C & I Lending

Skills – Risk - Profit

Presented by Dana Sumner, CEO & President

Credit Unions LOVE Commercial Real Estate

"Take the dirt, you don't get hurt"

So why would we change?

Profitability

What does a transaction cost your CU?

Profitability

- Are the rates offered by your CU based on actual calculations of profitability or simply an increase over some variable (Prime, CMT, etc.)?
- What is the true profit margin the CU is earning by booking loans at their proposed interest rates?
- Are the CU's lending rates attracting the kinds of credit exposure the CU is seeking?

Transaction vs. Relationship

- Easier to determine risk
  - Relationships have longevity, transactions do not
- Additional products and balances
- Yield not based on transaction

Yields 250-300 basis points higher

Portfolio Diversity

- Reduces Concentration Risk
- Reduces Interest Rate Risk
- Benefits Members and Community (NCUA is Watching)

Portfolio Diversity

"Historical experience shows that concentration of credit risk in asset portfolios has been one of the major causes of bank distress."

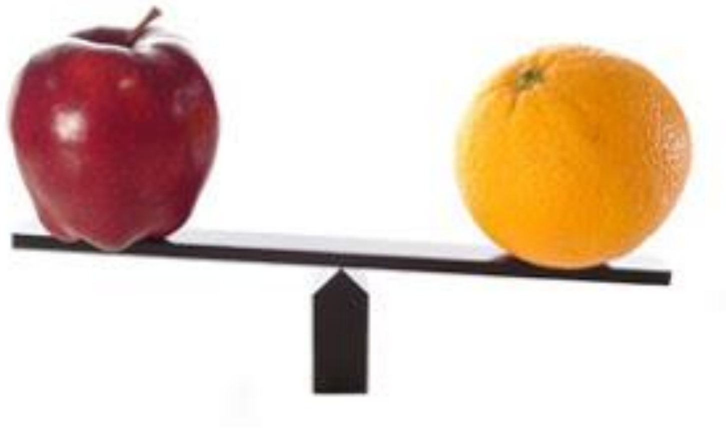
Basel Committee on Banking Supervision – NCUA Supervisory letter 2010-03

Interest Rate Risk

"Interest Rate Risk is the risk that changes in market rates which could adversely affect a credit union's capital and earnings."

Does this sound familiar?

Key Differences of C&I Lending



So what are some of the key differences?

- How we determine Cashflow
- How we analyze the business
- What we take for Collateral
- Understanding new industries

EBITDA Calculations

When calculating Cash Available for Debt Service, we should also consider the following:

Net Income

+ interest expense

+ depreciation/amortization

- distributions

+ non-recurring charges

= **Cash Flow Available for Debt Service (CADS)**

Where do we typically see this Simple Method of Cash Flow Analysis?

Real Estate - Referred to as NOI

Uniform Credit Analysis (UCA)

UCA measures how much cash is available for debt service by highlighting changes in the balance sheet that impact cash.

Net Income

+ interest expense

+ depreciation/amortization

+ non-recurring expenses

+ or – changes in A/R, Inventory, A/P, Accruals

- Unfunded Capital Expenditures (CAPEX)

= Cash Flow Available for Debt Service (CADS)

In Addition to the Income Statement, Where Do We Find the Information to Calculate UCA ?

Balance Sheets

How We Determine Cash Flow

Balance Sheets

- Financial Snapshot
- Dated
- Sources (liabilities and net worth) and Uses (assets) of Funds
- Assets= Liabilities + Net Worth

It's All About Cashflow

Every move on the Balance Sheet is a use or source of CASH

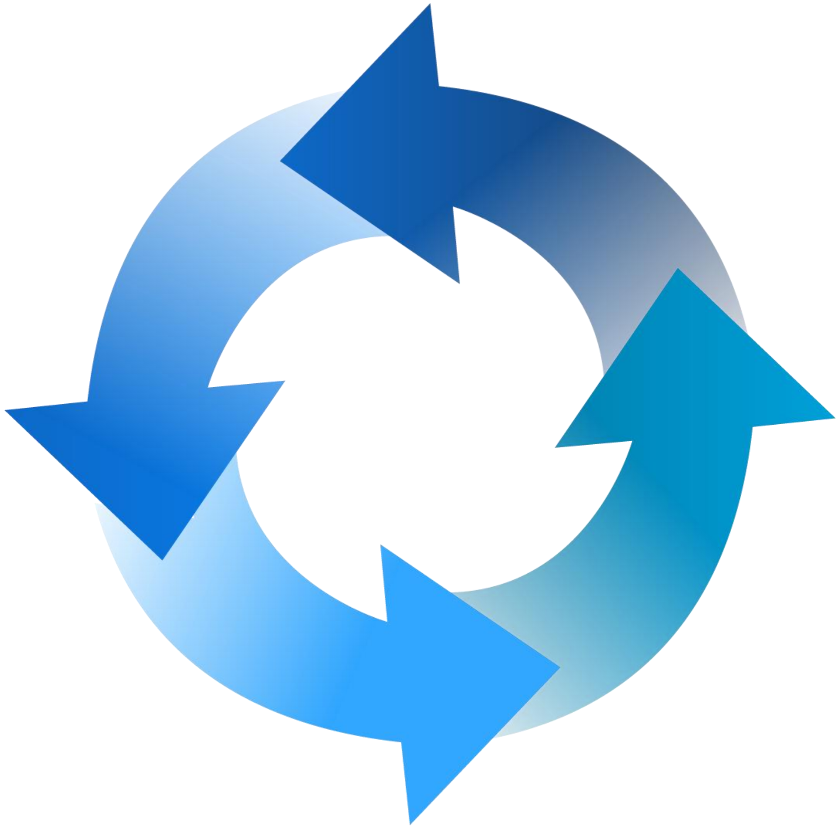
INCREASE IN ASSETS – **USE OF CASH**

DECREASE IN ASSETS – **SOURCE OF CASH**

INCREASE IN LIABILITIES – **SOURCE OF CASH**

DECREASE IN LIABILITIES – **USE OF CASH**

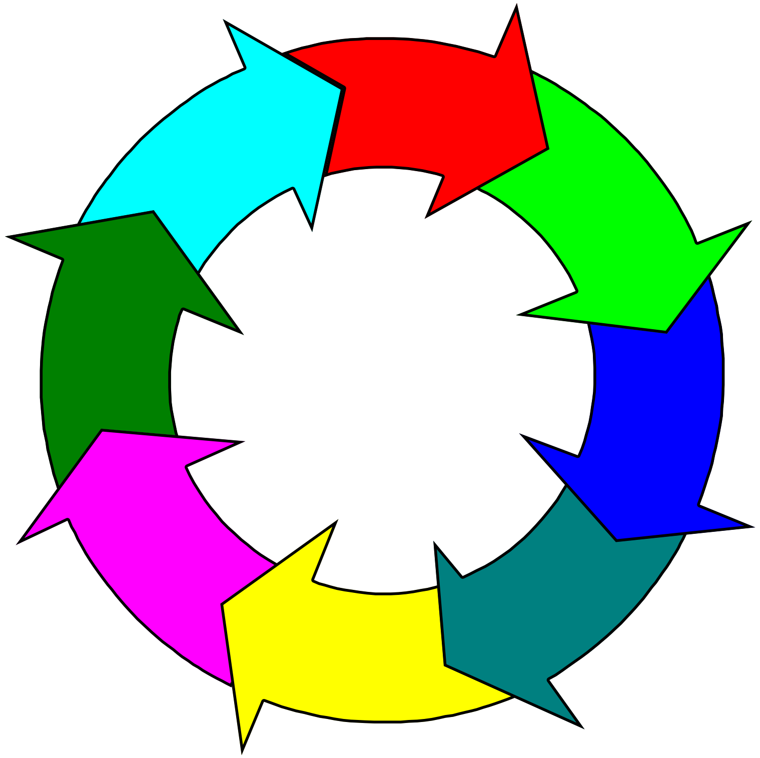
THE OPERATING CYCLE AND WORKING CAPITAL



The Operating Cycle

- Also known as the cash-to-cash cycle, is measured in days
- Operating cycles are different for different types of businesses
- Manufacturers have longer operating cycles, retailers and other cash businesses have shorter operating cycles.
- The longer the operating cycle, the more challenging for the business

The Operating Cycle



Days Receivables
+ Days Inventory
- Days Payables
- Days Accruals

= Operating Cycle

What We Take as Collateral

What is Chattel?

An item of tangible movable or immovable property except real estate and things (such as buildings) connected with real property.

Problems with Collateral

- Value at Liquidation
- Protecting Your Collateral Position
- Liquidation Costs Money
- Liquidation Takes Time
- Environmental Issues

Advance Rates for Working Capital

Uniform Commercial Code (UCC) Article 9 provides legal guidelines for accepting chattel as collateral

- Receivables and inventory are initially discounted for certain factors
  - Typically excluded: A/R > 90 days (or past due based on terms) and Work in Process (WIP) inventory

- A percentage is then assigned to the remaining assets
  - Receivables - 50%–80%
  - Raw material inventory - 50% (higher if commodity has many uses)
  - Finished goods inventory - 50%

EVAPORATION BEFORE LIQUIDATION

Liens and UCC-1s

- UCC-1: legal form filed by a creditor to give public notice that it has an interest in property of debtor
- Filing must be made in the appropriate registry per state statute
- Lien priority is established by date filed, except in purchase money situations

Lien Perfection Process

- Lien perfection process starts <u>before</u> loan closing

- To perfect liens, a CU should:
    - Conduct a UCC-1 search for priority liens on collateral
    - Assure documents are prepared and filed in conformance with UCC Article 9 and local and state laws
    - Use an attorney for complex collateral

- Examiner should:
    - Know lien perfection processes for their state(s) and counties
    - Confirm collateral descriptions match across UCC filing and Security Agreement (SA)

Each Industry Has it’s Nuances

- Internal Challenges
- External Challenges
- Butterfly effect

We Need to Have Expertise

Increased Diligence

Sometimes “Periodic” means Quarterly

So What Does the NCUA Expect?

Corporate Buy-In

- The objective of a well-run credit program should be clearly communicated from Top to Bottom within the organization

- Is everyone really on board?

Board of Directors

"A key principle in the member business loans and commercial lending rule (Part 723) is that a credit union's board of directors is ultimately accountable for the safety and soundness of the credit union's commercial lending activities. The board must remain adequately informed about the level of risk in a credit union's commercial loan portfolio. The rule reinforces the fiduciary responsibility of a credit union's board for maintaining the safety and soundness of the institution, hiring competent staff, establishing appropriate policies and procedures, and for providing adequate oversight."

Senior Management

A credit union's board of directors relies on senior management to directly oversee risk management activities and verify they are consistent with board policy.

Lending Personnel

Maintaining appropriate staff expertise in the commercial lending area is a central pillar of a sound commercial lending program.

Qualifications and Experience Requirements

Per §723.3(b)(2) a federally insured credit union must employ qualified staff with experience in the following areas:

- Underwriting and processing for the type(s) of commercial lending in which the federally insured credit union is engaged
- Overseeing and evaluating the performance of a commercial loan portfolio, including rating and quantifying risk through a credit risk rating system

Primary Objective

"The primary objective is to protect the Credit Union from undue risk of loss by applying safe and sound lending practices."

RECAP – The Why

- Profitability
- Portfolio Diversity
- Creates Relationships with Member Businesses

RECAP – The How

- Buy in from the Board and Senior Management
- Rewrite your policy
- Have the experience – internal or external – 3rd party
- Use NCUA Online Examiner’s Guide as a resource – it is really a good document