Credit Union to Mutual Savings Bank Conversions

House Financial Services Committee Legislative Assistants Briefing
Organized by Rep. Paul Kanjorski (D-Pa.), and
Hosted by the National Center for Member Trust

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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. He has worked with credit unions since 1984. In 1994, Alan coordinated the pioneering first conversion of a state chartered credit union to a Federal Mutual Savings Institution. 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 firm, as president of a mutual savings bank, as founder of a credit union focused mortgage banking and business lending firm, and as founder of a National Association of Securities Dealer (N.A.S.D.) Member firm serving credit union members.

Introduction

My sincere thanks are offered to Rep. Paul Kanjorski (D-Pa.), and the National Center for Member Trust for inviting me to be a part of this important panel organized to brief House Financial Services Committee Legislative Assistants regarding “Credit Union to Mutual Savings Bank Conversions”.

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

<u>Economic and Political Pressures Challenge the Industry</u>

Contracting margins - increasing operating costs - political pressure to reduce overdraft fees - declining interchange revenues – fierce competition from within the industry and elsewhere - 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[2] - commercial loans - third-party-originated sub-prime auto loans - and across-the-country commercial loan participations.

The 2006 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. [3]

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

[1] As of March 31, 2007, more than 236 credit unions were classified CAMEL 4 and 5. They represent .97% of credit union insured deposits. In 2006, 907 (11%) credit unions did not generate a positive rate of return. Since 1969, the number of credit unions plunged from 23,500 to 8,620 by February 2007. Because of current margin pressures, many expect the number will be below 5,000 by the end of 2010.
[2] On February 16, 2007 the National Credit Union Administration (NCUA) took control of $372 million Huron River Area Credit Union of Ann Arbor, Michigan. Some reports claimed the credit union was making risky real estate loans in Florida.
[3] The filing was precipitated by the National Credit Union Administration's (NCUA's) 2006 risk advisory against indirect auto lending by credit unions. In April 2006 NCUA took control of a $300 million Colorado credit union holding $100 million of such loans.

apparently felt they had to become aggressive indirect lenders to stay viable, even in good economic times when banks are booking record profits.

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.[4] The Credit Union National Association (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.

Meanwhile, using the pretext of consumer protection, in December 2006, NCUA imposed more bureaucratic red tape to slow [mutual savings association] conversions – for the third time in as many years. [5]

I assure you *many* 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.

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[4] In order to elude field of membership restrictions, and thus allow growth, some are resorting to "gaming" the system by organizing "clubs" or "associations" which become one of their "select employee groups." For a one time fee anybody, regardless of location or affiliation, can qualify for credit union membership. One credit union has found that this method was the only way that 90% of their commercial loan customers could qualify for membership and thus obtain the loan. My fellow speaker on the panel from GTE FCU has one such club. Its web site reads: "CU Savers" - You can join GTE FCU even if you are not eligible for membership through your employer or a family member. GTE FCU sponsors a non-profit educational financial club. If you share in GTE FCU's desire to reach common financial goals, joining CU Savers for a one-time non-refundable $10 membership fee qualifies you for credit union membership.

[5] 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.

During 2006, 4,591 (53%) credit unions reported a decline in membership; 4,427 (51%) reported a decline in assets. Credit unions as a group barely grew at a rate equal to credited interest. Moreover, the "Billionaire Club" of 116 credit unions, the industry's best performers, represented 67% of the industry's growth, yet it only grew at the rate of 8.1%, compared to the aggregate bank rate of 9.04%. Top bank performers grew at a much higher rate. The "Billionaire Club" currently holds 37% of the industry's assets.[6] Overall, credit union profitability declined compared to a sixth straight record year for banks.

In addition, credit unions are merging at the rate of one a day and 16 failed during 2006. Meanwhile, more than 640 new banks and thrifts were organized in the last five years, while only 42 new credit unions have been organized, mostly tiny community development credit unions with a social mandate. Minority-owned banks, banks focused on immigrant and foreign-born persons, and banks targeting community development and affordable housing are all growing at faster rates than credit unions.

A leading credit union analyst stated in a recent article: *"Through complacency or lack of understanding by boards, many credit unions are going through a very slow, drawn out business death spiral. The credit unions are not unsafe as capital levels are probably rising. But are they sound?"*[7]

The credit union charter has fuelled the growth of many successful institutions. But many credit unions can do a lot more and want to. 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. Some credit unions are being held back by their charter.

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[6] Smaller credit unions are complaining that since NCUA eliminated field of membership "overlap" protection in 2003 large credit unions are poaching their members, thus creating a disproportionate distribution of assets.

[7] *"Hostile Takeovers or Hostile Occupations? The Merger Challenge for Credit Unions,"* by Chip Fillson, President Callahan & Associates, Inc., April 30, 2007.

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 pay taxes and achieve 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.

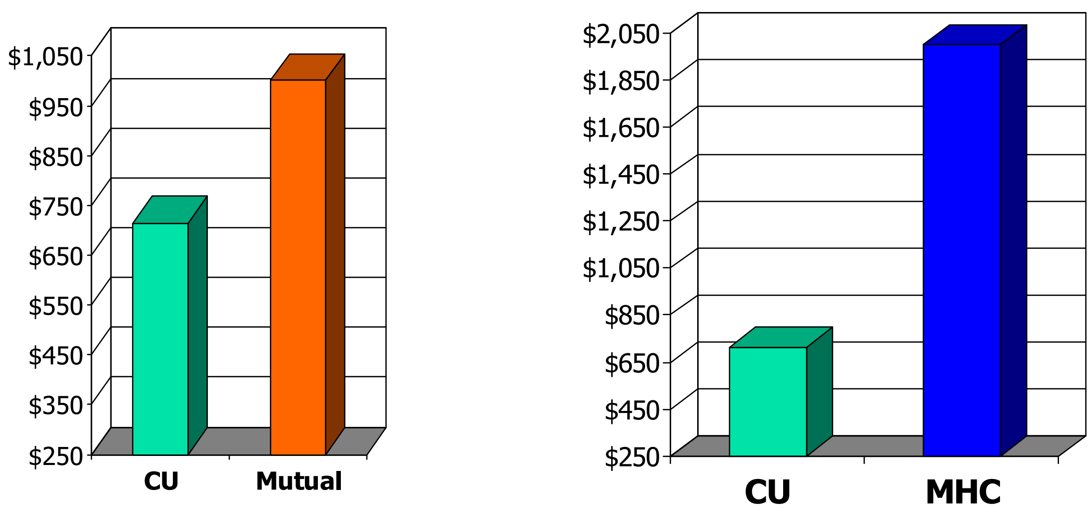
Conversion to a mutual is a legal option for credit unions. Conversion is a strategic option for some credit unions – not all. And, most credit union executives want to preserve the option to convert.

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[8], far more than the 20% limit you may have read about in the credit union press. This limit includes only the 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 lists 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

No Regulatory Relief in Sight

In 2006, Congress again adjourned without doing anything about CURIA.[9] In January, for the third time, the legislation was re-introduced. Nevertheless, many in the industry believe meaningful regulatory relief is only a remote possibility, and even credit union leaders are divided about the need for the legislation. Some view it as mere tinkering. As reported in a credit union publication, Dean Sagar, a senior lobbyist for CUNA, said because Congress just passed a relief bill in 2006, new relief could be five or six years away. Even more striking, a leading industry publication the *Credit Union Times* ran a poll of credit union executives' opinions and reported that a majority believes the tax exemption itself may crumble within five years.

[8] Commercial 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 commercial loan.
[9] H.R. 2317 – Credit Union Regulatory Improvements Act of 2005

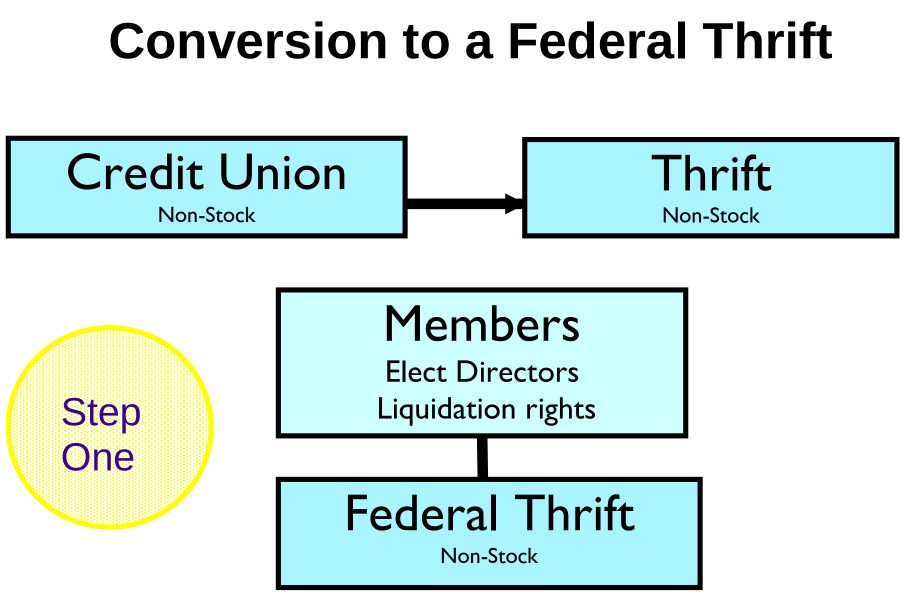
And, with taxation, will credit unions get more powers? Much will hinge on how Congress views NCUA. Is it a safety and soundness regulator, or an industry "cheerleader?"

Progressive credit unions are caught in a legislative "stalemate".

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.



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. <u>A majority of the voting members need to approve the change.</u> 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); <u>but only after another vote of the membership</u>. (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 Credit Union Service Organization (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.

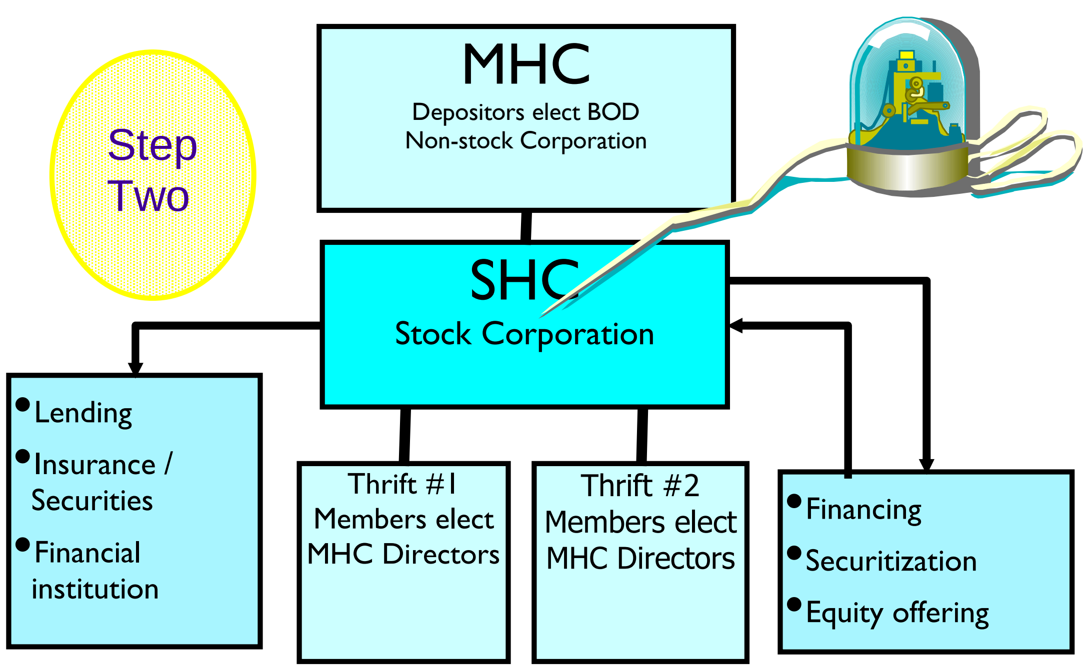
It is at the stock holding company level that shares are sold to the membership – up to 49%. The proceeds from the offering can be sent down to the bottom tier.

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.

The sale of shares to the membership is a process which is highly regulated by the Office of Thrift Supervision and the Securities and Exchange Commission. The U.S. Congress specifically authorized it in the early 1970s as have all 50 states. It has also been extended to the insurance industry. So, for over 35 years conversions have survived public scrutiny and marketplace demands. Many well respected institutions like Washington Mutual, New York Life, and John Hancock have gone down this road and nobody believes for a moment these companies have done anything wrong.

Mutual Holding Company Structure



Even in Congressman Kanjorski's own state is a striking example of the success of a mutual holding company. When this institution reorganized into the mutual holding company structure in October 1994, it operated 45 branch offices and had

$1.4 billion is assets and 537 employees. Because of the mutual holding company structure, and access to capital, it has been able to implement a long-term community banking strategy consisting of internal growth and strategic acquisitions. At year end 2006, it has grown to 133 branches and 48 consumer finance offices for a total of $6.5 billion in assets and $5.2 billion in deposits. It now has 1,528 full-time and 315 part-time employees in the state.

Likewise, the credit unions converting to the thrift charter are growing at five times the average rate of credit unions. Their growth funds millions of dollars in new loans to support the community. In addition, these converted credit unions for the first time are held to an objective standard relative to their service to low-and moderate-income borrowers and low- and moderate-income tracts. And, the federal tax obligation is something they expected to have to face some day anyway.

Concluding Remarks and Observations

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. In the last few years, five billion-dollar institutions announced conversion plans. In the last 10 years almost 40 have made the switch.

Unfortunately, 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."

Recognizing H.R-1151 put handcuffs on credit union growth and diversification, Congress authorized conversions of credit unions to the thrift charter and abolished NCUA's approval authority. 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.

In conclusion, the ability to exit one charter for another at reasonable cost promotes innovation and prevents regulatory turf-building. Our regulated financial system is a system of charters, both state and federal, but also corporate and cooperative. We should think of credit unions, not as isolated, but in the context of the overall financial system.

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?