STRATEGIC INSIGHTS FOR POLICY MAKERS

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Commercial Lending Governance Starts at the Top

Understand the policies and risks associated with creating or managing an existing MBL program.

Thanks to NCUA's Member Business Lending (MBL) rule, it has never been easier for credit unions to enter the commercial lending market.

The rule forgoes most prior prescriptive limits in favor of a more flexible and business-friendly "principles-based" philosophy.

But commercial lending is not the same as consumer lending, and credit unions should approach this as an entirely separate business practice.

One of the main differences is that commercial lending requires considerable guidance from the board of directors. According to the MBL rule, "A credit union's board of directors is ultimately accountable for the safety and soundness of the credit union's commercial lending activities."

As a director, you are expected to understand the processes and risks associated with your credit union's commercial lending policies.

Use the following tips to maintain effective commercial lending oversight, whether implementing a new commercial lending program or managing an existing program.

COMMERCIAL LENDING REQUIRES CONSIDERABLE GUIDANCE FROM THE BOARD OF DIRECTORS.

Are you new to commercial lending? Ask these questions to help you implement the basic components of a commercial lending program:

- **Have you established and approved a commercial loan policy?** Section §723.4 of the MBL rule requires credit unions to adopt a more robust commercial loan policy that incorporates broad commercial lending risk management practices. Credit unions are required to address these components within their commercial loan policy.
- **Is your commercial lending program appropriately staffed?** When starting a new program, finding an experienced commercial lender can pose a significant challenge for credit unions.

The ideal candidate has a broad understanding of the business, formal training in cash flow analysis, analytical skills, technical proficiency, and more.

It's not enough to promote your best consumer or real estate lender to manage commercial lending. The commercial lender has to understand and be able to talk the language of the business in addition to overseeing and evaluating the performance of a commercial loan portfolio.

- **Do you understand the nature and level of risk in the commercial loan portfolio?** Directors should clearly understand the potential impact of commercial lending on earnings and net worth.

Determine your risk appetite and decide which types of loans you will provide based on where they fall on your preferred spectrum of risk.

Managing your existing program

If you've already established a commercial lending program, keep these tips in mind as you manage your program long-term:

- **Mitigate risk.** Establish a separation of duty ownership within the program to guard against internal risks. Ensure the same staffer doesn't wholly manage loan approval, posting, and disbursement.

Perform annual audits to look for unauthorized activity, defalcation (misappropriation of funds), and noncompliance with regulations using an outside audit

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QUICK TAKE FOR YOUR NEXT BOARD MEETING

Consumers' Payments Preferences

A growing number of consumers—61%—welcome open access to their finances to view account balances prior to making payments from a mobile app. "Delivering this unified mobile payments experience will become ground zero in the battle over customer experience," reports Accenture's 2017 North America Consumer Payments Pulse Survey, which also outlines these trends:

68% of Gen Z is interested in instant person-to-person payments

64% plan to use a mobile wallet by 2020, up from 46% today

48% would switch a primary rewards card for a large signup bonus

Source: *Accenture 2017 North America Consumer Payments Pulse Survey*

- CUNA Mutual Group: *cunamutual.com*
- CUNA Business Lending Roundtable, Feb. 6-7, 2018, Austin, Texas: *cuna.org/bizlending*

firm or your internal audit department.

- **Conduct due diligence.** Conduct due diligence on all third-party vendors in the commercial lending program to ensure they're following processes and procedures, and not putting your credit union in harm's way.
- **Understand your portfolio.** Perform a risk assessment of your commercial loan types to determine acceptable concentration levels relative to net worth.

Diversify loan types and amounts to avoid a financial disaster due to overexposure to a negative event, similar to what occurred with the recent commercial real estate market crash.

Monitor the portfolio's financial performance by regularly reviewing board minutes.

- **Assess the program's value annually.** Effective oversight requires the board of directors to receive regular reports and opinions from management, counsel, auditors, and expert advisers.

Require management to hire a third-party vendor with sufficient experience in commercial lending to review the commercial loan portfolio.

Commission the review annually to determine compliance with loan policy, documentation compliance, and credit underwriting standards.

The vendor should evaluate loans of a specified size, nonperforming loans, loans with exceptions, and loans originated since the last review.

Remain vigilant in your approach to risk management, especially as it relates to commercial lending. You must continually evolve and monitor portfolio changes, and address new or evolving risks to stay on top of the ever-changing commercial lending landscape.

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CUNA Volunteer Conference, Jan. 28-31, 2018, Punta Cana, Dominican Republic: *training.cuna.org/cvc*

A Road Map for Strategy Execution

Align your organization behind these four interrelated principles.

Does your credit union have difficulty taking strategy from concept to reality?

Jeffery Downs, a regional practice leader for FranklinCovey, urges credit union leaders to utilize the "Four Disciplines of Execution" to get results.

This approach doesn't work for unilateral action by the board or management, but rather to enact strategies that require behavioral change within the credit union. So, directors can play an important albeit indirect role in execution by maintaining accountability through the process.

- **Discipline 1: Focus on the wildly important.** To achieve excellence, you must focus on just two or three goals, Downs says. Any more than that and your success rate gets worse.

"You have to say 'no' to good and great ideas," Downs says. Advancing too many ideas too quickly dilutes the priority of each, penalizing high performers for throwing their support behind ideas that eventually fizzle.

Providing definition of goals is key, too. For example, President John F. Kennedy specified a focus and a finish line in his space race challenge by pledging to put a man on the moon and return him safely by the end of the 1960s. "What is your moonshot?" Downs asks. "Declare a desire to win."

- **Discipline 2: Act on the lead measures,** which can be influenced and predicted—such as improving your diet and exercising to get in shape.

Lag measures, however, such as weighing yourself, provide immediate feedback but don't create results. "Teams must develop and deliver on these lead measures," Downs says.

One convenience store increased sales and reduced theft simply by greeting customers as they entered the store. A shoe store wanted to sell more kids shoes, and sparked purchases by routinely measuring kids' feet.

- **Discipline 3: Keep a compelling scoreboard,** which engenders competitiveness in achieving the goal. The trick: The scoreboard is for the players, not the coach.

> 'HORIZONTAL ACCOUNTABILITY…IS MORE POWERFUL THAN VERTICAL ACCOUNTABILITY.'
>
> JEFFERY DOWNS

"If I have to tell players on the field the score, we've lost the game already," Downs says.

- **Discipline 4: Create a cadence of accountability.** Convene regularly to assess progress toward goals, reviewing the previous week's commitments and making commitments for the following week. But management doesn't assign the important tasks—employees do.

"It's a commitment, not an assignment—they need to own it," Downs says. "Horizontal accountability, from team member to team member, is more powerful than vertical accountability."

The side benefit is that employees make time amid the whirlwind of their day-to-day responsibilities to focus on these exciting challenges, which is reinvigorating, Downs notes.

"These commitments start to drive this process," he says.

Don’t Shy From CEO Compensation Conversations

Educate yourself on current trends, and find agreement on preferred outcomes.

When is the last time you researched compensation philosophy and credit union-specific data?

And when did the board as a whole last broach the subject of compensation with your CEO?

If those actions occur rarely or never, you’re missing out on a prime opportunity to ensure the stability and vitality of your credit union.

At the inaugural CUNA CEO Council Conference, two executive compensation experts—Scott Albraccio, executive benefits sales manager for CUNA Mutual Group, and Tom Telford, principal/area senior vice president for BFB Gallagher—provided pathways to break down barriers and conduct healthy conversations on the topic.

Scott Albraccio

First, they presented some common hurdles to communication about executive compensation:

- **A lack of understanding** from the board of the capabilities of pure, sortable compensatory data, such as that available through CUNA’s Compensation Analytics and compensation reports.
- **Conflicting communication** between the two parties about how to define a compensation philosophy, and how it interrelates with organizational success.
- **Uncertainty surrounding** the responsibilities of a modern CEO and the competitive compensation market for executives who can move the needle on organizational performance.
- **Budget constraints**—sometimes self-induced—that limit flexibility, and thereby place a damper on productive discussion.

Telford places responsibility on CEOs to initiate these discussions, but Albraccio notes that many credit union executives worry about the board’s perception: “How do I talk about compensation without sounding greedy or self-serving?”

To gently nudge a reluctant CEO, directors can grease the skids for these important conversations by suggesting the two parties speak in generalities about compensation philosophy. Agreeing to use that framework is the first step toward determining how best to reward and retain a particular executive.

Albraccio offers two real-life scenarios that illustrate the need to customize compensation packages to an executive’s needs and maintain flexibility from a budget standpoint.

1. Positive: To improve the chance of retaining a successful 41-year-old CEO, the board structured a compensation package that focused on the needs of his three young children, and addressed executive team members so they would be less likely to depart due to a lack of succession opportunities.

“The CEO needs to weigh what they’re giving up if they decide to not stay there,” Albraccio says. “And we look at those other executives as the bench. They’re critical to the progress of the organization.”

2. Negative: A board that selected a 48-year-old CEO didn’t anticipate the desire for a package geared toward retention as opposed to retirement, which the predecessor favored. The previous plan worked well for the former executive but caused capital constraints that prevented the board from properly recalibrating its approach for the successor.

“The board didn’t think through the downstream impact of the plan,” he says.

To properly customize a compensation plan, the board must first know the answer to this question: What is important to the CEO?

Only through candid conversations will that become clear.

Credit unions that best address this complicated issue align strategic goals and compensation philosophy, and have systematic processes to regularly review and discuss the effectiveness of their current approach, say Albraccio and Telford.

They offer two practical tips to keep compensation conversations at the forefront:

1. Include in every board packet an offering of compensation data for local, regional, and national peer institutions, and updates on compensation trends. “Then, directors are getting information that makes them more comfortable in their understanding of the topic,” Telford says.

2. Insist that the board conduct a thorough annual review of the CEO’s performance. “That’s [the CEO’s] time to shine in front of you—to explain all the achievements of the past year,” Albraccio says.

It’s also a time to look ahead, together, to the challenges the credit union will tackle in the next 12 months.

- CUNA compensation resources, including Compensation Analytics: *cuna.org/compensation*
- CUNA CEO Council: *cunacouncils.org*

CUNA Technology Council:
cunacouncils.org

Deposit Displacement, Slow Money, and Open Banking

Cutting-edge financial services trends present threats and opportunities.

Several leading financial services research and consulting firms use the podium at Money 20/20 to unveil their latest industry insights.

Here are a few that stood out:

■ **Deposit displacement?** Cornerstone Advisors' Ron Shevlin put forth a compelling hypothesis on how "deposit displacement" is eroding the checking account's status as the core consumer banking product.

Shevlin points to prepaid cards and PayPal/Venmo accounts taking hold as alternative stores of value, and perhaps more importantly to vehicles like health savings accounts that divert balances before they even make it to direct deposit.

But his message wasn't all doom and gloom. In proposing hypothetical bundled offers to consumers, Cornerstone found that fee-based checking accounts with appealing value-added services (e.g., mobile phone insurance, identity protection) were actually more popular than free checking without similar perks.

The trick is determining which items the consumer values highly enough to pay for.

■ **Address stress about 'slow' money:** Cognizant shared its findings on consumers' emotional connection to money. The company's study segmented spending and investment into eight categories of "fast" and "slow" money—reminding me of a granular take on the current Voya Financial campaign.

The fast categories are largely transactional in nature and fairly straightforward. It's the slow money—future spending and saving—that seems to create consternation.

Lacking instant gratification or a clear feedback loop, it tends to leave consumers feeling stressed and ill-informed, sometimes causing them to avoid the issue altogether.

Not only is this an opportunity to add value, it's likely a higher-margin area.

According to Cognizant's research, 75% of consumers with a $1 million windfall would look for advice somewhere other than banks, which they see as "product pushers."

Sounds like a credit union opportunity.

■ **Gen Z and 'open' banking:** In the "kids these days" category, one-third of Generation Z consumers like sharing their payment history on social media, compared with a mere 3% of baby boomers, according to Accenture's annual North America Consumer Payments Pulse Survey.

Gen Z—those born since 2000—are expected to represent 40% of U.S. consumers by 2020. As the first full generation of digital natives, it's not surprising that 69% of them use mobile banking apps regularly. But their transparency with purchases runs against historical norms.

More than half of millennials and Gen Z consumers say they're willing to share online bank account credentials with third parties, which would end financial services providers' monopoly on the data they need to deliver meaningful customer experiences.

And although we all know consumer intent does not necessarily align with actual behavior, plans to adopt mobile wallets continue to increase, and nearly half of consumers say they would swap out their primary credit card in pursuit of richer rewards (see Chase Sapphire Preferred and the newly launched Uber card).

■ **Deep thoughts:** Matt Harris, Bain Capital's managing director, offered two predictions:

1. The pendulum is about to swing back from unbundling to rebundling of financial services products.

2. The notion of "fintech" will gradually disappear as its various capabilities become absorbed into our everyday ambient background.

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