

Second Edition

CONSUMER LENDING MANAGEMENT

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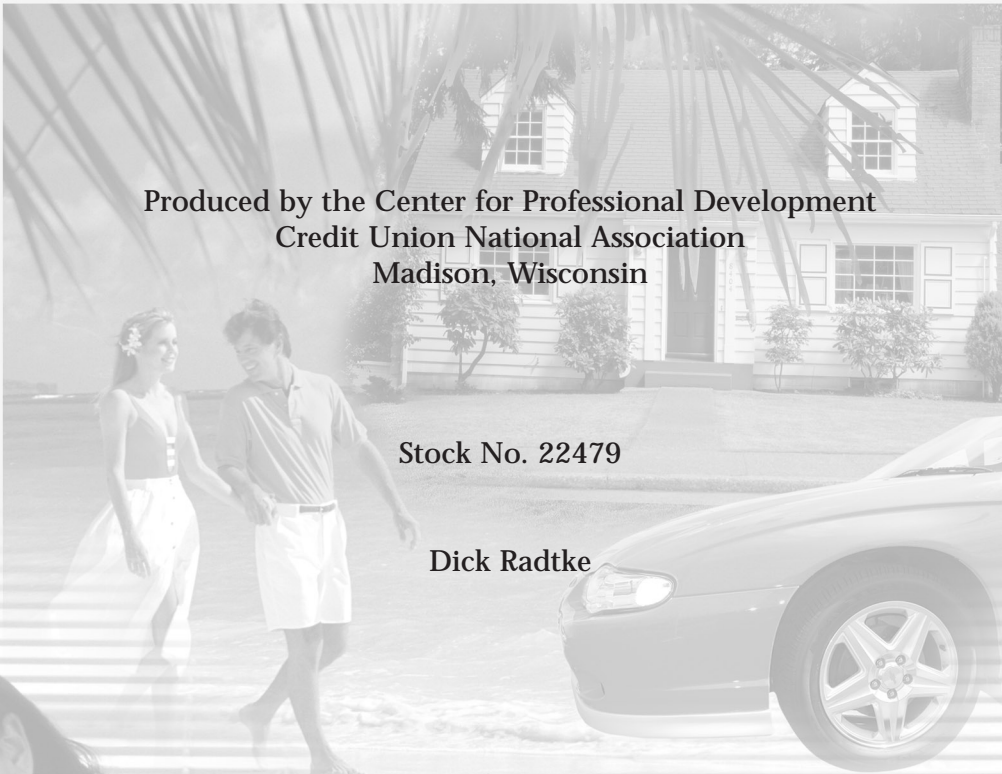


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Project LEAP is a Credit Union National Association (CUNA) educational initiative supported by the CUNA Mutual Group and the American Association of Credit Union Leagues. It will help credit unions succeed in a rising rate environment by coordinating national and state training, research, and publishing resources on strategies that strengthen credit union bottom lines. Project LEAP will link CUNA and League products and programs addressing overall growth strategies. Its focus will be on asset/liability issues, sales and service, and identifying and implementing successful strategies to build membership and grow consumer loan portfolios

and increase inflation. Higher energy prices promised to be unfavorable to the overall economy. Each of the last five recessions was caused by some form of oil shock.

The trade deficit was one of the biggest downside risks to economic recovery, reaching 5% of GDP or \$600 billion. In this kind of scenario, the U.S. economy becomes highly dependent on inflows of foreign savings. The recovery of 2004 was caused by massive fiscal and monetary stimuli, which were no longer sustainable in 2005.

Interest Rates

The price of money is expressed in interest rates. Figure 1.1 shows interest rates on two basic financial instruments in the 16 years from 1988 to 2004: Federal Funds, and 10-year Treasury Bonds. The Federal Funds rate reflects credit unions' cost of funds. This is because deposit rates in credit unions are affected by movements in federal funds interest rates.

The 10-year Treasury Bond is also a typical example for credit unions' yield on assets. Yield on assets measures what we're earning on loans and investments. It's a good idea to study these interest rates over time, since they indicate credit union yield on assets and cost of funds. By subtracting our cost of funds from our yield on assets we are able to approximate the credit union's gross spread, or net interest margin.

When interest rates move significantly, as they did in 2001-2002 in response to a mild recession, they affect the gross spread of credit unions. The objective of the Federal Reserve Board in 2001-2002 was to stimulate the economy out of recession. As a result of lower interest rates, credit unions' cost of funds dropped dramatically.

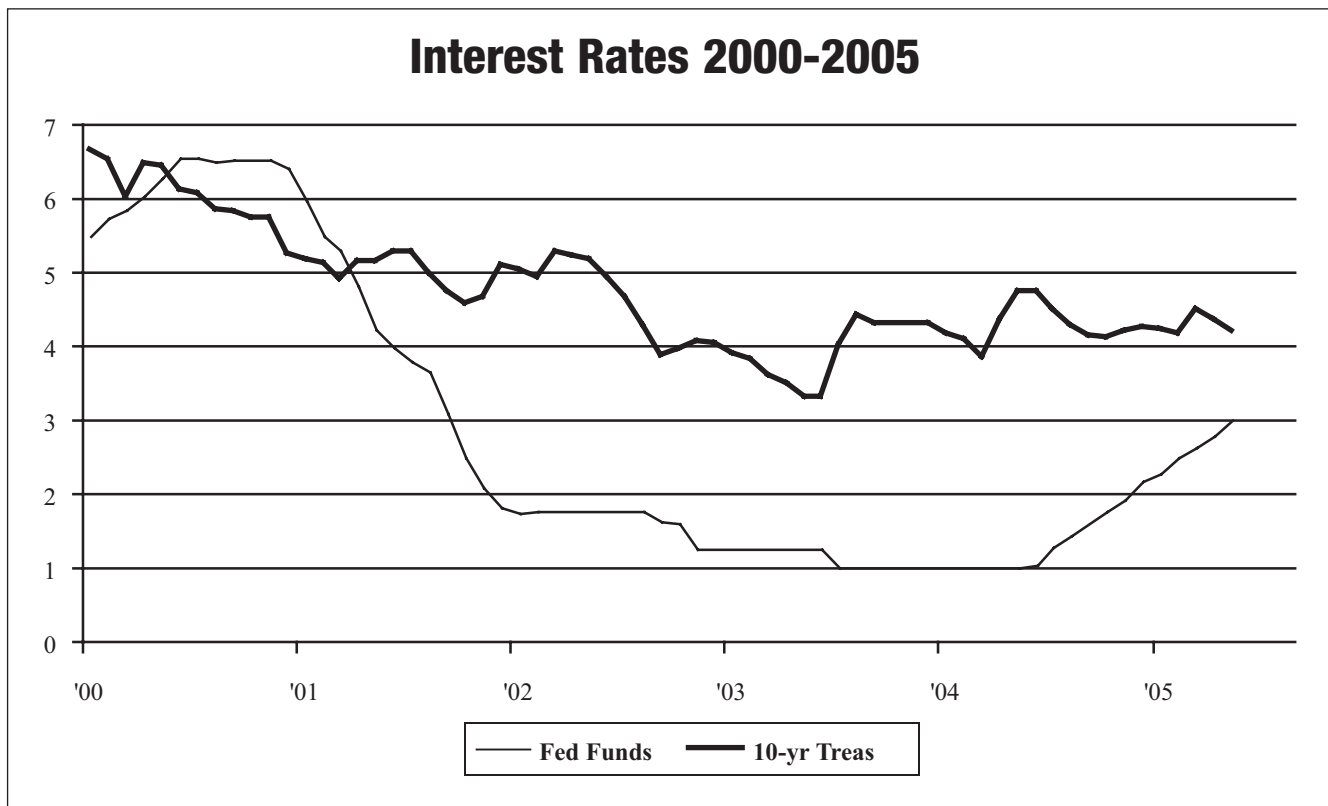


Figure 1.1 Interest Rates 2000-2005

While short term rates dropped quickly in 2002-2002, the rates on long term investments dropped much more slowly and less dramatically, as indicated by the 10-year Treasury Bond curve. For example, money lent out on first mortgages and even five-year auto loans took some time to be paid back and lent out at the new rate. So yield on assets didn't fall as fast as the cost of funds, thereby producing high net interest margins.

In 2004, however, inflation began to worry the Federal Reserve Board, and it raised short-term interest rates. From mid-2004 to early 2005 the Fed raised interest rates 2%, or 200 basis points. As a result, net interest margins narrowed considerably over this time period.

Factors leading to higher long-term interest rates include a growing economy, which leads to increased investment opportunities, which in turn lead to increased corporate borrowing and higher rates. Higher short-term rates also lead inevitably to higher long-term rates. Higher oil prices are a factor contributing to higher inflation, which leads to higher interest rates. And higher federal budget deficits also produce higher rates.

Balanced against these harbingers of higher interest rates are a number of factors that dampen interest rate rises, including the intervention of Asian currencies when Asian central banks purchase dollars on the world market. In effect, these central banks are purchasing U.S. debt which lowers interest rates here. When bond investors consider the U.S. economy weak and inflation under control, they create higher bond demand which also leads to lower rates. And when monthly payroll employment is weak, fears of inflation subside, creating higher bond demand and lower rates.

Figure 1.2 shows yield curves for various Treasury instruments. A yield curve represents rates for various maturities on investments. In June, 2004

► definition

Basis Point

Unit of measurement for the change in interest rates that is equal to 0.01%.

Yield Curve

A graphic representation that shows the relationship between yields and maturity dates for a set of similar bonds at a given point in time.

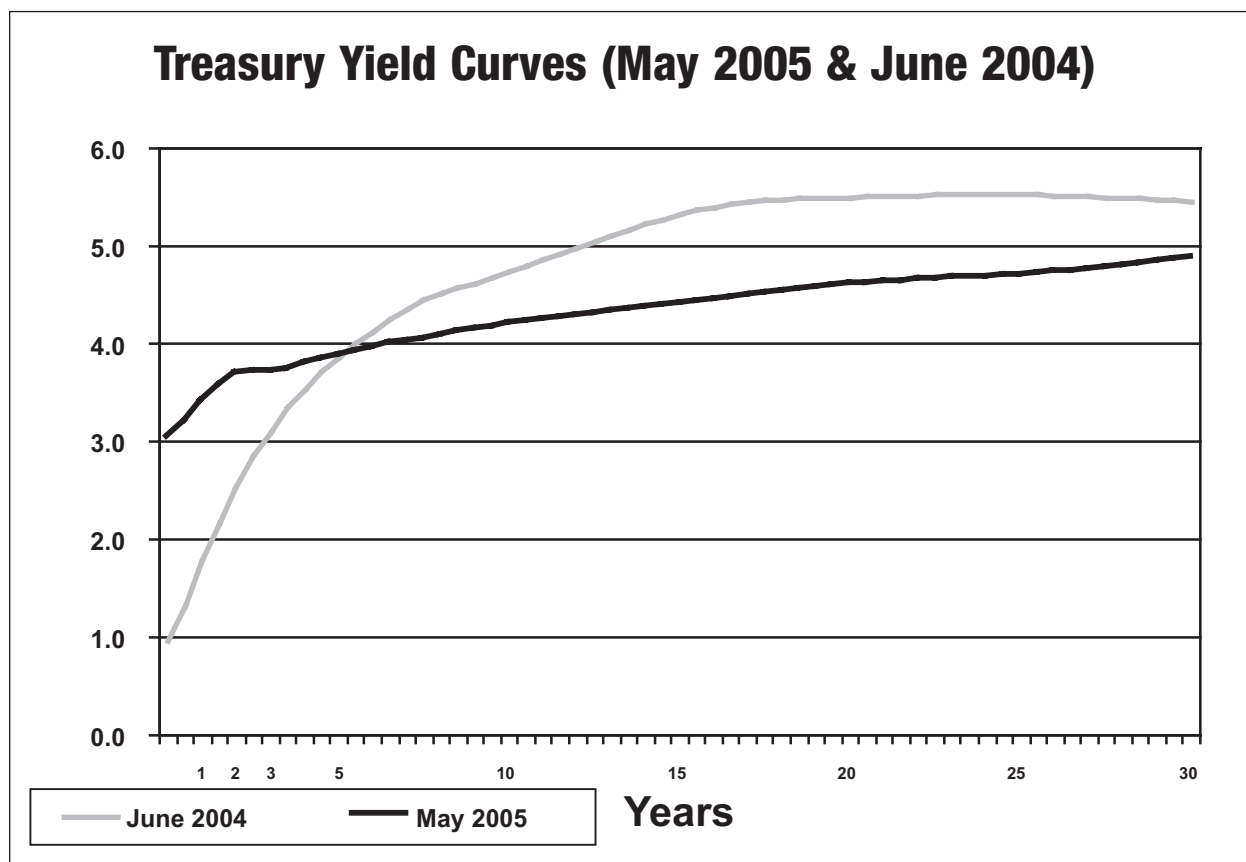


Figure 1.2 Treasury Yield Curves