Podcast 160 Jim Devine Business Lending

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By Jim Devine

Lisa Hochgraf 00:03
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Lisa Hochgraf 00:08
Welcome to the CUES Podcast where leaders and experts discuss the top topics in credit unions today. I'm Lisa Hochgraf, senior editor at CUES. In this episode, we explore member business lending, both where it's been and where it could be headed.

Lisa Hochgraf 00:24
Our guest is Jim Devine, co-founder CEO and chairman of Hipereon, a financial training company based in Washington State. Jim is also a lead faculty member for CUES School of Business Lending, which starts its 2024 session on April 1.

Lisa Hochgraf 00:40
In this show, Jim talks about what has been happening with credit union business lending post-pandemic, and what may happen to it as the economy shifts again in 2024. He describes the school and how it helps credit union leaders learn foundational tenets of success in business lending, plus what he's doing that's new and cool with this year's school.

Lisa Hochgraf 01:01
I know you're going to learn a lot from what Jim has to say. So let's get started.

Lisa Hochgraf 01:08
Welcome to the show, Jim.

Jim Devine 01:10
Thanks. I appreciate the opportunity to talk with you.

Lisa Hochgraf 01:13
It's always good to talk with you. I feel like I know you pretty well since you've been teaching the School of Business Lending since like 2002, I think that's when the pilot was. But many of our listeners won't have met you yet. And I'd like to help them get to know you better. To that end, would you have a mantra or a quote that you live by that you would share?

Jim Devine 01:34

We do have, you know, a couple of things that we're well known for, as you well know. We've done a lot of commercial lending training over the years for both banks and credit unions. And we have kind of a battle cry that we created several years back. And so most of our students, over all the years we've been doing these schools, if we say this out loud, they all absolutely buy in, and we say, "If the cash don't flow, the loan don't go."

Jim Devine 01:57
And so it's just our way of telling them that when you make a credit decision on a business lending opportunity, people have to be worthy, you know. So you have to diagnostically assess their capabilities to repay you. Are they worthy to get the money because they have a an identified capacity to pay you back? And are you confident that the processes that you execute to determine that capability are processes that are valid, and you're not kidding yourself? And again, don't sell credit, grant credit, and realize that the money that you are making available to a prospective borrower isn't your money, it's your depositors' money. So you have a fiduciary responsibility to, you know, to mother it and protect it.

Lisa Hochgraf 02:40
Yes, it's your members' money, right? People would say, and I attended your School of Business Lending a few years back, and I still remember that mantra, "If the cash don't flow, the loan don't go," and you would say it over and over until people were saying it in the hallway because that was so foundational.

Lisa Hochgraf 02:59
So, Jim, I've been reading that 2023, this past year, was the first year since 2019, without some sort of pandemic-era-induced liquidity excess or low rates. In other words, we're slowly getting back to like a "normal" environment.

Jim Devine 03:16
Well, it's a normal environment. But again, you have to look back and see what happened in 2023 from an interest rate structure perspective, because the Fed, in its attempt to try and curb inflation that was happening rapidly out of the pandemic, started to raise the Fed funds rate, which is the rate that financial institutions borrow from the Fed. And it was, you know, at an almost zero level at the beginning of last year, and over the course of that year, it increased 500 basis points.

Jim Devine 03:46
So effectively, what happened is prime borrowing rates and banks went from around three, three and a half percent, at the beginning of 2023, to now eight and a half or 9%, depending on the institution you're dealing with. So you know, to put it in perspective, let's say you have a million-dollar loan. And that million-dollar loan is amortizing based on a 3.5% rate on a 20-year amortization schedule, that loan payment would be around $6,000 a month. If you take that same loan and put it in place today. And you say, "Okay, that's a prime rate borrower," so I'm going to apply an 8.5% rate; that payment all of a sudden jumps up. And so instead of paying $70,000 in annual payments, you're going to be spending $105,000 in annual payments. So it's going to literally go up by 50%.

Lisa Hochgraf 04:37

That's amazing. So what did this do? What What impact does this have on credit union business lending last year?

Jim Devine 04:43
Well, I mean, what it's done is again, what we talked about being creditworthy, right? And so you have to have the cash flow capacity to service the debt. And that cash flow capacity is going to link back to your underwriting policies and operational guidelines. And so typically, when you look at debt service coverage, you want a fudge factor in there. For a secondary source of repayment, you want a loan-to-value logic that has a fudge factor in it. And so here's the irony of what's happened.

Jim Devine 05:09
Let's suppose that you have a lending policy that says, "Okay, my debt service coverage requirements in the underwriting guidelines, I need $1.20 capacity to cover every dollar of principal and interest that needs to be repaid." Well, what happens if all of a sudden, you're hedging that and you're you say, "Okay, well, I'm going to approve this loan, even though it's not at my minimum requirement, I'm going to approve it. My analysis says it's $1.15 at capacity, not $1.20. But I'm going to do it."

Jim Devine 05:38
And so now interest rates go up, and I have to reevaluate this loan, probably reprice it, and commercial real estate, which really dominates. There's roughly $160 billion worth of commercial loans on the books of credit unions today, when you look at that pool, 80% plus of those are commercial real estate loans. And so we've gravitated to commercial real estate because there are less moving parts than there are in commercial and industrial loans and operating loans to a business. You got the tangible collateral. And so the thought process for identifying primary and secondary source of repayment capabilities is more focused. It has less moving parts. And so you take the income that the property is generating; you measure that against the debt service coverage requirements. And if you get to the 1.2 capacity, that's a reason to say yes, yeah.

Lisa Hochgraf 06:28
So what are you expecting for 24?

06:31
Well, a couple things are going to happen in 2024. For one, a lot of the commercial real estate loans that have been made are going to end up in a position where they need to be repriced because typically how they would be structured is you know, they will have 20- to 30-year amortization schedules, but five-year calls or balloon payments. And so at the end of five years, you have to revisit the deal, reprice it, restructure it and go forward. Well, when you look back five years ago, it's coming right out of the middle of the pandemic. And you look at where properties were, what's happened over the course of the last year and a half is we've seen, because of what happened with pandemic demand for let's say, commercial office spaces as an example, there are a lot of people you know, that are working from home. The demand for office space is low. It takes Seattle where I'm at commercial office space right now in downtown Seattle is about 20 to 23% vacancy rates. Wow, if you go five years ago, they were at about 10.

Lisa Hochgraf 07:25
Wow.

Lisa Hochgraf 07:26
And so you've got properties that aren't generating the gross income that they were because of the vacancy issue. And so the cash flow capacity that the building is generating to service the mortgage isn't as robust as it was five years ago.

Lisa Hochgraf 07:41
Here we go with the cash flow. If the cash don't flow.

Jim Devine 07:43
you got a challenge to meet the debt service coverage requirement. And it's a double whammy, because when you value the property, you take the income stream it's generating typically, and you apply a required rate of return against that income stream, a capitalization rate. And the net result is the capitalized income value of the property is X dollars. Well, if you drop the net income down because of the vacancy problem, and the pressure on branches is tough because you know, there isn't enough demand, pull that keeps the rents high, you could easily see a building today have a net income pool that that would be 60%, of what it was five years ago. So if I'm capitalizing that 60% number, and doing so with the current interest rate, so a cap rate based off current rates of interest, that property could be worth 30, 40, 50% less than it is now. If so, if you loan the money against the property, and the capitalized earnings valuation on the property drops, what was 80% loan to value and in compliance with your policy may now be 120%. And so now you're out of compliance. And so a regulator would say, "So what are you going to do to get back in compliance?" Well, I just need more collateral, or I need the property to be more valuable. Okay, easy to say when you say it fast, but very hard to execute. I read an article just the other day that Goldman Sachs said that there's $1.8 trillion worth of commercial real estate loans on the books of financial institutions in this country that have to reprice by the end of 2025. And so

Lisa Hochgraf 09:20
So let's see when I plan to do an article on how that works because I think that's something that would be really good to put down for our listeners. And then we'll circulate that out through CUES and get that information to people.

Jim Devine 09:32
Yeah because that concentration risk caused by the fact that 80% plus of the loan portfolios is linked into commercial real estate. And commercial real estate is very cyclical. I'm doing credit and credit means people have to be worthy and I have a primary source of repayment analysis and a secondary source of repayment analysis, and then maybe a tertiary source of repayment analysis that I have to do. And typically tertiary sources of repayment are linked to guarantees. Well, one of the things that the NCUA decided to do in their era of relief back in 2017 and 18 is they took the mandate to have all commercial loans personally guaranteed by the borrowers. And they lifted the guarantee requirement. So there's a lot of loans that have been made where there is no tertiary source of repayment, that guarantee doesn't exist. Yeah, oh, I am really back on the primary secondary source of repayment

logic. And if interest rates go up 500 basis points in less than 18 months, and I'm dealing with a pricing issue for credit. That's going to have as as I said, before, a profound impact on the amount of cash flow you have to have to service the debt.

Lisa Hochgraf 10:39
Yeah. So Jim, you know, you're kind of laying out the big picture here, what happened last year, what people are going to be facing next year. And to me in my editor brain, it's translating into like, key things that credit union business lending programs might need to have. And one thing I'm hearing is readiness to pivot, right? When you get that five-year balloon, you got to know what to do. And another thing I'm hearing is layering of possible repayment. So you're talking about you'd like to have three and now we have two, but making sure you've got those solid, right?

Jim Devine 11:11
Right, right. What you can't do, you have to know that the analytics that you're applying are arm's length, and there's no bias. You're not trying to figure out a way to say, yes, you're trying to figure out whether yes is the right answer. And again, in order to do that, you have to have the analytical skills to do it, right. And, you know, with incentive compensation linked to a lot of commercial lending programs, and where people are getting paid to book credit, that's another issue that has an impact. And so the objectivity of the analytics really have to be championed now.

Lisa Hochgraf 11:46
Um, okay. So objectivity is another important characteristic of a solid program. Gotta have numbers. They have to be real. They can't be full of bias.

Jim Devine 11:49
Right. And if you think about loan portfolios, and again, because of the heavy concentration that's associated with commercial real estate, and most commercial real estate deals are transactional, so it's somebody who is going to build a commercial building. And so they form an LLC. They have a single property in the LLC. They form the LLC in order to create the liability coverage. But that's it; there's not multiple things involved. It's very linear; that deal has to work.

Jim Devine 11:58
And if you don't have a guarantee, the only thing you have left to fall back on if the cash flow doesn't service the debt property is the underlying value of the property. And unfortunately, the underlying value of the property is determined primarily by capitalizing the income stream that the property generates. And so if there's anything causing structure problems with that capacity, meaning that there's a higher vacancy rate, or whatever it might be, but again, if you take the cap rate, and you take a cap rate, I'm just gonna take pick a number, say I'm using a 5% required rate of return as a cap rate. And I decide, use 6%. If I go from 5% to 6%, 100 basis points up, what happens to the value of the property? Well, the value of the property will drop by 20%. You know, and so if I'm at 80%, LTV, and the rates go up, it doesn't take very long for that cushion that we have in the logic of our underwriting process to all of a sudden it's no longer 80%. It's 90 or 95%, either out of compliance, or worse yet, it's over 100%. I've got a chasm there that I have to somehow resolve.

Jim Devine 13:28
So there's just a lot of issues that I think are going to come up. And as I said, according to what, you know, that article said that Goldman Sachs wrote, there just happens to be a ton of these commercial real estate deals that are on the books of financial institutions that need to reprice by the end of 2025. And so in 2024, there's going to be a lot of need to identify those deals that need to reprice.

Jim Devine 13:51
And so what's the strategy? What are we going to do if interest rates are now up 500 basis points from where they were when that loan was originally underwritten and there was any pressure on occupancy that causes vacancy to go up--and as a result, possible operating income to drop because part of the property is not even being used. It's the double whammy, the attack on primary source of repayment capacity and the attack on backup plans for secondary source of repayment collateral value, that in combination are, you know, it's like a perfect storm.

Jim Devine 14:23
And so people are going to have to start looking at the feasibility of figuring out how to make more operating loans to operating businesses and not have such a huge concentration risk in a loan portfolio linked to commercial real estate. It's just gonna have to be a more diversified portfolio. And then having said that, what kind of business is it? Is it a service business or retail business, wholesale distribution, manufacturing construction? Every one's got a different chemistry. And so to understand how to do lending correctly, I have to understand business model structure because the structure of the business model will dictate the cash flow capacities that are generated.

Lisa Hochgraf 15:03
So what are some elements of the School of Business Lending that you'll lead coming up later this spring that are evergreen that never change from year to year? And I think you're gonna say the cash flow. But maybe there's other things, too. And why are those ideas so foundational?

Jim Devine 15:19
Well again, I mean, you know, we live in such an AI plug-and-play world that everybody's looking for a software tool that will be the answer. You know, "Why do I need to do all the diagnostic analytics? I can just push a button, and the software will take care of it." And again, software is a tool, right? And so what we need to understand is that if we don't understand structure, it's hard to apply analytical tools and do it accurately. And so the way we built the school is we want people to clearly understand the chemistry of the documents that are financially oriented that they're going to be analyzing to determine creditworthiness.

Jim Devine 15:55
So we start out by making sure they're aware of the various business entity structures that are out there, and what's unique about their organizational design. And we look at issues that are critical to continuity in those businesses and going concern capability. Then we segue into a discussion of the financial documents. So we get into basic accounting logic and how financial statements are actually designed and why they're designed in that fashion. So that kind of brings back, you know, some of the years of accounting experience we had when we worked in the CPA world. Then we say, "Okay, once

we understand the structure of the documents we're going to analyze, now let's apply an analytical process to those documents. And what we're going to determine, if we're going to determine liquidity, solvency, capital structure, profitability, asset utilization in an analytical process, linking it all together to the structure of what these business financial statements look like, then once we get a financial analysis process down, we segue from that into a discussion of financial analysis in a credit context.

Jim Devine 16:57
So now, how do we make a credit decision where we have a primary, secondary, tertiary source or repayment logic that has to apply to the financial analytics that were utilized to determine, you know, how the business is operationally performing? And so does it meet the debt service coverage standards? Yes or no? And why?

Jim Devine 17:17
And what about backup plans whether it's, you know, collateral or guarantees, or whatever? What are we going to do so that we have a strategy for collateral a strategy for the use of guarantees the strategy for how primary source of repayment fits its business model structure expertise that we're trying to convey in the school. And we do it through a significant number of case study exercises that show how you apply the logic of the analytical process, and then segue in again, to a credit context.

Jim Devine 17:47
And so it's a boot camp workshop kind of experience. And so we're not assuming that anybody has specific background skills coming in. But what we are going to make sure is that everybody going out the back door has the foundational skills that give them confidence that they can take a set of financial statements from a prospective borrower, do a diagnostic assessment of the performance of that business, link it to their debt service coverage policies and guidelines, and determine whether I'm willing as a fiduciary to let my depositors' money fund their credit request.

Lisa Hochgraf 18:20
Yeah so, and then the School of Business Lending for 2024 will begin on April 1, right, Jim? Are there any new things or details that you're planning to add for the current environment as you teach it this year?

Jim Devine 18:32
Well, I think that, you know, again, what we want to try and create, we have always had a personal bias to face-to-face type type of training. And we like to look you in the eye and make sure that you're, as you look back at us, we can determine whether or not you're you're with me and you're getting it. And so as we've gone to online base training, we want to personalize it. And so what we have is we have a lot of sessions that are held that are live sessions, and we're trying to enable a more interactive capability than what traditional online kind of training does, so that they have, as a participant in the program, a capability of contacting me personally contacting Bob, personally, whenever they have an issue about application, and they're not exactly sure whether what they've decided to do fits, we have an open line to them. If you have a question, call us and we'll get you in a dialogue. And we'll make sure that you get it. And so the extension this year is to try and create more access and to you know, have these sessions where we kind of circle the wagons and we visit the key component parts of the

architecture of the program and we make sure that everybody is okay. And so what people will have is an opportunity to ask more so than they have in the past since we moved to the web-based format for the program. And so I'm excited about that because it just gives us a chance for better personal dialogue with the participants. And to me, that's always been a big part of this educational experience

Lisa Hochgraf 20:02
And you and your partner in this, Bob Hogan, have so much experience and so many amazing stories to tell that I encourage anyone taking the class to reach out to these to further deeper expertise.

Jim Devine 20:13
Yeah and again, it's we say, don't suffer in silence. If you have an issue, you have an absolute capability to get it addressed. All you have to do is pick up the phone, drop us an email, and we will connect you and we will make sure that whatever it is that you are confused about or concerned about, we can address--because the intent is to give you a set of skillsets, that you can, you know, walk out the back door confidently with and utilize it to make good credit decision.

Lisa Hochgraf 20:40
Very applied. Jim, you've been really generous with your time today. But before we close the show, what's the question that I didn't ask that you would like to answer for our listeners?

Jim Devine 20:51
What's going to be really important over the next couple of years as the economy kind of settles in, I mean, we have an election year, we have lots of stuff going on this year, but the fact that rates are up and there's, there's never been a time in my opinion, where you just have to make sure that what you're doing from an asset liability planning perspective, from a credit decision making perspective, that you're doing it in a systematic way that says, "Look, I grant credit to people who are worthy. I don't sell credit. I'm not cavalier about my process, I'm consistent. And what I do is when I make the credit decision, then I set up a monitoring process. Because again, I'm anticipating capacity to pay. What I have to be watching is that capacity to pay actually happening. And I'm on track and you have to be capable of thinking about, you know, like, the real estate stuff. I mean, there's going to be a lot of reengineering that's going to be needed for these loans. And so if I'm going to re-engineer the loan, and still have it be creditworthy, given the environment, I mean, what can I do?" And so there needs to be a lot of thoughts about how the execution of both underwriting and then ultimately credit administration for those loans that you now have on the books. They now are an asset that you have to manage. How am I doing this thoroughly and consistently, going forward? Because it's going to be an interesting, you know, next couple of years as this economy starts to recover from the pandemic.

Lisa Hochgraf 22:17
We continue to live in interesting times. And it sounds like what you're providing is a nice framework, steady guidelines, solid metrics and clear ideas on which to make judgments.

Jim Devine 22:27
Yeah, don't be arbitrary, be structurally sound and consistent. That's the message.

Lisa Hochgraf 22:31
Thanks so much for being on the show today, Jim.

Jim Devine 22:34
Absolutely. I appreciate the time. And again, we look forward to anyone that's out there in the credit union space that has the time, come to the school, I think you'll find it it's a tremendous educational experience. It will be well worth your time and effort.

Lisa Hochgraf 22:47
I would like to thank you, our listeners for taking time out of your busy schedules to listen to today's episode of the CUES Podcast.

Lisa Hochgraf 22:54
And many thanks to Jim for sharing so many insights about doing member business lending during these economically interesting times.

Lisa Hochgraf 23:03
If you liked the show, you can sign up to learn more at cues.org/sobl. Find a full transcript of this episode at CU management.com/podcast 160. You can also find more great reading and specific content at CU management.com.

Lisa Hochgraf 23:23
Thanks again for listening today.

Lisa Hochgraf 23:25
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