Solid Benefits &

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Conversion applicants correctly reason that the credit union's members and the future growth of the institution requires an unrestricted customer base and expanded products that will include an increased emphasis on real estate lending and business lending. The federal mutual bank charter encourages both and offers capital and corporate structure advantages. Some also convert to remove marketing impediments related to the credit union charter and to avoid the public relations and political risks of staying in the credit union system.

Many credit unions, especially community chartered ones, are now facing the impact of limits on business loans and the fact that PCA requires them to carry 40% more capital than banks. As operating margins narrow - credit unions must grow in order to generate the earnings to pay the bills - during these low interest rate times the issue is magnified.

The following benefits prove that a bank charter is a solution - available now - for credit unions that want to better serve their members, communities, and grow their franchise:

Unlimited Field of Membership - The bank charter offers an unlimited field of membership which helps make marketing efforts more effective and supports bank and branch acquisitions and mergers with credit unions and banks. The federal charter also supports nationwide activities.

Product Flexibility - Banks are able to offer a wider range of products - including real estate and business lending - products in high demand by our communities. The bank regulators understand this type of lending, encourage it, and field examiners are experienced at addressing such concentrations. Credit unions, however, face portfolio restrictions and a capital haircut because of real estate and business lending, as well as inexperienced examiners since NCUA, historically, has been focused on examining consumer loans - like car loans and unsecured loans. Investment flexibility is also a benefit with a bank charter - a wider range of permitted investments helps boost yields and provides better service to local communities by diversification into municipal bonds and tax advantaged investments.

Capital Advantage - It's been said that credit unions pay a hidden tax which is evident by the fact that to be well capitalized a credit union must maintain a 7% capital ratio versus a bank's requirement of only 5%. Competition and economic conditions are putting pressure on margins while increasing costs will shrink the bottom line. The future will require utilizing more leverage (asset growth) in order to maintain member benefits. To illustrate the disadvantage, consider that a bank with $50 million in capital can grow to $1 billion and be well capitalized, while a credit union must stop growing at around $700 million. The bank's $300 million asset advantage not only translates into earnings to handle the tax obligation, but the community benefits from the impact of more lending and services. Directors, management, and staff benefit from higher growth opportunities and greater compensation tied to asset size.

In addition to retaining earnings, banks have many ways to increase regulatory capital empowering them to expand services to members and the community, including loans, branches, employment, and deposits products. For example, in August, Pacific Trust Federal, a former credit union, raised almost $65 million in regulatory capital in a member approved IPO. The additional capital allows it to grow from $300 million to $2 billion, thus seeding a significant boost to the local community. As a credit union - even if other impediments were lifted - growing to this level of service would require over a decade of retained earnings.

Consumer Awareness - Consumers understand the business of a bank, but most are confused about credit union capabilities. Credit union sponsored studies on both sides of the country prove that much needs to be done to improve consumer awareness. Consequently, gaining solid market share and correcting these negative perceptions could take decades. Meanwhile, as credit unions become more active within communities, they need to serve municipalities, nonprofit corporations, immigrants, business owners, and other legal entities. These customers provide valuable demand deposits to support emerging business models, however, many just refuse to do business with a credit union.

Corporate Governance Issues - Just 1,000 credit unions control 75% of credit union assets. Many over $100 million in assets are complex fast growing institutions. The bank charter supports the risk taking and growth with a director compensation and retirement plan structure that attracts a motivated and sophisticated directorate. As banks and credit unions consolidate, in addition to being able to offer compensation to directors of target credit unions, other consolidation and expansion tools are provided, like holding companies, operating subsidiaries, service corporations (like CUSOs), real estate investment trusts, and trust preferred securities. Although some criticize the director compensation plans that are available after conversion, it is worthy to note that many cooperatives and non-profits - like charities and hospitals - compensate their directors.

Public Relations and Political Risks - The unmeasured risk of political and public relations fallout also factors into the bank conversion decision process. Although safeguards exists, the failure of a large credit union, whether linked to a sponsor bankruptcy, loan or investment concentration issue, or an internal control failure will have negative ramifications for all credit unions, much like the impact of recent credit union debacles in Mexico, Japan, and Korea. The fact that some credit unions are not federally insured is a blemish in the minds of those that remember the collapse of private insurance in Rhode Island and other states.

On another note, NCUA is working overtime to make credit unions look like the savior of the inner city and the economic partner of low income and disadvantaged people. The flip side of the NCUA public relations bet, however, could lead to credit unions being viewed as a group that is merely exploiting those in "need" in order to profit from a tax subsidy. Consumer groups and community activists have their eyes on credit union capital and obtaining credit union funding will be part of their business plans. If NCUA's threats fails to get credit unions to respond to the call to "serve the underserved" you can bet these groups will put credit unions in the headlines.

In addition, unlike 1998 when HR-1151 was being debated, massive budget deficits prevail, and many powerful credit union allies have retired from Congress. Increasing revenues and closing tax loopholes will be a popular topic in Washington, DC and in state capitals. Tax advocates are likely to picture decaying grammar school buildings next to shinny new credit union office buildings as teachers appeal for more money and argue that large credit unions should pay taxes to benefit both schools and homeland security. Although nobody likes to pay taxes, management of credit unions in Canada and Australia and at $274 billion TIAA-CREFF, a college professor retirement organization, argue the benefits gained by accepting this social duty is worth the cost. Taxes are managed like any other business expense.

Although efforts are being made to correct charter impediments, hope is not a sound business strategy and building a business model that depends on a tax subsidy is risky. The CU trades promise reg relief, new powers, a better informed regulator, and want to educate consumers about the credit union model; but competitive pressures will not allow a progressive institution to be complacent and live by the status quo. One session of Congress is like a lifetime in the financial services business and the snail's pace that bankruptcy reform moved will look like lightning compared to new credit union legislation. And, when the Bill hits the President's desk, credit unions may only gain a few new powers, but face taxes and be handcuffed to an out dated charter with new markings of a social service agency.

Switching charters is a common practice among financial institutions as their mix of business or goals change, or when a more supportive charter or chartering state is uncovered. Competitive pressures and member requirements demand efficiency and flexibility. A focus on providing quality services to members and communities rather than wasting energy debating field of membership issues and making excuses for a tax exemption is imperative. A. progressive institution must seek a charter that supports its mission rather than modify a mission just to fit a charter. Converting solves many problems, relieves the pain, and provides dynamic new opportunities.

For more information about the mutual bank charter, the stock bank charter, raising regulatory capital, bank holding companies, and other progressive growth strategies contact the authors, Alan D. Theriault, President, CU Financial Services, at 800-649-2741; or Robert Freedman, Esq., Silver, Freedman, & Taff, at 202-295-4502.
