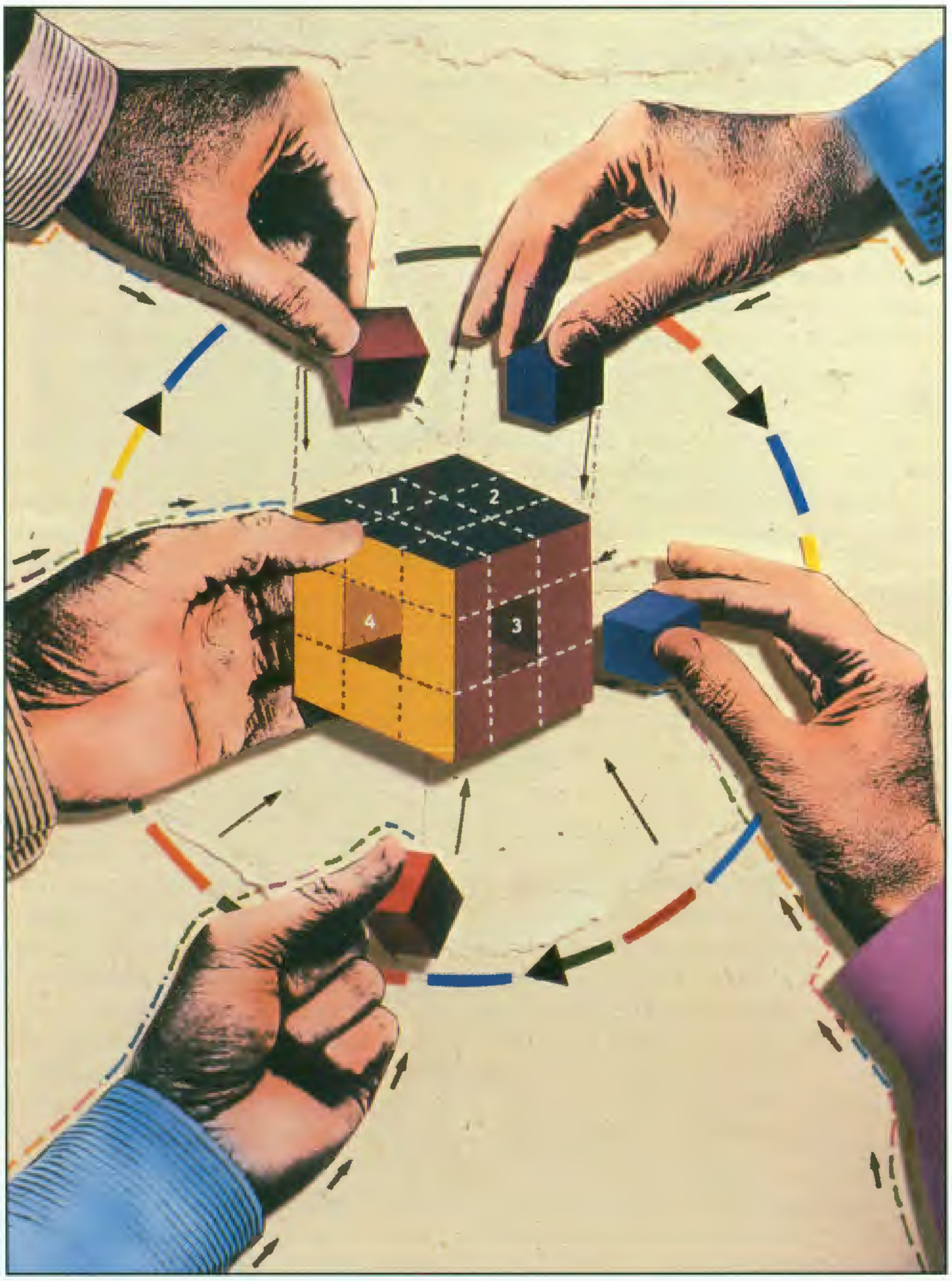
FINDING THE RIGHT LOAN MIX



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In a tough new environment, be careful to supplement low-balance credit products with high-balance secured loans.

By Ken Williams and Joseph Harrington

How does a credit union know if it's offering the right mix of loan products?

At a time when many credit unions are only 65-percent loaned out, it's tempting to say that any loan is a good loan. And it would follow that any loan mix that paid better than six-month Treasury bills (currently at less than four percent) would be a good loan mix.

All that might be true if the economy remains as sluggish as it was during most of 1992. But there are signs that things are improving, and credit unions should be cautious about saddling themselves with bad loan mixes created in ad hoc fashion to get through tough times.

This danger is particularly acute in light of two challenges currently facing credit union managers:

•Loan volume has been falling in all areas except for revolving credit. Consumers are clearly trying to shed debt after rolling it up in record amounts in the 1980s.

•At a time when there is intense competitive pressure to cut loan rates, many credit unions may see their deposit costs increase as a result of Truth in Savings. This is because regulations implementing the law will limit use of the low-balance method of calculating interest.

"ALL THINGS TO ALL PEOPLE"

The market positioning of credit unions also contributes to the danger that they will assemble loans in haphazard fashion. A 1991 Moebs $ervices' survey of banks, savings and loans (S&Ls) and credit unions indicates that more than 76 percent of credit unions with more than $25 million in assets offer at least nine consumer loan products. They are: new and used car loans, signature loans, loans for recreational vehicles (RVs), boat loans, home-equity lines of credit, credit cards, adjustable-rate mortgages (ARMs) and fixed-rate mortgages (FRMs). See Figure 1.

In contrast, the only loan products offered by 76 percent or more of commercial banks are new and used car loans, boat and RV loans, credit cards and signature loans. And the only loans offered by 76 percent or more of savings institutions are ARMs and FRMs.

What does all this mean? It means that, despite the recent transformation in financial services, the three depositories still show a bias toward their traditional positioning in the credit market. Banks target product niches, S&Ls stick with real estate, and credit unions, driven by a member-service philosophy, try to be "all things to all people."

This approach *can be* successful: It's interesting to note that the survey grouping that most closely resembled the credit union profile is the one called "market leaders." Market leaders are large institutions that participants in Moebs $ervices seminars identify as trend-setters for product design and pricing in their respective markets. Like credit unions, more than 76 percent of market leaders offer a wide variety of loan products, so they must see something in this approach.

Still, large institutions certainly have had their troubles of late, and credit unions are in no position to develop the servicing systems that money-center banks use. Hence, as credit unions seek to boost loan volumes, some careful choosing is in order.

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LOSING PROPOSITIONS

When it comes to making product choices, Moebs $ervices' surveys indicate that many financial institutions simply don't offer many potentially profitable loans. Given the slack demand for loans, can you afford to overlook any opportunities?

Conversely, we have found that many institutions, especially credit unions, offer products that produce little or no return—products that even lose money.

To determine which loans contribute to the bottom line, we calculated the return on assets (ROA) for each loan product using the following factors:

•the average amount financed for various loan products, provided by the Federal Reserve and various trade associations; and

•data from the Fed's *Functional Cost Analysis* and Moebs $ervices' research on the costs of originating and collecting the various loans. (Both sources break down data for banks, S&Ls and credit unions.)

The average amount financed was divided by its net earnings (after costs) to determine its ROA.

A classic example of loans that have a negative effect on ROA—loans that lose money—are the low-balance signature loans made by so many credit unions. Because of the costs for originating and collecting these unsecured personal loans, lenders would have to charge rates greater than credit card rates to break even on them—even after accounting for automatic payroll deductions. Of course, charging rates greater than credit card rates would defeat the purpose of these loans: Borrowers often use them to pay off credit card balances.

Yet every one of the credit union respondents to our 1991 survey indicated that they offer signature loans. Moreover, 58.8 percent of the respondents indicated that they require no minimum balance for such loans.

In contrast, more than 75 percent of banks and savings institutions required minimum balances. Credit unions that did require minimum balances on average required only $500, half the $1,000 required by banks and savings institutions and only a fourth of the $2,000 required by market leaders. Unless you charge usurious rates, the interest on a $500 loan is hardly enough to cover the origination cost.

Credit unions stand out from their depository competitors in their propensity to offer another money-losing product: the overdraft line of credit. The 1991 survey showed that, while only 49 percent of banks and 23 percent of savings institutions offer consumers a line of credit to cover overdrafts, fully 75 percent of credit unions do. The overdraft credit line is another form of the short-term, low-balance loan that hardly covers the cost of making it—if at all.

Clearly, credit unions still are driven by a member-service philosophy that impels them to offer loans that for-profit institutions would avoid. But credit unions should keep in mind that every loan to a member that does not at least break even becomes a subsidy paid by your thrifty members to the more profligate ones. "Profit" should not be a dirty word, once you consider to whom the profit will accrue: your share accountholders, in the form of dividends.

Signature loans therefore may not be your institution's ideal product. Several alternatives allow members to enjoy nearly the same service at a lower expense to the credit union. These include: lines of credit that carry fees to cover costs and are accessed by drafts, overdrafts on credit card balances and overdraft protection with annual fees.

SAFE AND SECURE

OK, we know what can make for a bad loan mix. What constitutes a good one? We recommend that credit unions do more high-balance, secured lending to offset the low returns made on low-balance, unsecured products. We're also suggesting that credit unions face certain new realities:

•High-balance, secured auto lending, which has long been the "bread and butter" of credit unions, may never again be as lucrative as it was years ago.

Cars are lasting longer than they used to, and people are hanging on to them longer than ever before. After growing steadily from 1910 to 1970, the number of cars per household has remained stable for two decades.

•There may be some increase in auto sales activity in the near future as cars purchased in the mid-'80s' buying spree exhaust their useful lives, but this won't be enough to bring back the glory days.

•Home equity lending is rapidly displacing many traditional consumer loans, now that the tax deduction for personal interest payments has been completely eliminated. Your best borrowers—members who have substantial equity in their homes—want the tax deduction that's still available for most home equity loans.

All this suggests that there is a need to find a new base of high-balance, secured loans, and that real estate can naturally fill the void left by autos. Many credit unions have gotten this message.

A 1991 survey of home equity offerings showed that nearly twice as many of the larger credit unions offered equity lines of credit (nearly 97 percent) than did banks or savings institutions (54 and 52 percent, respectively). Credit unions even surpassed banks in the area of traditional, closed-end second mortgages. Nearly 47 percent of credit unions reported that they offer traditional seconds, compared to 43.6 percent of banks.

Indeed, one of the most significant changes in the home equity market in recent years is the emergence of credit unions as major players.

OVERLOOKED OPPORTUNITIES

Because so many credit unions already offer equity lines of credit, how are they supposed to find new sources of high-balance, secured loans?

Figure I

What loans are credit unions offering?

Loan product	Percent offering
New car	100
Used car	100
Recreational vehicle	100
Unsecured installment	100
Boat	97.2
Home equity line of credit	96.9
Credit card	86.1
Adjustable-rate mortgages	77.8
Fixed-rate mortgages	77.8
Overdraft line	75
Mobile home	69.4
Closed-end second mortgage	46.9
Single payment	38.9
Personal line of credit	13.9

Source: Moebs $ervices' 1991 surveys on product offerings and home equity lending.

Moebs $ervices has identified two underutilized areas of lending that show higher ROA than many products commonly offered by financial institutions.

The first is traditional second mortgage lending. Many conservative borrowers reluctant to put their house at risk for an equity line feel much more comfortable taking out a closed-end second mortgage for debt consolidation, home improvement or other purposes.

Consumers have long gone to savings institutions for these loans. With the decline of S&Ls, credit unions should move quickly to fill the void.

Another area for earnings potential is mobile home lending. Despite the bad experiences some lenders have had with mobile home loans, they *can* bolster a portfolio if executed properly. They showed a high ROA in Moebs $ervices' calculations of earnings after costs.

Mobile home loans are considered risky because the lender is going long on an asset that depreciates. But that is nothing new to credit unions. They are very active in lending on boats and RVs, which carry prices that are comparable to those of mobile homes, and which also depreciate over time.

Mobile home loans have one advantage over boat and RV loans: Mobile home collateral is more important to your borrowers than boats or RVs, and mobile home borrowers are more willing than boat and RV borrowers to repay their loans when times get tough.

You will no doubt protest that it is much easier to sell a boat or an RV than a mobile home. That may be true, but several trends are at work that will make it easier to sell mobile homes, and will expand the market for mobile home loans in general.

For one thing, affordable housing has become a critical issue. Young people especially feel locked out of the housing market, and are seeking affordable alternatives. They are a prime source of demand for mobile homes.

Another factor is the need to bring workers closer to jobs. Many light manufacturing jobs are being created in open spaces on urban peripheries—just the type of areas suitable for mobile home parks. Mobile homes also can help meet the housing needs of the growing army of temporary workers in America. It may well be cheaper for many contractors to buy or rent a mobile home near a job site than it would be to travel to the site.

The suitability of mobile home lending will vary by region, but national trends clearly are making it more viable in all areas. The trick to doing it right is to keep the term of your loans shorter than the standard 15 years, and charge rates comparable to those on boats and RVs. You'll incur some losses, but we find the rewards that go with a well-managed program to be worth the risks.

A conscious effort to cultivate high-

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customer requirements).

By learning the needs of members, you become their voice. Instead of merely reacting to their complaints, you are pro-active in building their input into decision-making.

In becoming a coach-counselor, you are developing your staff. Then they become the member-champions.

The authors use this portion of the book to present one of their most important points: "Customer relations mirror employee relations. The way you treat your employees is the way they will treat your customers." They attribute this to a study of 112 top service organizations by New York-based Citicorp. The study concluded that "if management solves employee problems, employees will solve customer problems."

Therefore, you must empower employees to solve and prevent dilemmas, say the authors, offering numerous worksheets and exercises to assist with this process.

Next, feedback must be communicated—both to and from employees. This ties all of the steps together.

The last step in the customer satisfaction process is providing for a continuous improvement network. The organization must become and continue to be customer-driven, and everyone must be committed to working together to improve the quality service process.

In revealing the 12-step process for quality service, Cannie and Caplin have offered credit union managers and front-line supervisors a tool for developing a member-driven environment. While many organizations talk about providing quality service, few actually "practice what they preach." By following the 12 steps, you can do a lot more than "take care" of your members; you can keep them for life. ■

***Keeping Customers for Life** is available from AMACOM Books, a division of the American Management Association, 135 W. 50th St., New York, NY 10020.*

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balance, long-term secured loans may expose credit unions to more interest rate risk than they are accustomed to. Using variable rates when expanding into such areas as traditional second mortgages and mobile home loans will help alleviate some of this risk.

TIME TO CHANGE?

In creating a loan-product mix to see you safely into the next century, you should look to the lessons of the past. You may find you have to consciously develop new areas of lending to hedge against the risks inherent in traditional products. You also may learn that the best way to serve your members isn't necessarily to make the type of loans they ask for.

The following are four guidelines you may want to keep in mind when creating your product mix:

1. Identify the "earners" and "losers" among your loan products by calculating their effect on ROA.
2. Determine what percentage of your annual originations and total portfolio is secured. Seek the highest percentage allowed by law for both.
3. Establish pricing incentives to steer low-balance unsecured installment loans into credit card balances or lines of credit that carry fees.
4. Use variable rates when expanding into such long-term products as traditional second mortgages and mobile home loans. ■

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