CU Financial Services

Strategic Planning and Implementation Services for Progressive Credit Unions

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October 4, 2004

National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Att: Becky Baker, Secretary to the Board
Re: Comments on Proposed Rule 708a, Conversion of Insured Credit Unions to Mutual Savings Banks

Ladies and Gentlemen:

CU Financial Services is a strategic planning firm with experience helping credit unions investigate the merits of the credit union community charter, the mutual bank charter, the stock bank charter, and the mutual holding company charter. We also work with credit unions to expand business lending programs. We help credit unions grow and realize their full potential. We have had a hand in the majority of the two dozen plus credit union conversions to mutual savings banks and the HR-1151 US Senate amendment that ultimately reversed 1995 NCUA rulemaking that was widely viewed as a self-serving attempt to stop credit union conversions to the bank charter.

The proposed rule is another such effort to stop conversions. The rule requires actions that result in an <u>illegal</u> attempt to influence a <u>no</u> vote and make conversion more difficult than Congress intended. Congress, as a matter of public policy, authorized conversion of a credit union to a bank. Considering and undertaking such a conversion is perfectly legal and the NCUA should not be in the business of finding loopholes to complicate, make more difficult, more costly, or which could stop conversions. The Senate Banking committee wanted the process to be simple - similar to rules for banks going from a state charter to a federal charter, or a national charter. NCUA was stripped of its conversion approval authority. The message was loud and clear - converting to a bank is okay for credit unions and NCUA was ordered to facilitate the move, not hamper it.

<u>Statistics</u>

Only 29 of the 9,000 plus credit unions elected the option to convert from a credit union charter. From the list, eight merged with other mutually owned institutions and members are benefiting from a longer list of services and are a part of a stronger and more competitive corporate family. Nine have elected to access the corporate flexibility of a mutual holding company (MHC) structure allowing members to benefit from expanded revenue sources and participate in the current credit union and bank consolidation wave. *(The MHC structure involves reorganizing the mutual bank into a stock bank, however, the ownership of the stock bank remains under the control of a non-stock holding company which depositors control.)* Members

of seven voted to convert to a full stock operation; three of these were institutions under $100 million in assets, and all were located in highly competitive metropolitan areas. *(The capital raised in the full stock conversion allows these institutions to better address the highly competitive marketplace which has resulted, in part, by the elimination of credit union overlap protection and NCUA's & states' approval of huge credit union community charters.)*

Conversion Disclosure

The executives of converting credit unions recognize that careful attention to informing the membership is a fundamental part of the conversion process. The conversion disclosures were thoughtful and comprehensive. Striking a balance between producing a reader friendly brochure and a 100 page document that will go into the trash is a challenge, but we are doing it. The disclosure should be broad enough so new strategies could later be explored and executed; after all one of the reasons for leaving the credit union charter is to get rid of the handcuffs, not put on a new set.

The proposed rule will require a converting institution to publish a NCUA mandated false and misleading notice with information already considered by the board of directors and which by the time of the publishing has little or no value for purposes of voting on the conversion. The demand is ridiculous and unreasonable.

Contrary to a few claims, I believe converting credit unions have done an excellent job of addressing the key conversion issues as part of the disclosure materials. Given that over 500,000 disclosure statements have been circulated to members of converting credit unions, the sincere critics are few. However, I've observed that some critics have private agendas and include employees of credit unions who must now compete with a more aggressive former credit union, disgruntled former employees, jilted job applicants, denied loan applicants, CU trade association employees, and serial protesters and activists looking for a cause, including at least one whose web site reports hasn't held a job in the productive sector of the economy since his 20's. For example, during a recent credit union conference, after boldly proclaiming the need for more conversion disclosure, the critic, a credit union CEO, admitted he had never read a disclosure. Another, the CEO of a credit union trade association has repeatedly published false information about conversions including the following comment that "each member has an equal ownership share in the credit union regardless of the amount held on deposit" in order to create the illusion that members give up something with marketable value during the conversion process.

Thus, the agenda is not always transparent. Frankly, writing a disclosure that would keep everyone happy is probably impossible, definitely unnecessary, and more importantly not required by federal law. Finally, NCUA has reviewed, commented on, and approved all the disclosures statements, so a mechanism is in place for handling issues on a case by case basis.

Full Disclosure and Transparency

The proposed rule is designed to generate the presumption that the conversion is motivated by a desire for more management and director benefits, but says it is designed to achieve full disclosure and transparency,

a new concept for credit union management and directors, especially on the subject of compensation and benefits. **Recent press coverage of credit union executive salaries in Oregon illustrate that one does not have to convert to a bank to get a big pay day. The proposed rule will generate an unintended precedent for credit unions that want to remain credit unions.** Consumer and taxation activists would love to know the wages and benefits of credit union managers and directors, so you can expect this proposal to open the door to new pressures to expand the scope of transparency to all credit unions. Several years ago a Utah house bill proposed such a transparency requirement. A round of golf at $250.00, Ritz Carleton accommodations, first class travel reimbursement, travel reimbursement for a "significant other" or family member, director health insurance reimbursement, and rotating board member positions so each director gets a shot at a the single FCU paid position may be reasonable and necessary "compensation", but some politicians and consumer activists may take exception, especially since the story line is that credit union directors are volunteers and management teams are underpaid. **Like your preacher says: when you point one finger, three are pointed back at you!**

Assault on True Cooperative Principles

The proposed rule and parallel attempts to get federal and state legislation designed to stop conversions represents a blatant attack on the rights of a credit union cooperative to determine its own destiny. Cooperative participation in principle and practice is voluntary. As you know, the vast majority of the credit union members choose not to participate in governance activities or even use the available services. In fact tens of millions of members are carried on the books of credit unions because of the "once a member - always a member" legal interpretation and for feigning political clout. These "members" are often the one time users of a single credit union service, and have contributed in only a minor way to the accumulation of capital - more like a retail store customer than an engaged cooperative member. Members who fully patronize the institution, and care enough to vote, benefit the most from a conversion and generally vote both in favor of conversion, and if applicable, the stock issuance, which requires another vote and a Securities and Exchange Commission approved prospectus. **These faithful participating members should not be penalized by costly and onerous conversion regulations or legislation, which in effect supports the status quo and puts power in the hands of non-participants. This is the impact of the proposed rule and NCUA lobbying for voting quorums.**

Cooperatives are organizations designed to benefit those individuals that participate and are involved in the capital accumulation. We should oppose laws and policies that in effect turn these organizations into socialistic or charitable organizations. **The subject disclosure proposal and other NCUA efforts have the impact of providing non-participants the tools to block the organizational evolution, and are in direct conflict with federal law and the American Way.** Costly and onerous disclosure and voting requirements, in the end, could reward only the non-participants and the support organizations which become irrelevant after conversion.

Although credit union trade associations and the NCUA may have been involved in the organization of credit unions, they should not be allocated loopholes or legal mechanisms which allow them to interfere with later democratic initiatives. Yet, a few credit union trade organizations publicly vow to do whatever it takes to block credit union conversions, including direct and indirect contact with the membership. Others

secretly plan to work behind the scenes *(some without the knowledge of their dues paying members)* to influence members, regulators, regulation, and / or legislation. The conflict is obvious, wrong, and should be prohibited, even punished.

The following are my specific comments about the proposed legend:

1. OWNERSHIP AND CONTROL: Although the proposed text is true, printing the part about voting at a mutual institution in bold and capitalized generates the perception that something is wrong with voting by participation when in fact it is very common in the financial world, even with many cooperatives. Participation voting allows those members with the most at stake to have a greater say in the governance of the institution. The clause also fails to explain that limits exists and that no single member or group working together get more than 1,000 votes representing a deposit of $100,000. Generally about 20% of the members of a credit union control upwards of 80% of the deposits and hence are by far the majority owners of the net worth of the institution in a liquidation and are the most at risk. With the facts, these members are quick to endorse voting by participation.

2. EXPENSES AND THEIR EFFECT ON RATES AND SERVICES: This disclosure requires the false statement that credit union directors and committee members serve on a volunteer basis while directors of mutuals are compensated and also implying there is something wrong with directly compensating directors. In fact, credit union directors in over a dozen states are compensated and nationwide it is common practice to pay thousands of dollars to credit union directors for cell phones, computers, travel, spouse travel, health insurance, meals and for other compensation equivalent loopholes designed to transfer funds to directors, including in some cases rotating the single paid board member position (permitted by NCUA rules) so each director gets a shot at a paycheck and reimbursing for first class fares on excursion travel.

A comment about taxation is required without mention of the indisputable fact that credit unions operate under product and market restrictions and higher capital requirements than banks, thus generating a "hidden tax".

The required legend in bold and capitalized: "**ADDITIONAL EXPENSES MAY CONTRIBUTE TO LOWER SAVINGS RATES, HIGH LOAN RATES, OR ADDITIONAL FEES FOR SERVICES**" is crafted to imply that this is an automatic outcome of conversion when it is more likely that this outcome will occur if the conversion is <u>not</u> undertaken. Despite the credit union income tax advantage, it is an indisputable mathematical fact that a depository institution can do more for its members and its community, can offer more financial products and services, and can open more branches if it is has a bank charter. Contrary to NCUA's view that converting to a taxable institution would mean injury for members and the community, financial modeling shows that, as a future thrift, not only is increased loan activity a real benefit to members and the community, the earnings from that business – coupled with investment yields far superior than historically possible for credit unions – would produce net profits for members greater than what is now possible as a tax-exempt credit union.

Credit union executives and others surely understand the benefits banks enjoy from lower capital requirements and access to the capital markets. Several credit union CEOs recently told the GAO that

because of PCA, higher capital requirements and lack of access to secondary capital small to midsize credit unions are faced with 1.) Refusing deposits, 2.) Reducing services to members in order to retard the growth of assets, 3.) Converting to a savings and loan or community bank, or 4.) Merging with another credit union. The GAO also said "Credit union industry officials, including NCUA, have stated that some credit unions have had to reduce their services to members in an effort to satisfy PCA requirements."

A May 2004 report produced by the Washington Credit Union League entitled: "Defining the Credit Union Difference" stated, "PCA rules induce credit unions to maintain capital levels higher than necessary to protect the share insurance fund. Credit union response to these pressures is to limit growth, which requires limiting service to members. This, in turn, reduces the amount of funds that credit unions can devote to member loans that support the economy."

Senior vice president of CUNA Mutual's Credit Union Financial Solutions Group complained in a recent news story "current law mandates that credit unions, unlike other financial institutions, must rely on retained earnings alone to build capital to satisfy regulatory Prompt Corrective Action (PCA) requirements." He continued, "This puts most credit unions and ultimately their members at a competitive disadvantage because it dampens the credit union's growth potential." Speaking about conversions, the CEO of the Washington Credit Union League stated: "these conversions may represent a fundamental weakness in the overall national credit union charter that needlessly restricts capital accumulation and business lending."

NASCUS Chairman and Michigan Credit Union Regulator Roger Little told the Credit Union Times as reported in its September 22, 2004 edition, "credit unions continue to be punished for their success because they are restricted in their access to capital". Little added, "alternative capital for many state chartered credit unions is imperative if they are to continue to meet the financial needs of their members such as financing home ownership, financial education, and credit counseling. The combination of PCA requirements established by Congress for credit unions in 1998 and significant deposit growth has created a financial and regulatory dilemma for many state-chartered credit unions."

In an August 27, 2004 editorial to the American Banker, CUNA's Chief Economist Bill Hampel defends the credit union tax subsidy and uses quotes from Federal Reserve studies to support CUNA's position that "it's not just the credit union lobby who find strength and vitality in the small-bank industry". Hampel concludes, "**...** to suggest that credit unions are less regulated than banks is ridiculous. Granted, credit unions are not subject to the Community Reinvestment Act, a law passed to address bank redlining. But in virtually every other regard they are more regulatorily constrained than banks: Credit unions still face binding - although somewhat reduced - field-of-membership restrictions; have no access to net worth other than retained earnings; are subject to higher capital requirements than banks; are much more limited in business lending; and face more restrictive investment regulations." As the Treasury Department said in 2001, federal credit unions "have more limited powers than national banks."

In brief, these comments from credit union leaders, common sense and basic math illustrate that credit unions converting to a banks and maximizing the chartering opportunity are not assuming expenses, including taxes, which will negatively affect member savings rates, loan rates, or fees. The facts show these

rates are set by market forces and not by a dependence on a tax subsidy. By requiring this false and misleading comment one must ask: Does the insurer of deposit taking institutions with over $600 billion in assets somehow fail to comprehend the mathematical relationship and contribution to revenues that result from lower capital ratios and third party capital? If so, that comprehension gap in itself is enough reason to exit the charter.

3. SUBSEQUENT CONVERSION TO A STOCK INSTITUTION: The proposed statement is misleading in this context and clearly intended to discourage members from voting in favor of charter change as opposed to providing any meaningful information. Any conversion from a mutual thrift to a stock thrift requires a second, separate vote of the members. Executives are not permitted to adopt any stock benefit plans at this time, other than an ESOP that is applicable to all employees in an equitable manner (and is not available to non-employee directors) and may not receive any compensation as a result of this vote. In order for an executive to receive any stock compensation, a third vote is required, which may not occur until at least 6 months following conversion from mutual to stock form. This vote must specifically approve any stock compensation plans for executives. This could not take place for at least a year following the charter change and is so far removed from this in time and by the two additional votes that it clearly is aimed only at discouraging the member vote. Requiring this statement is a clear violation of the statute.

4. COSTS OF CONVERSION: The proposed required statement that "... the conversion costs reduce members ownership interests." is not correct in many cases. Many credit unions convert to raise capital and many of these choose the mutual holding company form of organization. In these cases the mutual form of organization, membership and control is preserved and members not only retain control, but also have their economic ownership interest increased by virtue of the capital raised in the conversion. Each member's economic ownership interest following a mutual holding company reorganization is actually larger than that same member's economic interest in the mutual credit union.

The requirement to provide a breakdown of the conversion costs provides virtually no benefit to voters since the money, for the most part, has already been spent and are costs which are required by the regulator and not within control of the institution. Frankly, since the costs are not optional, but yet necessary in order to get a refund of the NCUSIF deposit, perhaps all credit unions should expense an amount equal to the calculation in order to properly reflect the value of that NCUSIF asset on the books of the credit union.

The proposed voting guidelines and meeting requirements are just included to drive up the cost of conversion in an effort to make it less attractive and so NCUA can explain away its immaterial conclusions generated as it worked overtime to overturn a legal conversion vote earlier this year.

<u>Conclusion</u>

NCUA estimates that as a result of the proposed regulation, the number of converting credit unions will decline from approximately 10 per year to no more than 5 per year. The NCUA clearly understands and intends that the consequences of this proposed regulation will be to discourage credit unions from putting a charter conversion to a vote of its members.

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Congress recognized that HR-1151 put handcuffs on credit unions and provided relief by making it legal and easy to convert to a bank. Thus, **the Congressional solution for lack of capital options, loan limits, or other noncompetitive credit union limitations is not new legislation or regulation as is proposed by NCUA, it's conversion to a bank charter.**

Higher capital requirements than banks, PCA, and the inability to access the capital markets are causing competitive problems for progressive credit unions. For most, stopping growth is not a sound strategy. In addition, investment portfolios and loan concentrations perfectly acceptable for banks are being criticized or are illegal for credit unions. Community minded credit unions are finding that many consumers, business owners, non-profits, and municipalities lack confidence in, misunderstand, or are prohibited from banking at a credit union. Limitations on mergers, limitations on corporate structure innovations, and yes - director compensation prohibitions can have negative ramifications for dynamic institutions.

Throughout the credit union system, leaders are daily acknowledging that systemic problems are present; executives that move to a more supportive charter are doing something about it. They should be applauded, not ridiculed, or subjected to intimidation and false presumptions. Their solution is not to give up and find a new job but rather to find a charter that supports the survival of the institution. The presumptions in the proposed regulation are false, self-serving, and an insult to sincere hard working executives and directors trying to do the best thing for their members, institution, and community. The proposal should be withdrawn.

Sincerely,

Alan D. Theriault

Alan D. Theriault, President

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