Credit Unions in the Broader Financial System

Prepared remarks:
Alan D. Theriault, President, CU Financial Services,
P.O. Box 1053 * Portland, Maine 04104
800-649-2741 * www.cufinancial.com

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Speaker Profile:

Alan is a senior advisor to credit union managers looking at the mutual savings institution charter and President of CU Financial Services a nationwide strategic advisory firm serving financial institutions. Alan coordinated the pioneering first conversion of a state chartered credit union to a Federal Mutual Savings Institution, which, among the other obstacles at the time, involved getting two state laws passed to facilitate the switch. Since this historic conversion, Alan has remained in contact with numerous credit unions about the process and publishes a free newsletter entitled "Converting from a Credit Union" which chronicles this emerging trend. Also, Alan is editor of the 300 page: "Conversion Guide - The Cooperative Banking Charter".

Alan's diversified executive background includes positions with a major Wall Street investment firm, as president of a mutual savings bank, as founder and senior executive of a mortgage banking and business lending firm, and as founder and executive of a National Association of Securities Dealer (N.A.S.D.) Member firm.

Introduction:

My sincere thanks are offered to the American Enterprise Institute's distinguished board and fellows for inviting me to be a part of this important panel organized to discuss the timely topic of "*Credit Unions in the Broader Financial System*". Also, thank you for your steadfast defense of the principles of American freedom and democratic capitalism--limited government, private enterprise, individual liberty and responsibility, vigilant and effective defense and foreign policies, political accountability, and open debate.

I would also like to thank my fellow members of the panel and each distinguished member of the audience for being here today. I consider it a privilege to address this inquiring group of leaders from across the nation and I look forward to being a part of the open minded discussions on this topic.

Economic and Political Pressures Challenge the Industry

Contracting margins - increasing operating costs - political pressure to reduce overdraft fees - declining interchange revenues - and pressure to be more responsive to low- and moderate-income populations are among the many pressures on credit unions today.[1]

As might be expected, responses to these pressures are varied.

Many credit unions have liquidated their credit card portfolios to boost capital and book extra income as a short-term fix. Others are being aggressive to retard margin contraction by rapidly diversifying into higher-yielding real estate loans - commercial loans - third-party-originated sub-prime auto loans - and across-the-country commercial loan participations.

The recent bankruptcy filing by Centrix Financial of Denver, the nation's largest credit union sub-prime lender, amplifies these disconcerting pressures and underscores the importance of keeping the door open to conversions to the mutual savings association charter. [2]

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[1] At the end of 2005, more than 280 credit unions were classified CAMEL 4 and 5. They represent 1.1 % of credit union insured deposits, the highest numbers in a decade. In 2005, 1,181 credit unions did not generate a positive rate of return. Despite a tax subsidy, 2,997 earned less than 40 basis points. Since 1969, the number of credit unions plunged from 23,500 to 8,722 by December 2005. Many expect the number will be below 5,000 by the end of 2010. In contrast to the organization of more than 640 new banks and thrifts in the last five years, only 42 new credit unions have been organized, mostly tiny community development credit unions with a social mandate.

[2] The filing was precipitated by the National Credit Union Administration's (NCUA's) risk advisory against indirect auto lending by credit unions earlier this year, and follows NCUA's April 2006 conservertorship of a $300 million Colorado credit union.

Dozens of credit unions – some of which are billion-dollar institutions – are now facing substantial losses running into the millions of dollars. These credit unions apparently felt they had to become aggressive indirect lenders to stay viable, even in good economic times when banks are booking record profits.

Meanwhile, using the pretext of consumer protection, NCUA is planning to impose more bureaucratic red tape to slow [mutual savings association] conversions – for the third time in as many years.[3]

When credit unions are forced by their charter's limitations to pursue risky, non-traditional sources of income, closing off the ability to exit the charter introduces systemic safety and soundness issues. CUNA, has itself described the credit union charter as subject to "severe limitations" on business lending, "stringent limitations on investment," and being "inflexible" in operations and governance.

I assure you *numerous* credit unions are interested in the powers offered by the mutual charter, but not for the selfish reasons NCUA's career employees and a few others proclaim.

The life cycle of many credit union products has passed. The payroll deduction and auto lending franchises that dominated for many years are threatened. Community charter expansions have not produced the membership and asset growth many credit unions expected and many are finding they still need something more to stay viable.

The credit union charter has fuelled the growth of many successful institutions. But many credit unions can do a lot more. Some market areas are facing increasingly sobering news like weak employment numbers, layoffs, factory closings, and slow economic growth. These communities need every institution to do its part – to be their best.

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[3] NCUA's anti-conversion policies violate federal law and contradict the sound public policy anchoring the U.S. banking industry – the dual chartering system – where a depository is empowered to select the charter which best serves its mission. NCUA's containment strategy inhibits free movement between charters and eliminates the competition among chartering agencies that promotes innovation and the efficient evolution of institutions.

Unlocking Credit Union Potential

Reorganization as a mutual savings association unlocks substantial additional lending ability because bank regulations - and bank convention - permit higher loan volumes per dollar of net worth. The additional investments that can be made, in new loans, is a way for progressive conversion candidates to serve their communities to the very best of their abilities – something that they can't do under current credit union regulations.

Credit unions are handcuffed by punitive net worth requirements that affect their competitiveness in lending. Also, credit unions are prohibited from accessing the capital markets to increase net worth, providing capital to support growth, while banks do this on a regular basis.

Switching to a thrift charter means a credit union must give up the state and federal income tax exemption it currently enjoys. Critics point to taxation as a disadvantage without considering the growth in revenue and profit that can come from an expanded market opportunity, product line, and capital access.

A majority of financial institutions in the U.S. and other countries pays taxes and achieves a return on equity in excess of most credit unions, while delivering value which results in a dominant market share.

In a growing enterprise, income taxes are a manageable expense, like any other cost of doing business.

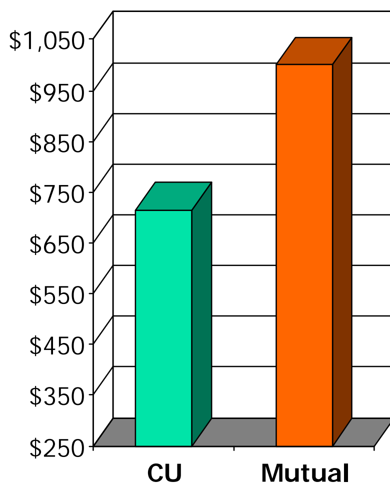
Conversion to a mutual is a legal option for credit unions. Conversion is a strategic option for some credit unions – not all. And, most credit union executives want to preserve the option to convert.

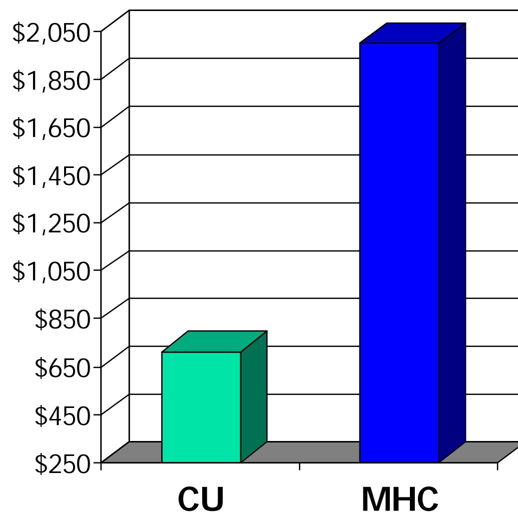
It is an indisputable mathematical fact that:

Compared to a credit union with an equal amount of net worth a mutual can make more loans, accept more deposits, and open more branches, and hence, better serve members and the community.

The chart below illustrates the difference in asset size potential of a credit union and a mutual each with $50 million of net worth. Clearly, the mutual can grow to $1 billion in assets while the credit union must stop in the $700 million range. Add the mutual holding company opportunity, which I will discuss in a moment, and the growth blossoms to $2 billion.

What does your Capital "Buy" in Assets?
Branches, Loans, & Services
$50 million in capital





A mutual can make far more business loans than a credit union[4], far more than the 20% limit you may have read about in the credit union press. This limit includes only the

[4] Business loans held in portfolio by a federally insured credit union are limited to the lesser of 1.75% of capital or 12.5% of assets. Rental real estate (including residential real estate and a second home) is counted as a business loan.

bucket for non-real estate secured business loans, like equipment loans, inventory loans, and loans secured by receivables. In addition, a mutual can make up to four times its net worth in commercial real estate secured loans. It also can make an unlimited amount of loans secured by rental residential real estate using standard underwriting rules.

The following are among the strategic considerations which trigger a conversion.

- Capital Advantages of Mutuals
- Better Consumer Awareness of the Bank Charter
- Enhanced Product and Market Flexibility
- Flexible Corporate Governance
- Unlimited Field of Membership
- Latent Public Relations and Political Risks

Credit Union Limitations

Credit union industry leaders complain that credit unions face serious limitations identified with these conversion triggers. Let's take a moment to review what a few credit union leaders are saying thereby validating these triggers.

- Dan Mica in a letter to the FDIC: "If your aim truly is to level the playing field, you might consider eliminating some of the advantages that banks enjoy over credit unions, which include no restrictions whatsoever on membership or customers, unfettered access to capital markets, lower capital standards, far less restrictive business lending, and the election of Subchapter S status as means of avoiding taxation at the corporate level," the letter said.
- Roger Little, Michigan credit union regulator and former NASCUS Chairman: "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."

- CUNA's Bill Hampel in an American Banker letter to the editor:" ... 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.
- Tom Merfeld, senior vice president of CUNA Mutual's Credit Union Financial Solutions Group: "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. This puts most credit unions and ultimately their members at a competitive disadvantage because it dampens the credit union's growth potential." Merfeld said corporate and low-income credit unions are the only exceptions.
- Washington Credit Union League White Paper: Because of the risk-averse nature of credit unions and the lack of access to capital markets, PCA rules induce credit unions to maintain capital levels higher than those 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.
- John Annaloro, president of the Washington CU League, editorial to CU Times and a press release: "... a string of conversions by credit unions in the state (WA) with the most progressive charter may point to the need for revolutionary, not evolutionary, changes." He also said in a press release that [mutual] conversions are representative of the "fundamental weaknesses in the overall national credit union charter that needlessly restricts capital accumulation and business lending."

- CUNA lobbyist Dean Sagar to a CU trade paper: "The stakes on the bill [2006 Reg Relief] are high because if Congress passes regulatory relief this year it is not likely to pass another bill for years to come, that includes CURIA." Sagar, a long-time veteran of regulatory relief lobbying while working on Capitol Hill, said he could see the House following up with another bill as soon as next Congress, but doesn't expect the Senate to do so for some time. "The Senate will take five or six years to revisit the issue," he said.
- California Credit Union Association Study: "only 1 in 2 people could name a local credit union"; "only 1 in 5 people know what a credit union is."

No Regulatory Relief in Sight

Once again Congress will adjourn without doing anything about CURIA[5] - no meaningful regulatory relief is on the horizon for credit unions. And, according to Sagar relief could be five or six years away. Even more striking, a recent CU Times poll reported that a majority of the credit union industry's own leaders believes the tax exemption itself may crumble within five years.

And, with taxation, will credit unions get more powers? Much will hinge on how Congress views NCUA. Is it a safety and soundness regulator, or an industry "cheerleader?"

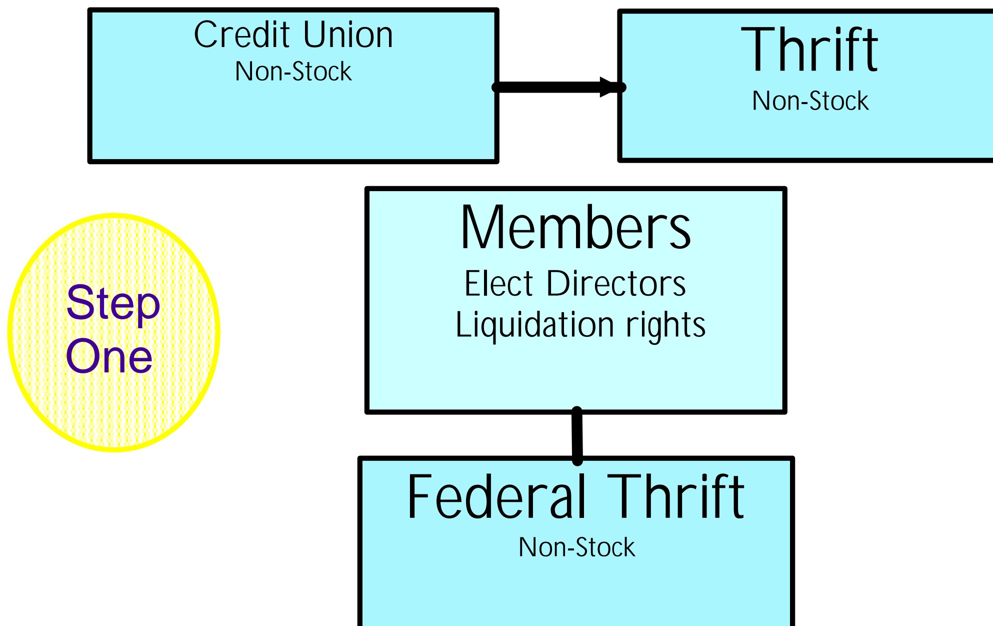
In light of these limitations, economic conditions, and risks - one must ask whether the credit union model is still viable for some forward-thinking, fast-growing institutions. It's the question of long-term viability that gets progressive managers thinking about charter alternatives.

The Mutual Conversion Process

Now let's take a moment to discuss the credit union to mutual conversion process.

[5] H.R. 2317 – Credit Union Regulatory Improvements Act of 2005

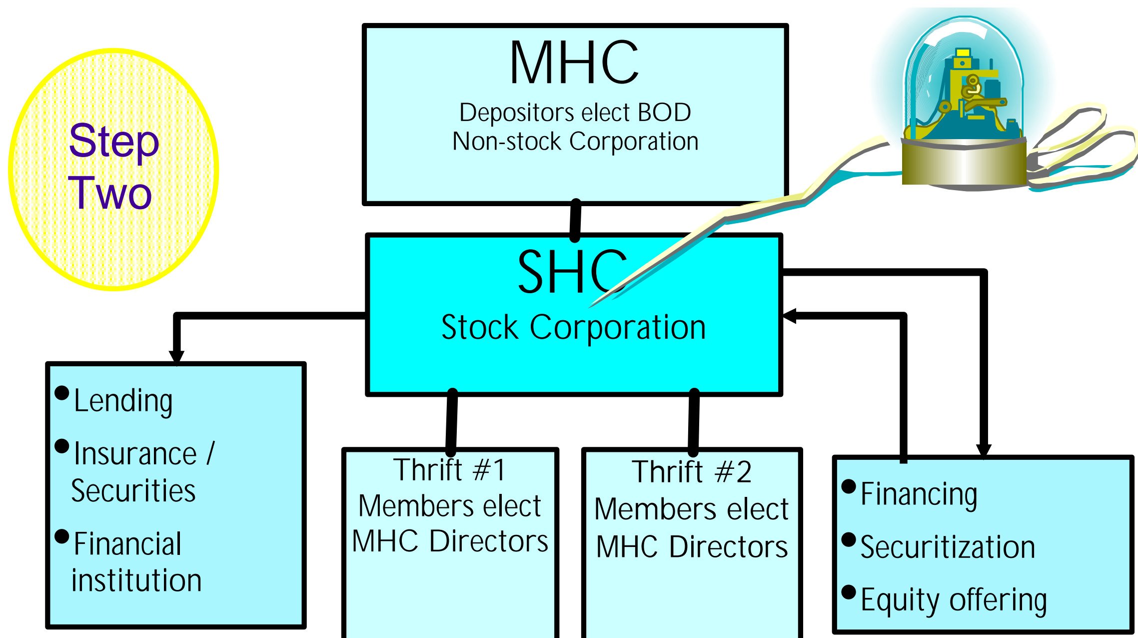
The diagram labeled *"Conversion to a Federal Thrift"* illustrates how a credit union, which is a non-stock entity, merges directly into a non-stock mutual organized for the purpose of the transaction. A majority of the voting members need to approve the change. Members retain control by electing board members of the new mutual. Their ownership interest from the credit union transfers to the mutual.



The process could stop here. Or, if more flexibility, powers, or capital are needed the mutual, immediately, or at some point in the future, could reorganize as a mutual holding company (MHC); but only after another vote of the membership. (See the diagram labeled *"Mutual Holding Company Structure"*.)

The mutual holding company at the top of the diagram is a non-stock company, just like a credit union. And, like a credit union which can organize a CUSO in stock form and retain 51 percent ownership, a mutual holding company can do the same.

So, to accomplish a MHC reorganization, as part of "step 2", the ownership and voting interests of the former credit union members moves up to the holding company level. The MHC organizes a stock company underneath, which is 100% owned by the MHC. This stock company is, in fact, a "Stock Holding Company" since it will own 100% of a subsidiary (or multiple subsidiaries) depository or bank. The bottom level receives the assets and liabilities of the former non-stock thrift, and is the public face of the institution.



It is at the stock holding company level that shares are sold to the membership – up to 49%. The proceeds from the offering can be sent down to the bottom tier.

As long as the MHC retains a least 51% ownership of the underlying stock holding company the entity remains in mutual form. It's a hybrid cooperative. The structure brings together the best elements of a consumer cooperative and an employee cooperative, while providing a source of capital so growth is no longer only funded on the backs of current members – by retained earnings. Members / depositors

of the depository on the bottom tier remain firmly in control by democratic elections of directors who control the mutual holding company.

In conclusion, I sincerely believe the evolution of a credit union to a mutual is as important an innovation as was offering share drafts, mortgages, business loans, or financial services. All these innovations had their critics and skeptics. What if former leaders cratered in fear in the face of the naysayer and thus maintained the status quo? Where would credit unions be today?

In light of recent events, today's leaders must ask whether the credit union model is still viable for some forward-thinking, fast-growing institutions. The question of long-term viability is what gets progressive managers looking at charter alternatives. Despite NCUA's and state credit union regulators' attempts to improve the charter, we've seen many high-performing, well-managed credit unions determine that the mutual savings association charter would be more appropriate for their members and the community.

Unfortunately, mutual conversions present revenue challenges for a conflicted NCUA, both a regulator and insurer of credit union deposits. Nevertheless, blocking the exit door is poor public policy and may generate outcomes reminiscent of the savings and loan crisis. NCUA's recent rulemaking illustrates that it cannot be trusted to administer the simple mandate issued by Congress in 1998 to promulgate rules for conversion voting that were to be "no more or less restrictive than those rules that apply to charter conversions by other financial institutions."

Congress wanted minimal conversion rules from an objective regulator. What it got was quite different. Because NCUA, in partnership with the industry's trade associations, has been unable to improve credit union competitiveness, it is turning the charter into a prison sentence by trying to lock the exits.