small and medium sized businesses that need growth capital. In fact, VanCity provides as wide a range of services to its business community as any credit union in North America. By highlighting the experience of VanCity, which has fully developed its opportunities in the business services field, we hope to demonstrate what is possible in the area of lending and other services.

Axel Christiansen, VanCity Capital Corporation's Investment Manager, notes that his organization makes investments in the $100,000 to $1 million range. The staff of VanCity Capital consists of seven people, most of them with Canadian banking and/or investment banking background. Executives in the corporation have many years experience with commercial banking, notably with the Business Development Bank of Canada. They also have the expertise to balance the organization’s social mission with good business practice.

VanCity Capital opened its doors in January 1999 after about two-and-one-half years of research on the services it now provides. VanCity was looking for a mechanism through which to provide financing to socially oriented ventures – non-profits, co-ops, and for-profit businesses that were doing good things in the local community.

The credit union quickly realized that, especially in the case of smaller non-profits, the lack of management capacity and ability to generate meaningful cash flow made lending a very difficult proposition. Because of the higher risk of unsecured financing, there needed to be higher cost financing as well.

In the end, the credit union created a broader subordinated debt portfolio in which about 90% is unsecured cash flow based financing for commercial, for-profit businesses. Many business members are in the technology and entertainment industries, with rapid growth. The focus is on organizations that are well managed, with excellent profit histories, and hoping to grow further and faster than they could if they leveraged only their tangible assets.
These companies are the models that work very well for VanCity's target market. Financing in this market allows the corporation to subsidize the 10% of its portfolio that is allocated to fund social ventures. “If we had to fund the social side of our business on a stand alone basis,” says Christiansen, “the venture wouldn’t be feasible. We want to have an altruistic social impact in our communities, but we also want to operate on sound business principles.”

VanCity Capital Corp. was capitalized with $25 million from VanCity Credit Union. Its portfolio now stands at about $9 million. Christiansen expects that it will take about four years to invest the $25 million in initial capital. Repayment schedules are generally from 3-5 years, a pace of repayment that will keep a $25 million portfolio functioning.

**The Making of a Deal**

The best source of leads for VanCity Capital has been other financial institutions. Accounting firms are another good source. The corporation has made many presentations at accounting firms to build awareness of its capabilities. Because its financing is unsecured, VanCity Capital can offer financing to a wide range of clients, regardless of who the senior lender is. “We’re not going after the collateral security,” says Christiansen. “That’s why other financials have been very receptive in giving us leads to their clients. It’s a cooperative, rather than a competitive effort.”

VanCity Credit Union itself has also provided leads, but Christiansen says VanCity Capital still needs to do more to inform the VanCity staff what the Capital Corporation and subordinated debt is all about. There’s a significant educational process involved in getting credit union consumer lenders to understand the subordinated debt function. Both internally and externally, VanCity Capital need to educate people on 1) what is subordinated debt; 2) why a borrower would be inclined to take a 16-18% loan and consider it a value-add to their business; and 3) who is VanCity Capital and why should we do business with them?

Deals range in size from $100,000 to $1 million on the commercial side; and generally from $25,000 to $200,000 on nonprofit side. The corporation currently has 55-60 deals in place. The average deal size for commercial loans is in the $250-300,000 range; and $50-75,000 for nonprofit loans. VanCity Capital actively managed its portfolio, initially taking on smaller loans, and
working its way up to larger deals in order to first achieve a certain level of diversification.

Pricing for loans is typically prime plus 8-12% on commercial deals, and prime plus 3% for social ventures. VanCity Capital's commercial pricing fits somewhere between traditional equity pricing and conventional debt financing. Generally, it does not ask for an equity position as part of the deal.

The corporation is owned 100% by VanCity Credit Union. It does have its own board of directors, which meets every two months. The board consists of 12 members, including a mix of financial people, socially-oriented people, and individuals from industry segments in the organization's target markets.

**A Social Commitment**

VanCity Capital is invested in a number of socially significant nonprofit ventures, including Tradeworks, a not-for-profit organization that receives most of its funding from the government. Tradeworks trains downtown street youth in a variety of trade skills, and computer skills as well. VanCity Capital's loan helped the organization to build an extension onto its building. The additional space enabled Tradeworks to offer an additional program, which in turn resulted in qualification for more government funding.

The Cooperative Auto Network is another example of VanCity Capital's nonprofit clients. This organization is a car-sharing co-op. Members contribute a given amount annually, and the coop purchases cars that are placed strategically in the downtown Vancouver area. A member may call the co-op and ask to reserve "car number 7 for two hours on Wednesday." After the member has finished using the car, he or she returns it and places the keys in a lock box. This system works well for people who don't own cars, and those who may own one car and need a second car only occasionally. It's an environmentally friendly system of limiting the number of cars on the road.
Underwriting

“Our underwriting criteria,” says Christiansen, “are ‘management, management, management.’ That means a lot to us, because we have no tangible assets backing up the loans we make. We spend a lot of time investigating the borrower’s management style and past success. We also put great stock in the ethics of borrowers, because we can’t rely on collateral to make us whole.”

Christiansen also looks at earnings. The borrower must demonstrate enough profitability historically to service their existing debt plus the pro forma debt currently being considered. And the corporation needs to be confident that the borrower’s position in the marketplace is secure, and likely to improve. Finally, VanCity Capital wants to be assured that the borrower has invested sufficiently in their business to make success likely.

The Lending Process

From start to finish, a deal is likely to take about three weeks to complete. First VanCity Capital meets with the client and collects financial information. The corporation issues a discussion paper that describes what it perceives the deal to be in terms and conditions, pricing and legal requirements. This is designed to stimulate discussion, and determine whether both parties are on the same page in terms of the fundamental elements of the deal.

If the discussion paper is agreeable, the client signs off on it and gives it back to VanCity Capital along with an application fee, which is usually 1 1/2 to 2% of the deal. If VanCity Capital subsequently authorizes the deal, it keeps that fee; if not the fee is refunded.

Due diligence usually takes about two weeks. VanCity Capital talks to the client’s suppliers and customers, does some market research, and prepares what’s typically a three-to-six-page credit submission, touching on specific underwriting criteria. That document is presented to a three-member credit committee that consists of the president of VanCity Capital, the treasurer of VanCity Credit Union, and an external accountant. They discuss any questions they may have in a 30 minute to one hour meeting, and approve the deal.
Performance

VanCity Capital’s portfolio performance has been remarkably good. Of its 55 clients, it has lost only two loans. When the corporation modeled its portfolio initially, it assumed a 15% ultimate loss rate, or 3% per year over the five year life of a deal. At this point, the organization is in a much better loss position than that model projected.

“We’ve learned that we need to be very careful with this type of portfolio,” says Christiansen, “and keep close watch on our credit criteria. If the lender begins easing up on cash flow requirements, for example, he can encounter trouble quickly. With an unsecured portfolio, capital can be lost at alarming rates. At the same time, this can be a profit center that can make a nice return for our organization.”
WILLIAM W. SAYLES

William W. Sayles is managing director of the Center for Credit Union Innovation, an organization dedicated to identify, refine and develop innovative ideas of commercial importance to credit unions and others. Sayles assumed his present position after a 23-year career with the CUNA Mutual Group in a number of senior management positions. He coordinated the credit union system’s successful national CUY 2K Initiative, which linked credit union organizational efforts to achieve a smooth computer transition to the new millennium.

Sayles was also responsible for CUNA Mutual’s marketing relationship with corporate credit unions and CUSOs. He monitored product development, delivery and service to meet the needs of these organizations. Previously, he served as Vice President of Consumer Lending Insurance Services, where he was responsible for market positioning and strategies for consumer lending products and services; and as Vice President of Marketing Support & Services.

As managing director of the Innovation Center, Sayles coordinates and manages projects in a broad range of consumer financial services. The Innovation Center identifies, researches, develops, and tests new and improved products, services, and delivery systems that enable credit unions to serve their members better. The Center works closely with the Filene Research Institute to deliver promising product and service ideas emerging from Filene research and from many other contributing sources.
CHAIRMAN
Gary J. Oakland, President/CEO
Boeing Employees Credit Union

DIRECTOR AND EXECUTIVE COMMITTEE CHAIRMAN
Daniel A. Mica, President
CU N A & Affiliates

DIRECTOR
Thomas R. Dorety, President/CEO
Suncoast Schools Federal Credit Union

DIRECTOR
Daniel F. Egan, Jr.
Chairman, American Association of Credit Union Leagues
President/CEO, Massachusetts Credit Union League
President/CEO, New Hampshire Credit Union League
President/CEO, Rhode Island Credit Union League

DIRECTOR
Michael B. Kitchen, President/CEO
CU N A Mutual Group

DIRECTOR
Lawrence Knoll, President/CEO
MidWest Financial Credit Union
CHAIRMAN
Gary J. Oakland, President/CEO
Boeing Employees Credit Union

VICE CHAIRMAN
Thomas R. Dorety, President/CEO
Suncoast Schools Federal Credit Union

PRESIDENT
Michael B. Kitchen, President/CEO
CUNA Mutual Group

VICE PRESIDENT/TREASURER
Daniel A. Mica, President/CEO
CUNA & Affiliates

SECRETARY
Daniel F. Egan, Jr.
Chairman, American Association of Credit Union Leagues
President/CEO, Massachusetts Credit Union League
President/CEO, New Hampshire Credit Union League
President/CEO, Rhode Island Credit Union League

DIRECTOR
Lawrence D. Knoll, President/CEO
Midwest Financial Credit Union

DIRECTOR
Andrew J. Policano, Dean
University of Wisconsin–Madison

PRESIDENT EMERITUS
Richard M. Heins, Director Emeritus
CUNA Mutual Group

Research Council
Eldon R. Arnold, President/CEO
Citizens Equity Federal Credit Union

John A. Bommarito, President/CEO
TRW Systems Federal Credit Union

David Brock, President/CEO
Community Educators’ Credit Union
Joseph C. Cirelli, President
US Airways Federal Credit Union

Edwin J. Collins, President
Lockheed Georgia Employees’ Credit Union

Olin F. “Rick” Craig, President/CEO
America First Credit Union

Mary T. Cunningham, President
USA Federal Credit Union

Paula A. Edwards, President/CEO
Nationwide Federal Credit Union

Charles F. Emmer, President/CEO
Ent Federal Credit Union

W. Craig Esrael, President/CEO
First South Credit Union

Michael Hale, President/CEO
Andrews Federal Credit Union

Frederick D. Healey, President/CEO
Workers’ Credit Union

Holly E. Herman, President/CEO
Kraft Foods Federal Credit Union

Hubert H. Hoosman, President/CEO
Educational Employees Credit Union

Daniel R. Kampen, President/CEO
U.S. Central Credit Union

Timothy R. Kramer, President/CEO
AEA Credit Union

Harriet B. May, President/CEO
Government Employees Credit Union of El Paso

Brian L. McDonnell, President
Navy Federal Credit Union

Dennis E. Pierce, President/CEO
Community America Credit Union
Frank Pollack, President/CEO
Pentagon Federal Credit Union

J. Alan Pughes, President
Community One Federal Credit Union

Vincent Rojas, Jr., President
Kern Schools Federal Credit Union

Marcus B. Schaefer, President/CEO
Truliant Federal Credit Union

Jack Sheets, President/CEO
Elkhart County Farm Bureau Credit Union

Juri Valdov, President/CEO
Northwest Federal Credit Union

David Vigren, President/CEO
ESL Federal Credit Union

Stephan L. Winninger, President
State Employees Credit Union

Ex-Officio:
Fred B. Johnson, President
Credit Union Executives Society

FILENE RESEARCH INSTITUTE
Robert F. Hoel, Ph.D.
Executive Director

CENTER FOR CREDIT UNION RESEARCH
William A. Kelly, Jr., Ph.D.
Director


Barron, David N. and West, Elizabeth, University of Oxford; and Hannan, Michael T., Stanford University. Competition, Deregulation, and the Fortunes of Credit Unions, 1995.


Burger, Albert E., University of Wisconsin-Madison and Lypny, Gregory M., Concordia University, Montreal, Canada. Taxation of Credit Unions, 1991.


Colloquium at the University of California-Berkeley. *Financial Incentives to Motivate Credit Union Managers and Staff*, 2001.


Donkersgoed, William L. and Hautaluoma, Jacob E., Colorado State University; and Pipal, Janet E. *Consensus Building Strategies for Productive CEO-Board Relationships*, 1998.


Fried, Harold O., Union College and Overstreet, Jr., George A., University of Virginia, editors; Frank Berrish, Thomas Sargent, and James Ware, contributors. *Information Technology and Management Structure: A Case Study of First Technology Credit Union*, 1998.

Fried, Harold O., Union College and Overstreet, Jr., George A., University of Virginia, editors; Richard Grenci, Peter Keen, R. Ryan Nelson, and Nancy Pierce, contributors. *Information Technology and Management Structure II: Insights for Credit Unions*, 1999.


Hannan, Michael T., Stanford University; and West, Elizabeth and Barron, David N., McGill University. *Dynamics of Populations of Credit Unions*, 1994.


Proceedings from the Second Annual Credit Union Colloquium co-sponsored by Filene Research Institute, Center for Credit Union Research, and the Center for Financial Services Studies. *Discrimination in Lending: What Are the Issues?*, 1995.


