The Pitfalls of Business Lending
By Joanna Bruno, Founder and President of J.R. Bruno & Associates

In the first year of operation, commercial lending products can earn between 30 and 50 percent returns. Not surprisingly, many credit unions are turning to member business lending and SBA lending to restore profitability, especially as consumer loan growth continues to dwindle. What is it that separates successful business lenders from other credit unions? Two things—a commitment to building and maintaining solid relationships with members and an in-depth knowledge of small business lending.

In the last few years the lending industry has experienced repeated waves of mergers and takeovers, while deregulation has increased. The combined effect of this trend presents credit unions with many new commercial lending opportunities. As one banking professional said "Every time a neighborhood bank gets bought out by a commercial giant, customer service gets reduced to a white phone. If it's a large branch, maybe two phones." While this comment is slightly tongue-in-cheek, customer service and customer relations are the cornerstone have long been the cornerstone of credit union culture, and may well prove to be the foundation of the largest new opportunity for credit unions. If you are considering commercial lending, we have collected some characteristics and tips of successful business lenders, as well as a few pitfalls to avoid; read on, and better prepare yourself. If your credit union has a well established portfolio of small business loans, then use this as a checklist and examine your progress!

Characteristics:

The core competency of any credit union successfully involved in small business lending must be twofold: Loan officers must excel in both small business finance and relationship building. An effective lending program will protect the credit union with safe and sound lending practices, while providing the financing that the business requires. An understanding of the composition and nature of their community, especially the local business climate is also required. They need to not only foresee new business developments within the community, but also know the community's history.

A lending officer who can prepare a long range fiscal strategy with the member, as well as offer the right financial products can help grow the member's business. The end goal for both Credit union and member is to foster the growth of the business, turning small profits into consistent larger cash flows.

Tips:

Educate Business Owners

Successful small business lenders all show a strong desire to help members find the best possible credit solution. While they may excel at their trade or commercial venture, Business owners may not know what credit product best suits their needs. A skilled loan officer can help to educate, while recommending appropriate credit products. For some businesses, a Member business loan, such as a 12 month revolving line of credit or a term loan, may be the best solution For others, such as a business with long term expansion needs, an SBA loan would be ideal.

Loan officers who take the time to educate borrowers lay the groundwork for future success. Many members need help in planning for future growth and hedging against disaster. Good lenders know that the more business skills their members have, the more likely they will succeed. For example, the Small Business Administration offers more than just loans, they offer access to a wide array of assistance. Business owners can visit the Small Business Development Center which provides reasonably priced training as well as the SCORE division, which provides personalized, industry specific counseling and advice across a spectrum of topics.

Know your Target Market

A good lender has a vision for the future. A well developed lending initiative will take into account your end goal, current market position, and your portfolio. Without a comprehensive strategy that addresses both short-term and long term goals, it is difficult to achieve success. In order to focus your efforts more specifically, think about the segment of the small business market that you plan to address. Try to define that market segment by size of company, industry type, or geography. Exclude companies that need services you don't have the capacity to provide. Cast your nets close to home; begin with SEG's and current members that have filed their DBA *(Doing Business As…)* papers with you, and gradually expand your focus to businesses that are within the primary markets of your branch locations. A good lender constantly examines the Credit union's position relative to other lending institutions in the community, and searches for market segments that are not being targeted.

Know the Competition

Management expert Peter F. Drucker wrote "Knowledge has power. It controls access to opportunity and advancement." In order to capitalize on commercial lending opportunities, it is imperative that you know what the competition is offering. How do you compare to banks in your area? Do some mystery shopping; visit their branches and pick up anything you can find on business services. Tour their web sites to get a snapshot of their product offerings. You should be able to learn a lot about their deposit product pricing and at least determine what they offer as loan products. This information helps shape your own product offerings and new product development.

Offer the Right Services

Credit unions offer an array of products that serve the market by meeting their member's needs and establish their credit union as a serious participant in the small business services arena. Make sure to include that interest bearing checking account, but don't be concerned if you don't have an account that sweeps excess balances to a multitude of money fund options. Be certain to include business credit cards, lines of credit and installment loans in your portfolio of loan products. Real estate financing can always be added, along with non-owner occupied real estate loans, as you gain experience. Consider also offering merchant card processing. Remember, all of these products provide you with additional income streams and strengthen your overall business lending program.

Pitfalls:

If you're already doing all of the above, take a moment and consider the following common mistakes. If you can avoid these, you'll be well on your way to consistent profitability. You may find that you've already committed a mistake or two, but we've got some solutions for you as well.

Insufficient Cash Flow

Insufficient cash flow is the biggest pitfall in commercial lending. Recurring cash flow is the key element in making the decision to underwrite a company's loan. But in a venture where "Cash is King," many underwriters don't analyze cash flows in enough detail. It must be established that operating cash flow is sufficient to meet current and projected debt obligations. This includes examining businesses for a variety of ills: Is the company slow collecting receivables; are there high interest lease payments; are general overhead costs prohibitive? Are the expenses affecting cash flow recurring, or are they one time charges? As the business continues to expand, will the cost of goods sold increase disproportionately? In short, be certain you are looking at the real cash flow of the business, and that the cash flow is sustainable.

Risk Management

According to Larry Ellison, of West One Federal Credit union, "one of the most common mistakes Credit unions make is poor Risk Management. First, you must have effective controls and procedures in place, as well as explicit policy guidelines. Second, you have to make sure that they're being followed." While this may seem like common sense, Mr. Ellison states that it is often not the case. The Board of Directors and the management must understand the products being offered from both a risk and a reward standpoint. Oversight is crucial; it is not enough to simply hire a commercial banker and assume that they are following guidelines.

Collateral

Credit unions can fall into the trap of placing too much reliance on the collateral, or making a loan that is under collateralized. The solution is to be certain that your collateral valuation techniques are conservative. Use an estimated market value for the collateral, not the replacement cost. Understand, however, that if you have reached the point where collateral is being liquidated, an error has occurred.

Lack of Understanding

It may seem obvious, but don't make loans to businesses you don't understand. Do enough research about the business or industry so that you understand the risks inherent in lending to that business or that industry. . Examine applications and ask "How does this fit into my portfolio?" If you can't answer this question, it probably does not.

Overlooked Needs

Many times CU's may not realize that they already have Small Business Loan's in their portfolios. Often times a Home Equity Line of Credit or a personal credit card may be financing a member's small businesses expansion needs. The solution is portfolio analysis. For example, examine your portfolio for loans to individuals using Tax ID numbers rather than Social Security numbers. Chances are, some of those are small business owners with a credit need.

Not Enough Training

Lack of staff training can also be a source of problems, as there are a variety of specific regulations and procedures that must be followed for a lender to participate in the SBA program. If those are not met, guarantee's can easily be reduced or denied in full. Even if you outsource some of the underwriting, you will still need to train certain people within the credit union; if you hire an experienced lender from a bank, they will need to become familiar with NCUA regulations. Training should include both initial and continuing education facets. The best solution is to learn by doing; as you become more familiar with the process of member business and SBA lending, problems will be addressed as they are presented.

Conclusion:

Small business lending makes sense for many Credit unions. It is a profitable extension of consumer lending programs, and of the Credit union service culture. Additionally, it's another way to serve current members; as Americans continue to leave employee positions to work independently or begin their own businesses, demand for business lending will continue to rise. Those lenders best positioned will be those who have a vision for the future and a clear strategy. If you want to be among those leaders, consider the current market you serve and ask yourself "How can I be a better Small Business Lender?"

Byline & Bio:

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Since 1994, J.R. Bruno & Associates and the G.A.P. Team have served more than 120 lenders nationwide, making small business lending easy, affordable, and profitable for lenders. They are the leading consulting firm offering Technical, Training, Marketing, Member Business Loans (MBL), and SBA lending expertise. J.R. Bruno & Associates is also recognized nationally by the U.S. Small Business Administration and is an SBA Pre-Qualification Intermediary.

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