Spread and Yield Considerations in Member Business Lending – Second in a Series

Member Business Lending (MBL) represents an attractive asset class for credit unions when executed with due diligence. MBL can be a profitable investment with good returns accompanied by product, rate, term and geographic risk diversification opportunities. It also may enhance member satisfaction through attracting and retaining members by providing a broader array of products and services.

Credit unions investing in MBL assets need to consider desired returns and risk/return trade-offs. Loan pricing for MBL is a key component of portfolio growth and management. The application of pricing in the MBL arena usually follows the same overall approach used for other asset classes. However, when reviewing loan and portfolio interest rate criteria, credit unions may choose to follow either the spread or yield approach.

The <u>spread</u> approach is followed by the majority of lenders in the national credit marketplace. This method reflects loan terms expressed via an interest rate spread over a chosen index. The index is a recognized independent baseline for comparison of alternative funding costs and potential returns. Lenders typically use the 5-year Treasury as their loan index, although many use the Prime Rate. Use of the spread approach may provide easier administration and monitoring over the course of a budget year, although the spread target should be reviewed periodically, as market conditions change.

Some lenders follow the <u>yield</u> approach, where predetermined yields are sought based on the asset class, perceived risk, and desired return. Use of a target yield (e.g., 4.5%) provides a quick benchmark for application, but may have some unintended consequences. For example, higher yields are generally associated with higher risk assets. Holding out for higher yields may result in overlooking higher quality/lower yielding investment opportunities that fit better into the risk profile and asset mix of the credit union. Set yields may not identify the risk/return tradeoff inherent in credit risk and interest rates and provide greater potential for mispricing of assets over time.

In the simplest formulation of the spread approach, the target rate is expressed in the terms of index plus spread. The spread reflects many influences, such as borrower and lender risk perception, alternative investment pricing, term, call protection, duration, and currency flows, given the highly liquid debt markets.

Following is an example of spread at a defined rate over the corresponding term Treasury instrument:

5-Year Treasury Index	0.75%
Plus: Spread desired	3.00%
Interest Rate	3.75%

Credit union funding sources may have a range of terms. Direct comparison of the cost of funds and the corresponding points on the Treasury curve provide only rough guidance when evaluating rates. Nonetheless, reference to an index is useful to see how a credit union's funding cost compares to other retail and wholesale options and the resulting income potential. The index is a handy proxy for your credit union's funding costs, as your liability accounts base may move in tandem. You can use that as a benchmark for comparison. Recent call report data show the average credit union cost of funds as 47 basis points, falling between recent 2-Year and 5-Year Treasury yields.

Loan Pricing and P&L Considerations

Index and spread are a few of the components used when looking at loan pricing. Another key factor is the non-interest expense associated with lending. Some lenders may use 1-1.5% to reflect the range of cost structures inherent in their credit union delivery models for each asset class. Some lenders also assign a shadow (non-booked) credit cost allocation, or anticipated loan losses, to reflect potential Allowance for Loan and Lease Losses (ALLL) impacts over the loan term. Others may book a credit cost, or ALLL cost, initially, while others add to that based on the fact pattern applicable to their institution. In any event, recognition of all the profitability drivers is key when setting interest rate parameters for lending programs.

Here is an example of how that loan profitability may work, drilling down from the interest rate to hit a standard net profit:

Interest Rate	3.75%
Less: Cost of Funds	0.47%
Net Interest Margin	3.28%
Less: Expenses	1.25%
Gross Profit	2.03%
Less: Credit Cost Allocation	0.50%
Net Profit	1.53%

Here is a rate build-up example for a different credit union, with its own cost of funds, expenses and credit assumptions for the asset class and target rate being reviewed:

Net Profit Target	1.50%
Plus: Credit Cost Allocation	1.00%
Gross Profit	2.50%
Plus: Expenses	1.50%
Net Interest Margin	4.00%
Plus: Cost of Funds	0.60%
Target Interest Rate	4.60%

Each asset class (MBL, auto loans, single family mortgage, credit cards, other) will have its own associated credit cost, and expenses, reflective of the institution’s cost structure.

Regardless of your lending approach, your institution competes with others in a vast nationwide financial market to attract and retain borrowers. Recognition and monitoring of the factors influencing market rates can help you tailor a profitable lending program. Unlike federal credit unions, many state credit unions are allowed to participate in loans where there is a prepayment penalty. That can help lock in rates for a longer term. Interest rates are one component of each loan to be considered together with the other loan terms to fit your duration, diversification, and cash flow requirements. Managing your MBL portfolio with attention to prudent asset/liability management policies and strong internal controls is critical in order to obtain the return you seek.