CREDIT UNION MAGAZINE

BEST PRACTICES

Risk-Based Lending:
More Members, More Loans

CUNA
Credit Union National Association
Research & Advice

Publisher's **Note**

Credit unions began offering risk-based lending in the early 1990s, and since then, their use of this lending practice has grown 308%. But only about one-half of credit unions (53%) are using risk-based guidelines to grant loans, according to CUNA's 2005-2006 Credit Union Lending Survey.

Many credit unions still haven't adopted risk-based lending guidelines even though a 1999 letter from the National Credit Union Administration (NCUA) to federally insured credit unions described risk-based lending as "a means by which a credit union may be able to more effectively meet the credit needs of all its members."

The NCUA letter described risk-based lending as a tiered-pricing structure that assigns loan rates based on an individual's credit risk, and says the practice holds most significant benefits for two categories of borrowers:

- Those attempting to repair their credit after previous mishandling.
- Those attempting to establish credit.

At credit unions, higher-risk borrowers pay higher interest rates than those with perfect credit pay, but far lower rates than they'd incur at payday lenders, finance companies, pawn shops, or rent-to-own stores. Credit unions price the loans to cover the potentially higher costs of underwriting, servicing, and collecting the loans.

With a one-price-fits-all loan program, many high-risk borrowers wouldn't meet standard approval criteria. By moving to risk-based criteria, credit unions can serve members—often those of modest means—who wouldn't qualify otherwise.

Risk-based lending also lets credit unions serve more members at the lowest-risk end of the spectrum. Credit unions can offer more attractive rates to members with excellent credit, rewarding them for managing their credit histories well, and frequently attracting their loans from higher-priced competitors.

Thirty-six percent of respondents to CUNA's lending survey say risk-based lending has enabled them to grant more loans to high-risk members, and 44% say it has enabled them to grant more loans to low-risk members. Many survey respondents also report positive financial results:

- Forty-four percent say their ratio of loans approved to loans granted has increased due to risk-based lending.
- Four in 10 say risk-based lending has had a positive effect on their loan-to-share ratios.
- Nearly one-third believe net income has increased due to risk-based lending.
- Twenty-seven percent say risk-based lending is responsible for an increase in their net capital ratios.
- Twenty-two percent believe risk-based lending is responsible for a decrease in delinquencies.
- Nineteen percent say it's responsible for a decrease in gross charge-offs.

Only 12% of survey respondents believe their risk-based lending programs are responsible for an increase in their credit unions' operating expense ratios. The vast majority (81%) believe their risk-based lending interest rates accurately reflect the risk and costs involved, and 78% says their rates are sufficient to cover the costs of servicing, administration, collections, and loan losses.

NCUA's letter notes that successful risk-based lending demands sound planning, specialized expertise, and reliable monitoring and control systems. The eight credit unions profiled in this report have taken that advice to heart.

While they're very different—one credit union's membership is 61% low-income while another's is mostly affluent, and their asset sizes vary from $5.5 million to $5.6 billion—they all have thriving risk-based lending programs, and all say several factors have contributed to their success:

- Developing underwriting criteria that enable them to make as many loans as possible without taking on excessive risk.
- Educating their lending staff on risk-based lending concepts and ensuring they understand how to interpret credit scores and make sound loan decisions.
- Educating collections staff to act proactively at the first signs of delinquency, especially with higher-risk loans.
- Educating members about how to manage their loans and how to improve their credit scores.
- Monitoring program results, including loan yields, delinquency ratios, and loss rates, and adjusting rate tiers and underwriting criteria to mitigate risk.

All eight credit unions offer risk-based loans for new and used vehicles, RVs, motorcycles, boats, and on unsecured loans. Most also offer risk-based lending on home equity loans, and several offer it on mortgages.

The credit unions all use various borrower characteristics—debt ratio, payment history, and credit score—to approve or deny loans. Six of the credit unions assign borrowers to rate tiers based strictly on credit score. The other two credit unions look at borrower characteristics in conjunction with credit scores.

Some of the credit unions have seen lower delinquency and loss ratios since implementing risk-based lending. None have seen significant increases. The credit unions also report higher loan yields, especially in the higher-risk tiers. In the end, what do they have *most* in common? All eight credit unions firmly believe in risk-based lending as a way to help more members and generate more loans.

Mark A. Condon
Senior Vice President
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PROJECT LEAP™
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BECU:

Providing Value to ‘A’ And ‘E’ Members Equally

by Judy Dahl

“We could see that we were missing opportunities on two ends of the spectrum because of our one-price-fits-all loan policies,” says Gary Fee, director of product and delivery channel management for BECU in Seattle. “We couldn’t afford to loan to credit-challenged members and we weren’t serving the really high-end folks because our rates were in the middle. We wanted to serve more members.”

That’s why, five years ago, the credit union implemented a risk-based lending strategy.

“Our risk-based guidelines apply to all loans now, including mortgages, but we started out with only auto loans,” says Fee. “We thought we could figure auto loans out much faster. There was a wider range of credit scores in that segment of the membership and it was our top product. We had an indirect lending program, so we saw different types of members coming in through that channel. We wanted to learn from that experience and grow it from there.”

Gary Fee, *director of product and delivery channel management for BECU, Seattle*

BECU

- Location: Seattle
- Asset size: $5.6 billion
- Number of members: 330,000
- Web site: *www.becu.org*
- Field of membership: BECU, formerly Boeing Employees’ Credit Union, was originally sponsored by the Boeing Company. The credit union is now open to all Washington state residents.
- Membership details: BECU’s membership is becoming increasingly diverse, according to Gary Fee. The demographics differ across the state, with large Asian and Spanish populations in Seattle and pockets of underserved areas throughout the Puget Sound area.

The credit union offered risk-based lending on only auto loans for 18 months, then expanded it to credit cards and unsecured loans, followed by home equity, boat, motorcycle, and RV loans, and finally mortgages.

“We have five rate tiers for auto and unsecured loans, credit cards, and mortgages. We have only three tiers for home equity, boat, motorcycle, and RV loans,” explains Fee. “We don’t have enough experience—and don’t see the need—to slice those thinner. We’re not attracting sufficient numbers and we’ve underwritten pretty high scores on those.

“We adjust our risk-based lending parameters based on what we’re seeing in the portfolio,” he says. “We started with only two rate tiers.”

Monitor and adjust

When reviewing its loan portfolio, Fee could see that in the credit score range of 730 and above, its auto loan losses were almost nonexistent.

“As soon as you go below that, you start to see some delinquency and losses, and you begin to incur some costs associated with collections,” says Fee. “We went back and figured out what those delinquency rates, losses, and costs would be, and built our pricing around that. "As you monitor over the years, you see where those breaks are."

BECU also looked at competitors' rates. "Our B rate is our base rate, so we monitored competitors' rates against that," says Fee. "Now we've gone beyond that and we monitor all rates. We look at what the competition is doing in our indirect-lending channel.

"Once the program is implemented, it's really just the beginning," he says. "You watch it, monitor it, and adjust it when you see trends. You may shrink a tier or broaden a tier once you see the performance of those loans.

"But you don't want to move too quickly and react to something you've seen just in the last two months," Fee cautions. "We'll watch a new loan tier for nine months. If we see rising delinquencies, we go back and look at the applications to see what's causing it. We might have to adjust our underwriting or our scoring."

Risk-based lending parameters

▪ Types of loans: All loans offered—first mortgages, home equity, new and used vehicle, RV, motorcycle, boat loans, credit cards, unsecured loans, and small business loans.

▪ Rate tiers: Five tiers for auto, unsecured loans, credit cards, and mortgages:

Rate Tier	Credit Scores
A	730 and above
B	680 – 729
C	640 – 679
D	600 – 639
E	599 and below

Three tiers for home equity, RV, motorcycle, and boat loans:

Rate Tier	Credit Scores
A	700 and above
B	630 – 699
C	629 and below

▪ Minimum score to qualify for a loan: None

▪ Criteria for loan approval: Numerous borrower criteria

▪ Criteria for placing borrowers into tiers: Strictly credit score

▪ Rate details: BECU's B-tier rate is its base rate. The credit union has loan-to-value requirements based on rate tier: For A-paper auto loans, the limit is 130%; for E paper, it's 90%. Within each rate tier, BECU has maximum loan amounts based on credit score. E-tier loans require a manual review—the credit union's decisioning software can't approve these loans.

▪ Decisioning software: APPRO Systems' LoanCenter

The credit union uses an APPRO loan origination system, which includes a decisioning feature. "We use it for all applications—online or other. It pulls a credit report, does the scoring, and assigns a risk tier," says Fee. The system designates loans as approved or referred, and its workflow-management feature sends referrals to loan officer queues for review. "Approved loans go on their way unless there's an exception for loan-to-value or something related to collateral," he adds.

Increased loan volumes

Fee thinks BECU's risk-based lending program is highly successful. "We measure that by our increased penetration into our field of membership and our continued growth in loan volume," he says. "Last year, the credit union industry standard was in the 8% to 10% growth range. Our growth rate was over 21%. We've consistently done that over the last few years, and we've seen a bigger share of high-end as well as D and E members. We now have the ability to serve them both.

"Our losses and delinquencies haven't changed percentage-wise despite writing more loans in the lower tiers. We've been able to price appropriately to manage it. The real delinquency and loss numbers have gone up, but the portfolio (volume) has also gone up tremendously. Managing the front-end application process and the collections process based on tiers has actually helped us," says Fee.

BECU manages lower-tier loans very carefully. "We run special reports based on risk tier, and our collectors start with the lower tiers," says Fee. "An A-paper member who's seven days past due won't hear from us. An E-paper member would get a phone call. The early phone call reminds the member the payment is due and gives us the opportunity to resolve any issues early in delinquency.

"If we see signs of problems, we can counsel borrowers early in the process and find a way to get them back on track. If there's a job loss, we can consolidate loans or temporarily defer payments," he explains.

High gross margins

The gross margins on BECU's lower-tier loans are higher than on the upper-tier ones. "The net return on any loan should be about 1%, and we'll manage to that net 1%," says Fee.

"On an A-paper loan, our gross margin is much lower, but we still manage to the 1%," he clarifies. "We don't need as high a rate because we don't have collection costs or losses. We have higher loss numbers on E-paper loans, but we price for it and still get our 1%. Our objective is to provide value to A and E members equally. It takes constant monitoring."

Fee's recommendation on risk-based lending? "Do it!" he says. "Many credit unions still have philosophical issues with it. They think it'll be abused. But with proper monitoring, you can give members greater value than they'd receive from someone else. We're getting an E-tier member into a vehicle at 16.9% versus more than 22% at a dealer. That's good for both of us."

Bellwether Community Credit Union:

Bringing 'A' Paper Back to the Credit Union

by Judy Dahl

In 1999, after joining Bellwether Community Credit Union in Manchester, N.H., as vice president of lending, Alice Stevens' first project was to implement a risk-based lending program. "The credit union's management realized they had middle-of-the-road loan pricing," she says. "They weren't attracting most of their members because these members are generally affluent with great credit scores—the average is in the mid-700s."

The really good borrowers were getting better rates elsewhere. "The credit union also wasn't able to take any risk on borrowers with lower credit scores because they couldn't compensate with higher pricing," adds Stevens. "We had mediocre pricing and middle-of-the-road borrowers."

With a risk-based lending strategy, the credit union hoped to serve a broader range of its membership and bring "A" paper back to the credit union,

Bellwether Community Credit Union

- Location: Manchester, New Hampshire
- Asset size: $240 million
- Number of members: Over 16,000
- Web site: *www.tcu.org*
- Field of membership: Bellwether Community originally served telephone company workers. Now its membership base mirrors the state's population, which is quite homogenous, according to Stevens.
- Membership details: Members tend to be affluent and technologically savvy, performing more than 85% of their credit union transactions electronically.

Alice Stevens, *vice president of lending for Bellwether Community Credit Union, Manchester, N.H.*

strengthening its portfolio. The credit union began by offering risk-based pricing on all loans except fixed-rate first mortgages. These are written to Fannie Mae standards so the credit union can sell them on the secondary market. Since its first foray, the credit union has seen an increase of about 20% annually in outstanding consumer loans.

Assigning loan rates

While Bellwether Community uses numerous borrower characteristics to approve or deny risk-based loans, it determines loan-rate tiers strictly by credit score. Borrowers are slotted into one of five rate tiers, A (highest scores, least risk, lowest rates) to E (lowest scores, most risk, highest rates).

"There's no interpretation of the credit score when assigning tiers," says Stevens. "We have very specific cut-offs for each grade of paper. That's how we protect the integrity of the scoring model. Whether you're a millionaire or not, or have worked at the same place for 30 years, if your score is 679, you're a B. We don't want any subjectivity involved. That's how I know we're treating everyone fairly."

Bellwether defined its rate tiers using national averages from a credit bureau scoring model. "The model tells you things like the propensity for a B-paper borrower to default versus an A-paper borrower," says Stevens. She notes, however, that every credit union's loans will perform differently based on its field of membership.

"We also looked at what our competitors were doing," she says. "If you went to a finance company with a poor credit history, what rate would you pay there? We wanted to beat that rate significantly, but also to compensate ourselves and protect our other borrowers from the risk," she notes.

Bellwether doesn't set a minimum credit score cut-off. "We look at every loan we get. Some larger lenders can place cut-offs, but I'm not willing to overlook any opportunity," explains Stevens. "That's the nice thing about risk-based lending. You can adjust the pricing and the member gets a loan they might not be able to obtain elsewhere."

Loan rates vary within the tiers depending on the term of the loan and the type of loan product—long-term and unsecured loans have higher rates. A borrower's tier also influences whether or not the credit union will allow that member an unsecured loan, and the maximum loan-to-value for a secured loan.

Bellwether Community uses APPRO Systems' LoanCenter software to automate its loan decisions. "It's customized to our policies and procedures," Stevens notes. "You can use hundreds of different factors to determine if a loan is approved or referred.

"We don't close a loan without reviewing an approval, even auto loans, and we don't allow APPRO to deny any loans flat out. We want to try to build a deal," says Stevens. "Members don't always know what they could be approved for. We may not give them what they ask for, but we can structure the deal in a different way so we can still make the loan, rather than just denying it outright."

Risk-based lending parameters

- Types of loans: Adjustable-rate first mortgages, second mortgages, home equity, new and used vehicle, RV, boat loans, and unsecured loans
- Rate tiers: Five tiers—A through E

Rate Tier	Credit Scores
A	680 and above
B	640 to 679
C	600 to 639
D	550 to 599
E	549 and below

- Minimum score to qualify for a loan: None.
- Criteria for loan approval: Many borrower characteristics are considered, including credit score, debt-to-income ratio, amount of debt incurred in the past year, unsecured balances/gross annual income ratio, stability in employment and living arrangements, length of credit history, number of active trade lines reporting at the time, and payment history with similar loans.
- Criteria for placing borrowers into tiers: Strictly credit score. No interpretation.
- Rate details: Bellwether Community uses its A-paper rate as an index and raises it by one or more percentage points for the higher risk tiers. For unsecured loans, there's a larger range in the rates between tiers A and E, because lack of collateral increases risk. The unsecured loan rate index (A-paper rate) starts at 9%. The E-paper rate is at least seven percentage points higher. For auto loans, the index starts at 4% and the E-paper rate is five or six points higher. Rates for longer-term loans are higher.
- Decisioning software: APPRO Systems' LoanCenter

Underwriting is the key

In addition to loan growth, Bellwether Community uses "asset performance" to measure the success of its risk-based lending program. "Our delinquency and charge-off rates have actually gone down," says Stevens. "The main argument people have against risk-based lending is that they think you'll fill your building with collectors, but it doesn't have to be that way.

"Many financial institutions got into risk-based lending without thinking it through and they had some bad experiences and risk-based lending got a bad rap," she says. "They didn't structure the underwriting piece of the puzzle properly. The underwriting is the key to falling delinquency and charge-off rates.

"It's not a one-size-fits-all approach to lending any more," says Stevens. "You adjust the underwriting according to type of loan and the type of borrower you're looking at. You compensate yourself in a different way than if you're just looking at whether you get the loan or not. I structure the deal to mitigate the risk for the lower grades of paper. I ask for a cosigner, or require collateral, or set a maximum loan-to-value of 80%—whatever it takes to mitigate the risk."

Education and monitoring

"The margins are larger on the higher risk loans, but you don't make money by charging a higher rate if it doesn't get repaid," continues Stevens. "Making loans that will be repaid is the key to successful lending."

To increase the credit union's likelihood of getting paid, Bellwether combines higher risk loan closings with member education. "If I have to give you a higher rate, I'll tell you why, that we'll be watching the loan closely, and that you might have less leeway to be late on payments," Stevens emphasizes. "You tell members that if they don't live up to their end of the bargain, there will be consequences—nothing should be a surprise."

Stevens also educates higher risk borrowers about the factors affecting their credit scores. "I can help them understand where they've gone wrong, and how they can improve their scores, so next time they'll pay a lower rate," she says.

It's also important that loan officers understand risk-based pricing and how the underwriting is different. "If you haven't trained them to take the appropriate risks, you won't get good results," she says. "If credit unions are afraid of the program, and sit back and use old attitudes toward lending, they'll miss some loans."

Bellwether Community sorts its delinquency reports by credit tiers. It has trained its collectors to handle the lower tiers more proactively. "If we see late payments, we call riskier borrowers sooner, and send out 10-day repossession notices sooner," she explains.

The management team also monitors the program closely. "We monitor the mix of credit scores in our portfolio. Every year we pull a report of loans approved and closed during the year," says Stevens.

"We look at the credit scores to see if we're underwriting a larger amount of any one grade of paper than the make-up of our membership would indicate we'd attract," she says. "Our mix is highly unusual. We know that about 6% of our loans are D and E paper, about 4% are C paper, and about 90% are A and B paper. That's high, but it's right for our membership. The average credit union shouldn't expect this, but they should expect to get the mix right for their membership."

Clarion University Federal Credit Union:
Fairness to Members

by Judy Dahl

Clarion University Federal Credit Union, Clarion, Pa., started offering risk-based lending in 2003 for a couple of reasons, according to Alice Swartzfager, manager and CFO. "We thought it wasn't fair to give good members with a low risk of loss the same rate as those with higher loss rates. It's about fairness to members. If members are paying their bills and have good credit, they should be rewarded," she says.

"We also wanted our loan income to compensate for the higher risk of some loans," she notes. "And, of course, we wanted to serve more members."

A discussion at a chapter meeting helped Clarion make the decision. "Credit unions are all about helping each other, and we openly discussed the pros and cons of risk-based lending with other local credit union managers," says Swartzfager. "We probably wouldn't have gotten into this otherwise. I got a feel for how simple it could be. We didn't see too many cons."

Clarion University Federal Credit Union

- Location: Clarion, Pa.
- Asset size: $5.7 million
- Number of members: 1,515
- Web site: *www.cufcu.net*
- Field of membership: Clarion University faculty, staff, students, and their extended families.
- Membership details: Clarion's membership is very diverse ethnically, according to Swartzfager, with many international students and professors, not all of whom are U.S. citizens. Members' income levels also vary widely.

As simple as possible

Clarion staff reviewed several risk-based lending policies from other financial institutions before implementing its program. "Some of them were very confusing and almost overwhelming—too much information for our needs," says Swartzfager.

"We made ours as simple as possible," she explains. "We took some things that could be open to interpretation and simplified them. If a loan falls into a certain category, loan officers can approve it if they're comfortable with it."

Swartzfager says setting loan-rate tiers based on credit scores helps streamline the lending approval process. "If it's B paper or above with a debt ratio of 36% or below, loan officers can act on a loan if they feel comfortable, and most of our loans fall in these categories. If it's in the C tier, it's a credit committee referral. We contact them and usually have an answer in an hour," she says.

"Before we used credit scores as a criteria, we had to manually review the borrower's previous history and other information, and then make a judgment call. The credit score gives you this information at a glance in an objective way" says Swartzfager. "If it's in tier C or above, it will probably be approved."

The policy allows Clarion to write some loans that would previously have been rejected. "Our loan volume is at least 10% higher," she says. "Our last annual review shows 89% of loan applications approved, compared to 79% before implementing risk-based lending.

"If a borrower has several past delinquencies, but is on target now, the credit score considers the previous delinquency but puts more weight on the current status," she explains. "In the past, if we saw several 30-day delinquencies eight months ago, we might have rejected the loan. Now, if the member's been current for five or six months, the credit score takes that into account and we'd probably approve it."

Setting rate tiers

At first Clarion used industry averages to set its risk-based lending rate tiers. "We got the information from our federal examiner at the time," says Swartzfager. "A year into the program, and after examining our results, we bumped up our A tier from credit scores of 680 and above to 700 and above."

The credit union made this policy change after Swarzfager and other staff read industry literature, attended a financial-education seminar, and looked at member data. "We found that actual rates in the industry were higher and we were being too generous," Swarzfager says. "We also ran some actuarial figures based on members' credit report information and looked at who was close to which tiers. We felt we were more comfortable with A paper at 700 and above. This broadened our B tier by 20 points, and we earned 1% more in interest income on those 20 points.

Risk-based lending parameters

- Types of loans: New and used auto, RV, boat, motorcycle, computers, and unsecured loans.
- Rate tiers: Five tiers—A through E

Rate Tier	Credit Scores
A	700 and above
B	640 – 699
C	600 – 639
D	550 – 599
E	549 and below

- Minimum score to qualify for a loan: No absolute limit, but Clarion usually doesn't grant loans to E-tier borrowers. Loans in this tier require submitting an exception report to the board explaining why the loan was approved.
- Criteria for loan approval: Mostly credit score, but also debt ratio. If a borrower has a high debt ratio, the credit union averages the borrower's and a guarantor's credit scores.
- Criteria for placing borrowers into tiers: Strictly by credit score. If a member is disputing a discrepancy on a credit report, Clarion reserves the right to move the borrower up one rate tier. If a borrower has a poor credit score and Clarion requires a co-signer, the credit union averages the scores of the borrower and the cosigner.
- Rate details: Clarion's A-paper rate is its posted rate. The rate for B-paper loans is one percentage point higher, C-paper loans are three percentage points higher than the posted rate, D loans are six points higher, and E-paper loans, if granted, are eight points higher than the posted rate (but do not exceed the maximum allowable rate of 18%).
- Decisioning software: None

Low delinquency rates

Clarion's delinquency and charge-off rates have remained low. "If anything, we've seen a reduction in delinquencies—most recently our delinquency rate was generally less than 1%," says Swartzfager.

The credit union has the same collections procedures for borrowers in all credit tiers. "We move fairly rapidly when someone first becomes delinquent. We call and inquire, send follow-up letters, and encourage them to set up automatic payments."

"If people are chronically delinquent, we get more serious with them. We tell them they're taking a lot of our time after we gave them a good rate," she says. "We send a letter that reminds them we have the right to take their collateral. The letter gives them three options: Set up automatic payments, get the loan current and pay by a certain time, or send in one payment and then set up automatic ones. The tenor of the letter depends on how far behind they are, and whether they've been in contact or are trying to ignore us."

The credit union also refers members to credit counseling when necessary. "If someone comes in and we truly can't help them, I go over a credit-counseling packet with them and suggest they go to an agency like the Consumer Credit Counseling Service," Swartzfager explains. One delinquent member did so, and is now paying the credit union a lower monthly payment over a longer term.

Keep members informed

It's important to help members understand the concept of risk-based lending. "When we originally posted rate information on our Web site, we did say rates were set based on credit scores. Many members didn't know what we were talking about," says Swartzfager. "Now we explain it in our newsletter, and if we send a postcard for a special loan offer, we explain it there also. It's helped a lot.

"When we first started, we weren't giving borrowers a risk-based pricing notice," she says. "Now we attach one to the paperwork when applications come in, and explain it to members when we meet with them. The notice tells them what their credit score is, that they've gotten a higher rate, and that they can go to the credit bureau to get more information about their credit scores.

"Before, we'd say, 'We're increasing your rate by three percentage points. Do you still want the loan?' It was more of a counter-offer," says Swartzfager. "Now we just approve the loan at the higher rate and it keeps things moving through the channels faster. Members understand it better.

"I'm really glad we went into risk-based lending. It's a plus for members and the credit union," says Swartzfager. "I'd recommend it to anybody."

Coosa Pines Federal Credit Union:

Helping Members *and* the Bottom Line

by Judy Dahl

Coosa Pines Federal Credit Union, Childersberg, Ala., began offering risk-based loans more than two years ago to improve service to members.

"When you have one rate for all members, it's hard to justify giving the same rate for the C and D paper as you give for the A and B paper," says Rick Higgins, vice president of lending. "Through risk-based lending, we're able to serve more members—that's the important thing," he says. "We can help more members because we can price based on risk."

When approving loans, the credit union "looks at credit scores and borrower characteristics, such as debt ratio and several other variables," says Higgins. "But credit score is the sole criterion for assigning borrowers to rate tiers. The credit score sets the price, but we use other criteria for the approval decision."

Coosa Pines Federal Credit Union

- Location: Childersburg, Ala.
- Asset size: $152 million
- Number of members: 15,700
- Web site: *www.coosapinesfcu.org*
- Field of membership: Originally Coosa Pines Federal had one sponsor group—a paper mill. Now the credit union's community charter covers St. Clair, Clay, Coosa, Talladega, and Shelby counties in Alabama.
- Membership details: The membership is largely working class, according to Higgins. Members are diverse in age and their median income is between $40,000 and $44,000.

Rick Higgins, *vice president of lending, Coosa Pines Federal Credit Union, Childersberg, Ala.*

The credit union sets the loan rates in each tier based on its competitors' rates. "We check about once a week to see what they're doing with their A tiers," Higgins explains. "Most lenders in our area are doing risk-based lending, and we're usually able to beat their rates."

To adjust its rate tiers, the credit union runs a credit score report every six months on all members age 19 and older—the legal age to obtain a loan in Alabama. "Based on that, we look at who has loans and what their scores are, and determine our ranges accordingly," says Higgins.

"Every year, I look at how much delinquency I have in each tier and I also adjust the ranges based on that," he explains. "For example, if there's too much delinquency in tier C, I might tighten that category. You want to contain as many of your delinquencies in tiers C and D as possible. That's where your higher rates are—where you've priced the loans to cover the costs of collecting on delinquencies."

Coosa Pines Federal doesn't use loan-decisioning software, but, "we have an outsourced, 24/7 call center, and we've set up a matrix for the staff to use," explains Higgins. "If a borrower has a certain credit score, say 640 or above, a loan will usually get approved right over the telephone. If the score is lower, the loan gets referred to the credit union and the borrower gets an answer the next day." Higgins is investigating some decisioning tools, but hasn't studied them in detail yet.

Loan volume

Since adding risk-based lending to its strategy, the credit union's loan volume has increased. "We had $77 million in total outstandings in 2004 and $85 million on the books when we closed out last year," reports Higgins. "Delinquency has dropped too. It's at 1.4% now. That's a little higher than our peers, but we've come down from about 3.5% four years ago."

Delinquency rates decreased slowly after Coosa Pines Federal implemented risk-based lending. "We're seeing the fruits of our labors now. It takes a while for your portfolio to re-price and settle down," says Higgins.

Risk-based lending parameters

Types of loans: First mortgages, new and used vehicles, boats, RVs, motorcycles, unsecured, and small business loans.

Rate Tier	Credit Scores
A+	725 and above
A	680 – 724
B	600 – 679
C	550 – 599
D	549 and below

- Minimum score to qualify for a loan: None
- Criteria for loan approval: Credit score and other borrower characteristics, such as debt ratio, time of employment, unsecured debt ratios, and time at residence.
- Criteria for placing borrowers into tiers: Strictly credit score.
- Rate details: At times, members with B, C, and D grades of paper will be required to have equity in a vehicle or collateral loan. Depending on various factors, the maximum loan amount the credit union will allow on these grades of paper is anywhere from 79% to 85% loan-to-value. This depends on the individual borrower. Interest rates in each tier are determined by comparisons to competitors.
- Decisioning software: None

Coosa Pines' loan yields increased 12% last year. "We earn higher yields on the riskier loans. If you have a D-tier car loan, it might be at 14.5%. But if 1% or 2% of these loans are delinquent, your charge-offs may be higher. If you can collect on them, your yields will be higher," says Higgins.

"If you charge 4.9% for an A-paper new-car loan, you'll hardly make any money," he says. "But if you lend to a low-B or high-C person, the rate would be more like 7.9%, which increases your overall yield."

To monitor the program, he reviews a quarterly breakdown of the portfolio by credit score to check delinquency rates by tier. "This also helps with target marketing. We can take the breakdown and target only those in a certain tier," Higgins notes.

Get staff buy-in

For credit unions implementing risk-based lending, Higgins recommends making sure everyone—from your tellers and lending personnel all the way to the board of directors—understands the purpose.

"When we had a single-sponsor field of membership, we knew everyone we made a loan to," says Higgins. "Since we've had a community charter, we're dealing with members we're not familiar with, and all grades of paper.

"Lenders need to be able to interview borrowers and consider all the factors," he adds. "Lending staff can't be just order-takers. They need training to know how to make low B, C, and D loans successfully."

When training lending staff, Coosa Pines Federal had them review credit reports. "We pointed out things to look for: Is this a one-time catastrophic event causing a low score—such as a divorce or loss of a job—or is this a person who hasn't paid his bills in a long time?" says Higgins.

"There are a lot of people who, because of recent problems, might have weak credit now but had good credit in the past. If you look back at their history you might find that they can become good credit risks in the future," he says. "You have to charge them a high rate now, but this C-tier person might become your A+ member later. If you can show that you understand their situations and can help them, you'll have a member for life. You have to look for a way to make these kinds of loans possible."

Higgins also recommends ensuring that lenders buy into the concept of risk-based lending. "If someone asks why they're getting a higher rate than somebody else, your loan staff must be able to answer in a positive way without degrading the member. You won't be successful with risk-based lending unless your staff buys into it," he says.

Educate members

"Take every opportunity—in your newsletter, monthly mailings, and annual meetings—to explain risk-based lending and how loan rates are based on members' qualifications," advises Higgins. "Members know how they've paid their bills in the past. It's not the credit union's responsibility or fault if you charge them a higher rate because of how they pay their bills. You have to price the loan based on the risk—how that member pays other creditors.

"Older members sometimes question risk-based lending policies, especially if they have to pay higher interest rates," cautions Higgins, "and you have to expect these kinds of questions. The key is having your loan officers help them understand. Maybe they've been slow paying their bills, and right now, based on their credit score, this is the rate they'll have to pay, but they can work their way out of it."

Higgins is currently considering a new policy for C- and D-tier members. "I'd put them on the books at the subprime rate, but tell them that if they make payments on time for 12 months, I'll refinance their loans at a lower rate. It's an incentive to make payments and to leave their loans at the credit union," Higgins says. "Also, members feel better about themselves. If they're paying this bill, they're more likely to pay other bills."

The credit union does indirect lending, but not in the lower rate tiers. "The average credit score is 736, but down the road, we'd like to get into subprime lending," says Higgins. "C- and D-tier people financing at the dealers are getting an average rate of about 24%. We can get them better rates while increasing our loan volume and income."

Episcopal Community Federal Credit Union:

It All Comes Down to the Relationship

by Judy Dahl

“Ours is a unique risk-based lending program,” says Urla Abrigo, CEO of Episcopal Community Federal Credit Union in Los Angeles. The credit union added the program about seven years ago, primarily to help its members of modest means.

“Most members (61%) fall into the low- to moderate-income category,” explains Abrigo. “Our field of membership includes anyone receiving services in the Los Angeles Episcopal Diocese, so we serve some of the homeless population, Alcoholics Anonymous members, people receiving service at the local mental health center, and people in food programs.

“We realized that as a credit union serving mostly

Urla Abrigo, *CEO of Episcopal Community Federal Credit Union in Los Angeles*

low-income members, we had many members who didn’t have credit, or who had credit but were being victimized when getting loans,” says Abrigo. “They’d be paying huge interest rates. They didn’t know how to negotiate when buying cars, so they were paying way too much.

“While conventional wisdom says low- to moderate-income people won’t pay their loans back, we’ve seen otherwise,” notes Abrigo. “It’s a matter of member education. If you have a good relationship with your members and counsel them, they’ll call you if they have a problem and can’t make a payment,” she says.

Episcopal Community Federal Credit Union

- Location: Los Angeles
- Asset size: $5.5 million
- Number of members: 2,600
- Web site: *ladiocese.org/creditunion/*
- Field of membership: Members of the Episcopal Church and anyone receiving services in the Episcopal Diocese of Los Angeles.
- Membership details: The membership includes some of the city’s homeless population, Alcoholics Anonymous members, people affiliated with the local mental health center, and those participating in food donation programs, according to Abrigo. She notes that 61% of members fall into the low-to-moderate income bracket.

Giving them a chance

“Risk-based lending comes down to the relationship between the member and the lender,” says Abrigo. “The level of the member’s financial literacy also makes it successful. You must educate your members on how to handle credit. Make sure they know you’re giving them a chance when no one else would.”

To that end, the credit union regularly offers financial education seminars.

“We did about 70 last year, and we also offer one-on-one counseling at closings for higher risk loans,” Abrigo explains. “It’s better to do it then than to wait for the borrower to take a course. We don’t require them to take classes, but we know they need the information to succeed with the loan,” she says. “We

Risk-based lending parameters

▪ Types of loans: New and used vehicles, motorcycles, RVs, boats, student/education loans, small-business loans, and unsecured loans, such as medical/dental, consolidation loans, and loans to pay off payday lenders.

▪ Rate tiers: Four tiers—A through D

Rate Tier	Credit Scores
A	700 and above
B	600 – 699
C	500 – 599
D	Below 500

▪ Minimum score to qualify for a loan: None

▪ Criteria for loan approval: Borrower characteristics such as years of employment or years in a residence.

▪ Criteria for placing borrowers into tiers: Strictly credit score.

▪ Rate details: The A-tier rate is the base rate. B-tier loans are one percentage point higher, C-tier loans are two percentage points higher, and D-tier loans are three points higher.

▪ Decisioning software: None

show them their credit report, how to read it, and what the symbols mean. We also counsel them on budgeting and how they should take care of loans."

In addition to new and used vehicle loans, Episcopal Community Federal offers many types of unsecured loans. "We help members pay off payday lenders, we do consolidation loans, and we offer medical and dental loans," Abrigo notes.

To approve loans, the credit union's lenders review borrower characteristics such as years of employment and years of residency.

"That tells us if they'll pay us back," Abrigo says. "If they have a high credit score but a bad payment record, we won't make the loan." The credit union assigns rate tiers based solely on credit scores. "To use other factors—like years on the job—could be discriminatory when setting the rate," she explains.

Needs versus wants

"We approve 99% of the loans that come into the credit union," Abrigo says. "If someone asks for $2,500, but we determine they need only $1,200, we won't give them more. We look at needs versus wants. If you just want cash but you have a lot of credit cards, that won't happen. If you want the loan to pay off a credit card debt, we'll pay the credit card company directly."

Episcopal Community Federal tries to keep its rates for even higher risk loans low, so low-income members can work their way out of debt. "We offer risk-based lending rates much lower than these members could get elsewhere," says Abrigo. "The highest we go is three percentage points over our regular rate. If our regular new-car loan rate is 7.5% and they have really bad credit, we'll add three points.

"We also try to help members caught up in payday lending schemes. We loan them money to pay those off so they have some funds available," she continues. "They see so many ads on TV, so they go to the payday lenders first. We have a lot of small loans to these members after they understand how they're being used."

She says the credit union doesn't make much money on these small loans. "But it balances out," she claims. "Our larger loans, like auto loans with high balances, support these small, high-risk loans and help with the overhead."

Low charge-offs

"Our risk-based lending program has been extremely successful," says Abrigo. "The number of loans we have is growing, and our delinquency rate is less than 2%. Our charge-off rate is less than 1%."

The delinquency rate on risk-based loans did increase when the credit union first implemented its program, so its collections staff began managing higher-risk accounts more proactively. "We know our members, and we have a risk-based delinquency report we look at," Abrigo explains. "We see who's 10 days past due and we follow up right away. We call, send notices, and bring in a collection agency when necessary."

Episcopal Community Federal promotes its risk-based lending program through statement stuffers and newsletter articles. "We also send information to the churches, or wherever we know members are available," she says. "We have a display table during special days at church, and we distribute flyers out in the community. If members don't have a Social Security number, we accept the Matricula Consular identity card to open accounts. We also post information at the Mexican Embassy," she adds.

"To be successful, you have to know your members," says Abrigo. "Develop a relationship with them, and make sure you don't give them more than they need and can afford. We ask how much they can afford without their family suffering, and how they'll pay if someone becomes ill or unemployed. When members need money, they'll tell you all about their lives so you can make a good decision."

Florida State University Credit Union:

Keeping High-Risk Borrowers from the Finance Companies

by Judy Dahl

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"About eight years ago," explains Chuck Adcock, Florida State University Credit Union's chief operating officer, "we made a decision to reach out to more members." Like a lot of other credit unions at the time, however, Florida State was seeing profit margins shrink.

Its strategy included risk-based lending, which allowed the credit union to both fulfill its service goals and be compensated for the effort. It implemented the program for all loans except first mortgages.

"We were very conservative in the beginning, but we began collecting data from day one, and after a while we loosened our guidelines a bit based on the trends we saw," explains Adcock. "At times we've gotten too loose and have had to tighten up a bit."

Florida State University Credit Union

- Location: Tallahassee
- Asset size: $67 million
- Number of members: More than 10,000
- Web site: *www.fsucu.org*
- Field of membership: Florida State University faculty, staff, students, alumni, boosters, business partners, and their families, along with staff and residents of HarborChase Senior Living Community.
- Membership details: Anyone donating to the university can be a booster, which broadens the credit union's potential membership base, according to Adcock.

Chuck Adcock, chief operating officer, Florida State University Credit Union, Tallahassee

"You can make more money with risk-based lending, so you can afford to be more aggressive," says Adcock. "When we found what works with our members, the program hit its stride. We could take a chance on more people," he says.

To establish competitive rate tiers, the credit union sought recommendations from an industry expert who had collected data on how finance companies, other financial institutions, and auto manufacturers' captive finance companies were setting their rates. "Our rate breakdown by loan term and unsecured versus secured loans is pretty common," says Adcock.

The personal touch

While the credit union uses only credit scores to assign borrowers to rate tiers, "the loan approval decision is much more complex," says Adcock, who says he's not a big believer in scoring models.

"Scoring models can get you close, but when it comes to underwriting, you might be an A+ borrower today and an E borrower next week," he says. "A credit score is a snapshot at the moment you pull it. You need to look at credit report trends to see if they're going down."

Florida State's lenders also review borrower characteristics and compare them to what would be typical for their age group. "If something's out of whack, I ask the member. It might be completely legitimate," Adcock offers.

"I rarely look at debt ratio—monthly debt to income—any more. I might eyeball it on a marginal loan" he explains. "The problem with the ratio is that, I might be close to an 800 credit score but have large loan payments that make the ratio look high. Someone with an 84-month car loan might have lower payments and therefore a lower ratio, but are they really a better risk? Someone with a loan like that is likely to have cash-flow problems, too."

Risk-based lending parameters

▪ Types of loans: All loans the credit union makes directly, which include home equity, new and used vehicle, motorcycle, RV, and boat loans. The program also covers credit cards and unsecured loans. First mortgages are excluded because Florida State uses a third party to make these loans.

▪ Rate tiers: Six tiers—A+ through E

Rate Tier	Credit Scores
A+	720 and above
A	680 – 719
B	640 – 679
C	600 – 639
D	550 – 599
E	549 and below

▪ Minimum score to qualify for a loan: None

▪ Criteria for loan approval: Many factors, including debt-to-income ratio, length of employment, payment history, and length of residence. The credit union's lenders review all these factors and compare them to the borrower's age to see if they make sense. If, for example, a 23-year-old has a salary of $90,000, credit union staff would ask the borrower for more details.

▪ Criteria for placing borrowers into tiers: Strictly credit score

▪ Rate details: Within each tier, Florida State has higher rates for longer-term loans, for new versus used vehicles, and for unsecured versus secured loans. All A+ borrowers receive the same rate regardless of loan term because the chance of default is low. The credit union offers rates as low as 4.25% for new car loans to A+ borrowers. It charges up to 18% (the state usury limit) on some types of loans to higher risk borrowers.

▪ Decisioning software: AnyHour Online

Florida State uses AnyHour decisioning software for online applications. "It's good for A+ borrowers to get an instant decision," Adcock offers. "I don't want to inconvenience them. If they don't qualify online, the software refers them to a loan officer to dig deeper.

"I prefer the high-touch approach. You miss out on loans you could make if you don't talk to the person. Some credit unions deny loans based solely on the credit score—they don't want to touch anything below 600," he continues.

"But that's where you really make money and can afford to offer competitive rates on A+ paper. I can offer a 2.99% rate to compete with the auto dealers," says Adcock. "We earn very low margins on such loans, but that borrower will tell his friends, and eventually he'll move his mortgage and credit card over to the credit union, too," he notes.

Extensive training

Employees need to understand which loans are good for the credit union, explains Adcock. "We lend very aggressively and we collect very aggressively—it requires extensive training. Collectors need to understand why lenders make their decisions, and loan people have to understand the collection process."

Each month, collections staff examine data on loans that have gone bad to see if there's something they should have recognized. "If the description of a bad loan fits a loan you're considering," he offers, "you might rethink your decision-making processes."

Adcock says it's imperative that lenders understand the components of the credit score and what factors affect it. "You can't just learn about it once—you have to keep up with it," he says. "The way it's calculated changes occasionally. It's interesting to look at peoples' track records and what's driving their scores. Sometimes I learn more about how scores work by tracking the different components."

It's also important to discuss with members how they can improve their scores. "If you just deny them without telling them why, you're sending them downstream to someone who'll charge them 200% or 300% interest," Adcock warns. "We take 15 minutes to show them how they can get the loan in the future."

Significantly higher income

Since adding risk-based lending, Adcock says Florida State's delinquency and charge-off rates have been slightly higher than at more conservative credit unions, but below the average rates at credit unions of similar asset size.

"Our portfolio is riskier than some, but we earn a significantly higher ROA [return on assets] and income than our more conservative peers," he notes.

The program's positive bottom line is an indicator of how well the credit union is doing with underwriting, Adcock indicates. "We also look at our portfolio's breakdown by paper grade," he says. "If charge-offs and delinquencies are in check, you can feel proud of having a large percentage of higher risk paper. You typically want to see less than 25% of the portfolio in C to E paper, but I'm proud that ours is at 35%.

"Risk-based lending allows us to re-attract the A paper we'd lost over the years to other lenders," says Adcock. "We're reaching members we couldn't in the past on both ends of the spectrum. We keep the low-end borrowers from the finance companies and save them money, and we reward the high-end borrowers for the hard work they put into keeping their credit scores high."

Florida Central Credit Union:

Converting High Credit Risks to B-Paper Borrowers

by Judy Dahl

“Our members tend to be middle-income, that’s why risk-based lending is suited to our membership,” says Laida Garcia, executive vice president at Florida Central Credit Union, Tampa. The credit union implemented risk-based lending about eight years ago.

“We started a risk-based lending program primarily because we’re conservative as lenders and we were turning down too many applicants with low credit scores,” says Garcia. “We thought risk-based lending would be a way to serve more of them. Also, on the high end, we wanted to be able to offer lower, more competitive rates to those members who deserved them.”

Florida Central uses risk-based lending primarily for new and used auto loans, and also some unsecured loans and mortgages. “It’s because of the collateral—

Laida Garcia, *executive vice president at Florida Central CU, Tampa*

we want to mitigate risk by collateralizing whenever we can. And most of us need wheels, but we don’t necessarily need a boat,” says Garcia.

Florida Central Credit Union

- Location: Tampa
- Asset size: $215 million
- Number of members: 42,000
- Web site: *www.fccuonline.com*
- Field of membership: Any resident of the 10 counties where Florida Central has a branch.
- Membership details: Most members have moderate incomes, which is why the credit union’s asset size is relatively low for its number of members, according to Garcia.

Look beyond credit scores

The credit union uses credit scores to assign borrowers to rate tiers, but not to approve or decline a loan. “We look at things like whether they have stable residency and a steady job,” says Garcia. “Especially in the lower tiers, that’s the kind of thing you focus on.”

Florida Central’s rate tiers are based on industry standards. “We mirrored what the auto dealers were doing in our indirect-lending program. We didn’t want to have different tiers for direct lending,” says Garcia. “We give dealers the authority to lend only to A+, A or B-tier borrowers. For tiers below that, they forward the application to us for approval. There’s too much risk exposure if they have authority beyond that level.”

To price loans, “initially we based it strictly on credit scores, but we thought that was unfair. If you look only at the score, you’re not bringing in new business, you’re just charging some of your regular members a higher rate,” says Garcia. “You need to look deeper and find out why the score is low. We modified our underwriting to look at additional factors.”

She defines higher-risk loans as those with scores of 639 or lower. “When structuring these loans we look at things like: Did they score lower because of an insufficient credit history? A catastrophic illness? Credit abuse by a spouse or former spouse?" she says.

The credit union has set 500 as the minimum credit score for loan approval. "Based on our members' credit bureau reports, this is as much risk as we want to take on," says Garcia. "Our members' scores tend to be at 500 and above."

Garcia says that while the credit union doesn't use loan-decisioning software now, it may in the future to expedite the approval process. "Currently, when people apply for loans online or by phone, the applications go into the loan officer queue for a decision. It takes a little longer," she explains.

Risk-based lending parameters

- Types of loans: Primarily new and used vehicles; some unsecured loans and mortgages.
- Rate tiers: Six tiers—A+ to E

Rate Tier	Credit Scores
A+	720 and above
A	680 - 719
B	640 – 679
C	600 – 639
D	540 – 599
E	500 – 539

- Minimum score to qualify for a loan: 500
- Criteria for loan approval: Not credit score; borrower characteristics such as stability of residency and employment
- Criteria for placing borrowers into tiers: Credit score plus a consideration of the reasons for any adverse information, such as insufficient credit history, a catastrophic illness, or credit abuse by a former spouse.
- Rate details: For tiers C through E, rates are three to seven percentage points higher than the tier-A rates.
- Decisioning software: None, but might add in the future

Room to grow

Risk-based loans constitute only about 4.5% of Florida Central's loan portfolio, and its board policy allows 15%.

"We have a lot of room to grow," says Garcia. "Although we're very conservative, we're trying to broaden our scope. We could do a better job of marketing the program." The credit union plans a direct mail campaign to target potential C- and D-paper borrowers, and newsletter articles to promote risk-based lending.

"We're trying to increase our loan yields, and risk-based lending provides a good opportunity to do so. The going rate in our area for an A+-tier auto loan is about 5.5%, and on loans to higher-risk borrowers, you can earn 8.5% to 13%," she says.

Less competition for lower-tier borrowers

A definite but not always recognized factor with risk-based lending is that there's often less competition for lower-tier borrowers. "When you're an A+ borrower, you're in high demand. If you're a C borrower, not everybody wants you," says Garcia.

She says that in order to build strong loan portfolios, it's critical for credit unions to offer risk-based lending. "At our credit union, we may need to be more generous with our judgmental criteria and lower our tiers a tad," Garcia offers, noting that her credit union won't make questionable loans, but "there's a gray area where there's room for flexibility."

Loan outstandings, loss ratios, and the bottom line are the indicators Florida Central uses to measure success. "We're comfortable with where we are. We have about $6.5 million in outstandings. We could do better. But we're pleased that our charge-offs have been low," says Garcia. In fact, she notes, charge-offs have gone up very little since the credit union added risk-based lending.

"We look at one-year and two-year loans in our risk-based lending portfolio," she says. "For the one-year loans, charge-off levels are at 0.57%. For two-year loans the level is 0.66%. For our overall portfolio, the one-year level is 0.25% and the two-year level is 0.27%. Delinquencies on our risk-based loans have increased a little, but are lower than on our credit card accounts."

Nurture riskier accounts

It's important to spend time nurturing loan accounts, especially the lower-tier loans. "You can't just make the loans and send the members on their way," says Garcia. "You need to spend time providing them with financial education, and hopefully you'll convert them to B-paper borrowers in the future."

While Florida Central hasn't added additional staff to support its risk-based lending program, Garcia acknowledges that risk-based lending takes a little more work on the part of the collections department.

"We attack the higher-risk loans a little differently. If you're 10 days late, we're on you," she says. "With the rest of portfolio, it's more like 30 days. We take a more aggressive posture with risk-based lending."

She advises monitoring riskier loans carefully, and attaching different collateral codes to risk-based loan accounts. "With risk-based lending, you should track the members' credit scores, payment histories, and employment situations, and contact them if you see anything adverse," Garcia counsels. "If adverse trends develop, adjust your program parameters. You can't treat these accounts like you do the rest of your portfolio."

Palmetto Citizens Federal Credit Union:

Yields Far Outstrip Losses

by Judy Dahl

“One of the challenges in South Carolina is that the state per capita income is so far below the national average—nearly $5,000 less,” says Nick Wodogaza, president, Palmetto Citizens Federal Credit Union in Columbia. “Our members’ average credit scores are far below the national average of 700. The state average is 666.”

This makes risk-based lending a natural strategy for Palmetto Citizens Federal.

“When I came to the credit union in 1994, I brought in the risk-based lending program,” he explains. “Our loan-to-share ratio was 42% and we weren’t making many loans. We looked at the program as an opportunity to make more loans to more members.”

Nick Wodogaza, *president, Palmetto Citizens Federal Credit Union in Columbia, S.C.*

He says Palmetto Citizens Federal will lend at high risk levels and at a high loan-to-value ratio. “We expect to have more challenges making the loans and collecting them, and we charge a higher rate because of it,” he explains.

Wodogaza had plenty of experience to draw on in structuring the program. “In the past, I managed a challenged credit union that was having delinquency and loan-loss problems. I saw people get loans who shouldn’t have, and I also saw opportunities to help members with credit challenges,” he says.

“With risk-based lending, it’s so important to know that the level of risk you assume needs to match your level of return,” says Wodogaza. “If you decrease your risk, you should be willing to decrease your rate. If you increase your risk, you should increase your rate. But if you loosen your credit standards and lower your rates, you can get in trouble.”

Defining credit risks

When Palmetto Citizens Federal implemented its program, “We talked about how to define excellent, good, average, fair, and poor credit risks,” Wodogaza remembers.

The credit union created criteria defining the type of

Palmetto Citizens Federal Credit Union

- Location: Columbia, S.C.
- Asset size: $258 million
- Number of members: 40,408
- Web site: *www.palmettocitizens.org*
- Field of membership: Formerly known as Columbia Teachers Federal Credit Union, Palmetto Citizens now has a community charter serving Richland, Lexington, Newberry, and Fairfield counties in South Carolina.
- Membership details: Most members are between the ages of 30 and 50. The membership’s economic diversity mirrors the state population, according to Wodogaza. There’s a growing Hispanic population and a small mix of other ethnic groups.

person representing each category, including credit score, number and extent of late payments, cash flow, and general creditworthiness. "We also worked with an attorney to make sure the factors were non-discriminatory," he adds.

The credit union uses its criteria both to approve loans and to assign rate tiers. "Our program has never been accused of being discriminatory. We can show it's based wholly on credit information," says Wodogaza. "Some credit unions allow overrides of their criteria, but we don't. It doesn't matter how much or to whom members complain. Our lenders know there are no exceptions to the rule, so they can explain it to borrowers."

While the credit union's highest overall loan rate is 18%, its car-loan rates range from 3.29% to 14.9% for the highest risk tier. There's a range of about 10 percentage points in some categories for the same vehicle over the same loan term based on the borrower's creditworthiness, he explains.

Risk-based lending parameters

- Types of loans: Home equity, new and used vehicles, RVs, motorcycles, boats, unsecured loans, and mortgages. The credit union doesn't plan to sell on the secondary market
- Rate tiers: Five tiers—1 to 5

Rate Tier	Credit Scores
1	700 and above
2	650 – 699
3	600 – 649
4	575 – 599
5	525 – 574

- Minimum score to qualify for a loan: 525
- Criteria for loan approval: Credit score and borrower characteristics, such as credit history, debt ratio, and cash flow.
- Criteria for placing borrowers into tiers: Same as above.
- Rate details: Tier 1 borrowers must have five years of blemish-free credit history. Those with shorter credit histories are considered fragile-1 borrowers. If members don't meet established standards for any borrower characteristics considered, they move down one credit tier. In tier 5, the credit union allows only used-car loans and mortgages.
- Decisioning software: None

Wodogaza notes that 66% of the credit union's borrowers are in the third tier. "We intentionally set the program up that way," he says. "It's the median rate and that's the rate we advertise."

Only 13% of the credit union's borrowers are in tier one and 14% are in the lower tiers. "If we advertised our tier-one rate, we'd make only 13% of members happy. The advertised rate applies to people who have good, but not great, credit," Wodogaza explains.

"With more challenged borrowers, it's not difficult to show them why they need to pay a little more for a loan. Of tier-one borrowers who see the advertised rate and are attracted, 20% will get an even lower rate," he continues. "We probably do miss some tier-one borrowers by advertising the higher rate, if they're shopping based only on rate. Those who've worked with us before know they'll get a discount."

Palmetto Citizens Federal doesn't use loan-decisioning software. "I find the judgmental lending system we've developed works well for us. It requires the completion of a checklist with only six questions. It allows for a pretty quick decision," he says.

Delinquency & charge-offs

Maintaining low levels of delinquency and charge-offs is a primary focus for the credit union. "We approve 63% of the loan applications we receive, where the average credit union approves 40% to 50%," Wodogaza says. "Our delinquency level is only 0.78% and our charge-off rate is 0.29%. We work with loan officers to ensure they're not missing loan opportunities, but we also monitor their delinquency ratios."

The credit union tracks loan yields, delinquency, and loss ratios by rate tier, and yields far outstrip losses:

Tier	Yield	Delinquency	Loss ratio
1	5.46%	0.02%	0.02%
2	6.80	0.14	0.13
3	6.56	0.62	0.31
4	9.69	2.15	1.02
5	12.77%	3.16%	0.49%

Palmetto Citizens Federal takes precautions to effectively manage its risk-based loans, including:

- A compliance officer reviews all high-risk offers within seven days of when they're made and reports any deficiencies.
- The compliance group meets monthly to review approved and denied loans, as well as charge-offs.
- Wodogaza regularly reviews a report listing all 10-day delinquent tier-four and tier-five loans and monitors collection efforts.
- The management team reports to the board monthly on adherence to board-set limits of $5.5 million in tier-four loans and $9.5 million in tier-five loans.
- Collectors follow-up quickly on high-risk loans that become delinquent.

"We know we're dealing with higher delinquency and charge-off ratios in the lower tiers. That's why we monitor the frequency of late payments and pay extra attention to them," emphasizes Wodogaza.

Helping borrowers improve

Wodogaza believes borrowers who need loans are going to go somewhere to get them. "We want it to be us," he says. "If people get in financial difficulties, we make referrals to credit counseling and find the best way to help them work through their loan problems.

"A lot of people wouldn't hesitate to pay 300% on a car loan just because they don't have the financial education," Wodogaza continues, noting that the credit union holds free educational seminars for members and the public, and offers a financial-counseling program through an outside organization. "Education and counseling can help people get back on their feet," he says. "And we can still help those who don't want to improve their credit scores with our higher risk categories.

"We have many success stories of members—who initially could get only used-car loans—improving to tier three or better," says Wodogaza. "Each lender has to talk to the applicant before denying the loan—they can't just send out an adverse action notice. We tell the applicant that we have to say no now, but here's what you need to do and it'll be yes in six months. Some people come back six months to the day."