TRENDS, PERSPECTIVES, & ADVICE ON OPERATIONS FOR THE PROFESSIONAL

CREDIT UNION executive NEWSLETTER

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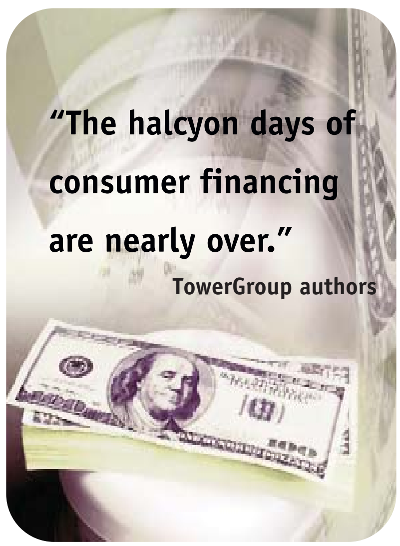
What Does '07 Hold for Consumer Lending?

The most critical IT priority is to transform legacy platforms

As we approach 2007, consumers' financial outlook is positive despite sluggish loan growth. Consumers' spending habits react quickly to adverse news, but they also rebound quickly. Credit unions can react to members' needs by recognizing what drives new business opportunities, reviewing strategic responses, and updating technology, according to Consumer Lending's Top 10 for 2007: Business Drivers, Strategic Responses, and Technology Priorities—a report from TowerGroup, Needham, Mass.

Consumer and mortgage lenders, as well as IT vendors and service providers, need a clear understanding of how key drivers affect their businesses. They need well-defined business strategies, and they need a clear road map of technology required in the lending environment. Without vision, financial institutions can limp along with two- to three-year timelines for new product development, be unable to meet changing market needs, keep pushing paper through origination centers, and eventually find themselves behind the competition. With vision, senior management can achieve consensus and move toward their goals.



Following two years of federal funds rate increases, "the halcyon days of consumer financing are nearly over," say TowerGroup authors. But market volatility can actually be a good thing.

Consumers' changing needs call for quick and creative thinking about new products and services. And low-volume periods give financial institutions the opportunity to implement technology upgrades that might have been too risky to install when loan volume was surging. It's far better to make those changes when the potential negative impact on members is low.

The Internet has become a useful tool for communicating with members. It helps you obtain valuable insight into member segments, preferences, loan profitability, and behavior. And you can use it to disseminate information on loan products, loan pricing, and service.

But the Internet also has increased information transparency for consumers, leading to price-comparison shopping that can erode your margins. Credit unions need to manage information transparency in two directions—increasing value to members without adversely affecting your bottom line.

Beyond Product Silos

Financial institutions need to move beyond product silos for pricing and servicing. Forward-thinking institutions will focus on consumers by offering new product bundles targeted to their needs. Your credit union needs to recognize members' life-cycle stages and anticipate their needs accordingly. You can nurture deeper member relationships by employing multi-product, cross-sales initiatives and meaningful customer relationship management strategies.

Few systems presently allow your credit union to see a complete picture of all your members' accounts and relationships. Your frontline staff might be able to see members' financial relationships, but with very little detail. Product managers, on the other hand, might be able to see details of

CUNA
Credit Union National Association

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members' accounts but no big-picture view. New IT architectures are becoming available that provide a full picture of members. Strategies for attracting new members and for cross-selling to existing ones now can be made specific to their needs and preferences, such as method of contact (phone, e-mail, or snail mail).

Lenders are also using new segmentation technologies that support doing business the way members want it. These include analytics for price/revenue optimization, which let you price loans based on the way the member shops for a product and the member's price elasticity for a particular product. Expect to see more vendors providing these capabilities and lenders embracing them as they look for increased sources of revenue.

Topping the list of technology priorities is the need to transform core lending systems with replacements or upgrades using Web services, individual components, and service-oriented architecture. Take a close look at your IT architecture, which is the foundation of core lending systems. And expect new credit-scoring and credit-reporting products and analytics in 2007, giving you greater access to untapped markets, such as immigrants with little or no credit histories.

Data Management

Data is the backbone of your institution, and managing data requires integrated database and reporting systems. Customized and integrated channel portals are necessary because consumer lending products have unique IT needs that also vary across distribution channels. Newer tools help lenders manage risk in new markets, including the underserved.

To further drive down processing costs and reduce timelines, lenders are moving beyond image-capture and filing systems to "enterprise content management" systems that are more flexible and scalable than previous systems. Document management in lending is no longer just for imaging and archiving activity at loan completion. It's becoming a beginning-to-end electronic process for scanning, imaging, archiving, and retrieval. Leading lenders are adopting sophisticated, enterprise-level loan origination systems that integrate documents into loan processing workflow.

Another benefit of these content-management systems is that they give multiple users access to shared documents. This shrinks loan processing time and eliminates the expense of photocopying and/or faxing documents between various departments that need to act on the file. It also provides document-version control, so everyone involved in the transaction is looking at the same document.

Automated Compliance Solutions

Institutions can no longer afford the risk of leaving compliance to manual processes. Lenders are turning to automated solutions that more consistently maintain required levels of compliance. This means managing compliance issues specific to various lines of business while taking a holistic approach to enterprise-level compliance management.

Regarding IT spending for regulatory compliance, senior management is now looking at compliance as more than just a necessary evil. Lenders are realizing that compliance technology can accelerate loan completion, improve member satisfaction, and reduce risk. Leading lenders are increasingly looking at compliance IT spending as a strategic investment focused on improving efficiency, not just as a short-term fix for new or revised laws and regulations.

Heading into 2007, financial institutions will need to focus on the revenue side of the balance sheet. Cost-cutting measures are good business practices, but measures that drive revenue generation will move organizations forward more effectively. ■

Action Items for Lenders in 2007

- Lenders live in a rapidly changing environment and they must become increasingly nimble to meet new challenges.
- No one strategy or tactic is right for every lender. A correct mix of system and technology enhancements will determine success.
- Focus on members, processes, paper, and products to understand key business drivers.
- Prioritize technology initiatives as lending volume declines. You need revenue-generating projects, and you'll have to spend more on IT for loan servicing, collections, and compliance enhancements.
- The most critical IT priority is to transform legacy platforms, eliminate redundant systems, and integrate subsystems for content management and compliance.

The complete TowerGroup report—Consumer Lending's Top 10 for 2007: Business Drivers, Strategic Responses, and Technology Priorities—is available from *www.towergroup.com*

Each Delivery Channel Has Its Own Strengths

But the branch is still boss

Knowledge of how often and why consumers choose a specific touch point is invaluable when defining channel strategies and allocating IT resources. Respondents to Financial Insight's 2006 U.S. Consumer Channel Preference Survey found that:

- Consumers are multi-channel users. All channels are important to consumers for different reasons.
- The branch is consistently the most used channel, primarily because of the personal interaction it offers. Almost 75% of respondents visited a branch at least monthly.
- Consumers who use the Internet channel interact more frequently with their institution than those using other channels; 25% log on more than 10 times a month.
- Financial institutions with clear wealth-management strategies should know that consumers earning more than $75,000 use the Internet and ATM more than other income groups, demonstrating their need for on-demand banking.

Branch is the Channel of Choice

Consumers say they consistently use the branch more than any other channel. The importance of the branch to the consumer validates the many branch-renewal initiatives underway in the retail banking community. In this age of instant gratification, however, consumers are demanding access to their financial institutions on their own terms.

Institutions made it easier for consumers to interact with them by offering a variety of channels, and consumers are interacting with their institutions more than ever. Financial institutions view these additional interactions as opportunities to cement relationships through enhanced customer experiences, with the goal of increased wallet share.

Respondents were asked how many times per month they interact with their bank through each of the retail delivery channels. With almost 75% of survey respondents stating they visited a branch at least once per month, the branch continues to top the list as the most used retail delivery channel.

The branch is consistently the most used channel by all age groups, mostly because of the capacity to handle complex transactions and provide personal interactions. The same theory explains the consistency of the call center across age brackets.

ATM use, on the other hand, drops off significantly among the mature age groups, following the premise that consumer interaction patterns are established early. The ATM has been commonplace for approximately 30 years and therefore has not been embedded in the lives of consumers over age 60. ATM growth has also been thwarted by the lack of new functionality and the growth of debit cards, complete with cash back from retail merchants.

It's not surprising that Internet banking is popular with the under-45 age group, who have grown up with and embraced the Internet. Institutions will enjoy an increase in Internet banking as Generation Y matures. Smart institutions will leverage Internet banking to further captivate younger, tech-savvy audiences for the purpose of creating lasting financial relationships.

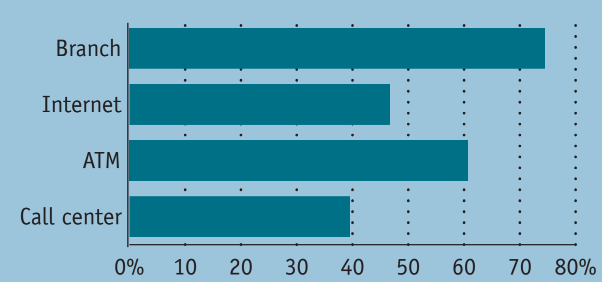
Income

High-income earners tend to be well-educated and lead busy lives, and their channel use reflects these characteristics. The highest use of the Internet and ATM exists among consumers earning more than $75,000, demonstrating their need for convenience or on-demand banking.

More than ever, financial institutions need a cross-channel integration strategy to support the multi-channel consumer. The multi-channel user also expects a consistent experience from channel to channel, including timely transactional activity. Consumers expect that their institution has a 360-degree view of the financial relationship and real-time transactional history. The future of an integrated customer view and cross-channel strategy is core technology to support individually priced products and bundled services. The ability to present customized offerings to consumers will bring retail channel delivery into the next decade. ■

Figure I

Consumers' Channel Preferences



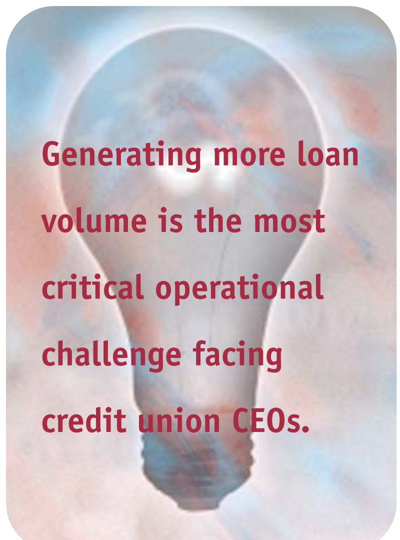
Source: Financial Insights' 2006 U.S. Consumer Channel Preference Survey

CUs Find New Ways to Boost Lending

Changing times require innovative ideas

For years credit unions would tout their auto loans, mortgage rates, personal loans, and home equity products. And for years members would come in, sign papers, and get their money for a car, home, boat, or RV.

How times have changed. Car dealers now arrange on-site funding, big-box stores offer credit cards and provide on-the-spot financing, Internet shopping is big business, and cash-advance stores are springing up everywhere. Almost overnight, members began to experience better, quicker, and more convenient ways to make purchases and get loans without having to visit their credit union.



As a result, credit unions have experienced declining spreads, slow loan growth, increased competition, and other challenges.

Declining spreads have been a factor for more than a decade. In 1993, the spread between loans and deposits was almost 400 basis points (bp). In 2005, it dropped to 322 bp, meaning credit unions are now charging less for loans and paying more for deposits. Credit unions' return-on-assets (ROA) have almost been cut in half during the past 14 years, and if you factor out fees and other income, the ROA would be negative.

Loan growth has also slowed. From mid-2003 through mid-2005, credit union annual loan growth topped 10%, but since mid-2005, it's fallen to 8.9%. Generating more consumer loan volume is the most pressing operational challenge facing credit union CEOs, according to CUNA's recent critical initiatives survey.

Credit unions are exploring new avenues for lending, leveraging technologies, and expanding into new markets to increase loans and better serve their members. These avenues include indirect lending, non-prime lending, and real estate lending.

Indirect lending. Only 1,700 credit unions offer indirect loans, but they control 70% of credit union auto loan balances. Indirect lending can grow membership and a loan portfolio. Nearly all (96%) vehicle purchases are financed indirectly, and 70% of new credit union members become members through an indirect lending transaction, according to CUNA Mutual Group's 2006 Economic Forecast.

To succeed, credit unions are going where their members shop, offering online decisioning and competitive rates. Members don't want to find a car, and then look for financing. They want financing options when they purchase the car. And research shows the first decision received by a dealer is often the one taken, so many credit unions now have 24/7 automated-decisioning systems.

San Antonio Federal Credit Union—recipient of an Excellence in Lending Award from the CUNA Lending Council—was the first credit union to offer e-Contracting, a paperless loan from application to delivery. Dealers often receive same-day funding.

Non-prime lending. This is an opportunity to reach a sizeable but often underserved portion of your membership. Recent research from myfico.com shows 42% of the U.S. population falls into the non-prime category, which is defined by a credit score of less than 700. Non-prime lending requires due diligence and disciplined processes, but increasing loan volume and providing lending opportunities to more members can make it worth the risk. Prospera Credit Union, Appleton, Wis., recently partnered with the local Goodwill Industries store to start a branch to offer financial services to those facing monetary challenges (*CU Executive Newsletter*, Sept. 4, 2006).

Real estate lending. Credit union members make up 30% of the U.S. population, but credit unions have only 2% of the mortgage market. Realtors control 70% of the purchase transactions, so some credit unions are establishing relationships with realtors to strengthen real estate lending. Some credit unions staff real estate offices, and host home-buying seminars. Allegacy Federal Credit Union, Winston-Salem, N.C., decided to create a real estate CUSO to compete in this market.

These are just a few examples of credit unions that, through innovative thinking, are growing loans at rates much higher than the credit union average. As you look for ways to improve your own lending results, consider these practices that have produced success in other credit unions. ■

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How to Navigate a Core-System Conversion

Odds are your CU eventually will have to go through one

Along with death and taxes, you can add core-system conversions to your list of dreaded life events. At some point, your IT folks will have made all the patches they can, and they'll need a new system so your credit union can deliver the level of service members deserve.

For GTE Federal Credit Union, Tampa, Fla., the credit union had gone as far as it could—25 years on the same system, according to John Thompson, senior vice president of IT. The $2.2-billion credit union's vendor was switching to a new platform and it was time to evaluate whether to stick with them or explore new possibilities.

Thompson says credit unions need to weigh the platform's integration capabilities, open architecture, the vendor's financial stability, and the proposed service contract.

GTE Federal considered five vendors including its current one at the time. It hired Cornerstone, Phoenix, Ariz., to oversee the system evaluation. Following that, the credit union hired Next Step, Orlando, Fla., a firm that specializes in system evaluations and conversions, to manage the conversion on-site. Thompson feels the expert opinion was well worth the added expense. "Getting their insights is invaluable, and the smartest thing we did," he says. "It helps catch unknown factors that you wouldn't think of because you don't do this every day."

For Thompson, narrowing down the selection of vendors started with watching their demos, then traveling to other credit unions to see how well each system operated. During these visits, he gathered insights into the conversion process and what he calls "life after conversion." After about 10 months, the credit union chose a new vendor with an Oracle-based platform. It signed a seven-year contract, over which period the total cost of around $8 million is expected to depreciate. Thompson describes the experience as "the largest undertaking I've ever been a part of."

An Objective Opinion

During your existing system evaluation and before looking at new vendors, Carl Faulkner, principal at Cornerstone, recommends hiring an objective project manager rather than delegating oversight to an employee. As an outside party, a project manager is unlikely to be dragged into internal politics and turf battles between employees or departments. The project manager will look out for the credit union's best interests in what Faulkner says is "a well-defined process including specific steps, meetings, changes, reporting, and resolving staff, time, and scope conflicts."

Cornerstone has overseen 12 conversions in the past year. Most credit unions change vendors because they lose confidence in their present vendor, says Faulkner. Another reason for change is that the credit union or vendor has changed strategies, so the vendor and the credit union are no longer in alignment. Another reason is pricing. "We believe the price of a new solution needs to be 25% or more below the incumbent," he says.

"A full-service provider can take a lot of the worry away from the credit union and ensure its system is professionally managed with skilled resources."

Faulkner says a conversion proceeds more smoothly if credit unions:

- **Pick** a time that will allow for a month-end run, as opposed to the end of a quarter or year.
- **Allow** sufficient time for the process. Rushing a conversion could cost the credit union economically and damage its reputation.
- **Test** all real time interfaces affecting members, including Internet banking, credit and debit cards, and ATMs.

A smaller credit union might consider outsourcing most of its IT functions to a third party. "A full-service provider can take a lot of the worry away from the credit union and ensure its system is professionally managed with skilled resources," says Faulkner. "It does not, however, free the credit union from management/oversight because the objectives of a third party and the credit union will always be different. If properly managed, I believe this is a smart option for most smaller credit unions."

Hands-On Expertise

For larger credit unions, engaging a firm like Next Step can save credit unions from what Next Step's CEO Peter Jeye calls "difficult clean-up phases and embarrassing budget overruns."

"The best ingredient for success," says Jeye, "is identifying and resolving risks to conversion during the selection phase while the credit union has the time and leverage." Next Step manages eight to 10 conversions a year, and its credit union clients have an average of $1.4 billion in assets.

Jeye says the leading vendors currently are Symitar (a subsidiary of Jack Henry & Associates), Open Solutions, Fidelity National Information Services, Harland Financial Solutions, and Fiserv.

He counsels that credit unions should consider these six factors when shopping for a new system vendor:

1. Robust functionality in the areas that truly affect credit union member service and sales.
2. A track record of successful conversions.
3. A history of above-average client care.
4. Staying ahead of the architecture curve.
5. Attractive pricing.
6. A technology roadmap that delivers in advance of the need.

Jeye also recommends credit unions ask these questions when preparing for a core-system conversion or evaluating vendors.

- Do all core-system modules and ancillary systems share member information, history, and business intelligence, including to and from external accounts such as credit cards?
- What are our unique requirements? Have we identified functionality gaps? What specific requirements does each potential vendor meet?
- What are the advantages of one vendor's architecture over another?
- Have we spent enough time with the vendor's senior management and key clients to feel that it's a good partnership? Do we truly know them? Do they have a "be ready to act gladly" attitude and willingness to work through challenges?

Jeye adds some cautionary advice on pricing. "Vendors bundle their system components differently and have a mixture of approaches to charging for professional services, especially conversion assistance. It's important to spend the time to create an apples-to-apples comparison to avoid surprises later. Be sure to include all components (ancillary systems and third-party products) and that you understand how the vendor's pricing changes as your credit union grows in assets and members. A vendor's pricing model should make the cost of growth economical, not expensive." ■

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Don't Wait for Internet Outlaws to Attack

Protect your CU and members from increased phishing attacks

More than likely, your credit union is protected either through firewalls or user knowledge from falling prey to an e-mail phishing attack. But what about your members? An e-mail phish may or may not link people to a deceptive replica of your Web site, but if one of your members gets phished and turns over account information, your credit union is the one that will lose either money or its reputation.

The first phishing attack against CUNA occurred in April of 2005, according to Dorothy Steffens, vice president of Web Services for CUNA. Since then, CUNA has been the target of 100 attacks per year. Steffens considers it part of CUNA's responsibility as a trade organization to do everything it can to stop such e-mails and Web sites launched in its name.

Steffens says that phishes have evolved rapidly over the past few years. In the past, phishing e-mails included grammar and spelling mistakes or a suspicious sender address that would tip off the reader. Today's phishing outfits have all the virtual tools they need to trick even smart people into becoming victims.

Three Components

Three main components allow phishing operations to run. The first is e-mail address lists of potential victims.

"The nature of Internet marketing makes buying and selling e-mail addresses really easy," observes Steffens. "Many public sites like universities or K-12 school districts publish directories containing e-mail addresses." Using a simple Internet program called a spider, these addresses are "harvested," says Steffens, and used for phishing. Phishers also use e-Bay-like marketplaces. There, Steffens says, they can purchase e-mail lists, credit card numbers, or tools to set up a phishing site.

The second component of phish production is the creation of "spoofed" e-mail addresses, using anonymous e-mail sender programs. These legitimate tools allow a phisher to create an originating e-mail address that appears to be from a real Internet domain.

"The nature of Internet marketing makes buying and selling e-mail addresses really easy…"

"Basically, this allows an e-mail message to appear to be from a valid, trusted sender, when in fact the reverse is true," says Steffens. That proved to be the case in one instance when people received bogus e-mails from both CUNA and NCUA asking them to fill out surveys that included sensitive account information. Steffens notes that until a viable e-mail validation system is developed that individuals can use to protect themselves, this type of attack will continue.

The third and most recent component is a phishing kit. Steffens says the earliest phishing scams were hand-crafted copies of legitimate sites.

"Organizations kept ahead by changing their site to update/notify visitors of the scam," Steffens explains. Because things were done by hand, phishers had to constantly play catch-up. "Over time and with increasing sophistication, the process of creating the look of the target site became easier, giving rise to a black market industry, thus the phishing kit was born," says Steffens.

A kit contains all the HTML images and programming needed to set up a phishing attack for a given site. This has not only made it easier to set up a phishing site, notes Steffens, "it has also led to a visible evolution in the quality of phishing scams."

The Situation on the Ground

Who are these Internet criminals and how can they be stopped?

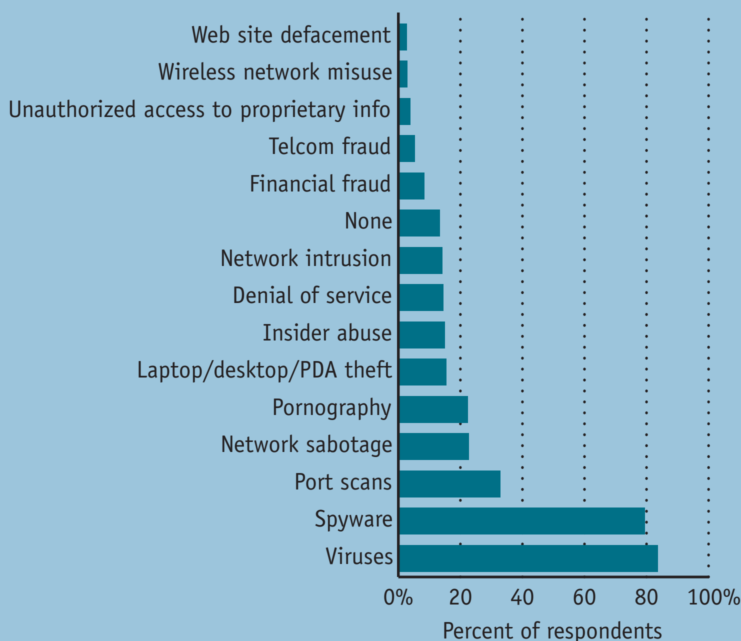
"Often Internet service providers (ISP) don't even know a phish is going on until you bring it to their attention," says Steffens. CUNA has pioneered its own internal system that monitors online traffic patterns for suspicious activity.

For example, if a Web address like "survey HTML" comes up repeatedly, an internal program at CUNA zeros in on the nine-digit IP address and CUNA notifies the ISP owner. "I've had good success (working with) American ISPs such as Yahoo, who will shut down the fraudulent site by the end of the same day," says Steffens.

Many times though the phish originates from an outside region such as China, Taiwan, the Middle East, or eastern Europe. When this occurs, Steffens reports the phish to Perimeter Internetworking, a counter-phishing firm and strategic alliance partner of CUNA Strategic Services that can shut down a phishing site in 12 hours or less.

Figure II

Computer Security Incidents*



**Detected within 12 months preceding the survey*
Source: FBI computer crime survey, 2005

Help Members Help Themselves

Despite what can be substantial investments ($10,000-$15,000 per year) by a credit union to "take down" phishing sites trading on their reputation or the look of their Web site, Steffens believes the best strategy for credit unions to fight phishing is to develop a communication plan to educate members about the various forms phishing can take. And phishers attempt many different attacks such as:

- An e-mail asking recipients to fill out a "survey" with the promise of a $250 prize.
- Multiple e-mails sent in a short time warning members that their

account had been breached and asking them to confirm such things as an account numbers or passwords.

- An e-mail suggesting that the credit union is trying to verify member's account information "in order to prevent identity theft and fraud."

A new phish with CUNA's name on it can generate 100 to 500 inquires a day from recipients trying to find out if it's real or not, says Steffens. "Eighty-five percent of those are people who don't even have credit union accounts or who haven't heard of CUNA," shares Steffens. "So if this happens to your credit union, you may get calls from people who aren't even members or have no idea who you are."

Steffens says educating members about phishing through inserts, letters, e-mails, and the credit union's Web site is a good start. But she also believes that a credit union's staff, particularly those in call centers, "should be able to instruct members and the general public how to forward the phish e-mail and check on activity within a member's account," she says, noting that college students seem least informed and particularly vulnerable to phishes.

Steffens says that almost all "dummy" or fake Web sites have links beginning with "http." Regarding such dummy links, Steffens offers one tip that can protect people:

"The link inside the phishing e-mail usually says "click here" or "access my account". If you copy and paste that into a new browser you then see the IP address coded behind the text. The most important reason for copying the link and pasting it into the new browser is to avoid any 'malware' or 'spyware' that may be associated with directly clicking on that link," she cautions, adding that such a program may then download in the background without the user's knowledge and harm their computer.

To find out more visit *http://www.cuna.org/initiatives/internet_fraud.html*. You may also want to check out the Internet Crime Complaint Center at *http://www.ic3.gov*. ■

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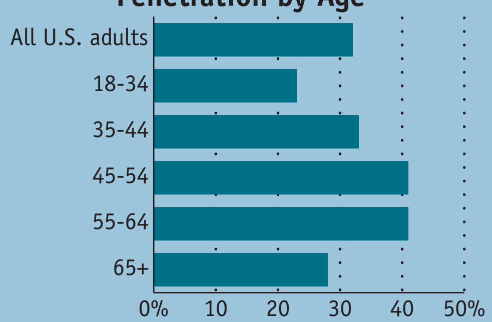
A CLOSER LOOK

Credit Union Membership Penetration by Age



Source: CUNA's 2006-2007 Survey of Potential Members

Credit unions record their lowest membership-penetration rate among consumers 18 to 34, according to CUNA's *2006-2007 National Member Survey Report*. Just 23% of these consumers belong to credit unions, compared with 32% of all adults. However, membership growth potential exists in all age categories. From a lending growth perspective, persuading eligible non-members between the ages of 18 and 44 to join a credit union and secure a loan would seem a crucial target to achieve both higher current loan volumes and maximize the potential for higher loan volumes in the future.

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