Converting from a Credit Union

FAX Update

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News for those interested in remaining informed about credit union conversions;

Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco, CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com; Vol. 23 No. 1 **March 18, 2003**

NCUA Rules - Economy

Unleashing a Flood of Credit Union Mergers

Proposed NCUA FOM rules and economic conditions will accelerate the flood of credit union mergers. Therefore, consideration should be given to merging with a mutual bank or even a stock bank as a way of remaining relevant and to transfer value to members, before this decision escapes your control.

The elimination of overlap protection and NCUA's recent sweeping territorial and associational expansion proposal and current practice fuels the rapid shift of member accounts from the smaller credit union to the larger. In addition, the 2002 plunge in investment yields and the small CU's inability to offer competitive loan products leads to falling earnings and, ultimately, regulatory scrutiny. Statistics show large credit unions growing at a much faster rate than the smaller. About 1,000 credit unions now control over 75% of deposits. In order to manage these realities, legislation is being sought to reverse merger restrictions among healthy federal credit unions and regulation is likely to drastically increase NCUA's ability to eliminate small credit unions.

Some large credit unions dismiss the concept of a merger with small credit unions because of the frustration faced in dealing with the social issues. Instead, members of small credit unions are acquired with competitive product offerings, leaving the smaller credit union in an increasingly desperate earnings situation. Consequently, merger contingencies need to be added to the strategic planning of nearly every credit union. To maximize options, credit union managers should investigate the benefits of merging with a mutual or stock bank before willingly, or because of regulatory pressure, handing over capital and membership to another credit union.

Credit union numbers have been declining for almost three decades and in 2002 the total fell below 10,000, after some 300 mergers were completed. Advisors predict several thousand credit unions will be merged or liquidated in the short term. Lacking the lending and technology resources of the large credit unions, the multitude of small credit unions that depended on investment income to pay bills are likely to raise regulatory safety and soundness concerns and continue to drain NCUA's examination resources which are already being scrutinized by the large credit unions and their trade associations. A merger is often the only solution to avoid punitive enforcement action and to remain relevant to members. Recently, NCUA's efforts to raise the "small credit union" designation threshold from $1 million to $10 million (CUNA wants a $50 million level) sets the stage for special handling by NCUA of a much larger group of credit unions and, some believe, with the unpublicized result leading to rules that would accelerate mergers to preserve NCUA resources. ***(Continued on page 4)***

Why Convert to a Bank?

Solid Benefits & CU Handcuffs Lead Some to a Bank Charter

Credit unions convert to a bank charter because of pain or opportunity. Capital issues, product limits, and poor consumer awareness create pain. Expanding service to a growing community, filling voids left by banks and credit unions, and maximizing personnel and infrastructure potential provide opportunities.

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 deposit 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

Conversion to a Federal Mutual Savings Bank

- Member ownership continues
- Vision & Mission maintained
- Positive reception at OTS & FDIC
- Lower capital requirements
- Unlimited field of membership
- SBA & USDA
- Compensation flexibility
- Holding company powers - merger growth
- Full range of products
- RE & Business Loans: trained examiners
- Increased marketplace credibility
- Use of 1% deposit
- Unlimited branching authority
- State law preemption
- Maintain control of future direction

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.

Utah’s Tax Bill Compromise

Taxation Fear Leads to Business Lending Prohibition

In an effort to balance state budgets, legislators in at least five states are looking at taxing large credit unions. The Utah legislature recently introduced a measure to tax the profits of credit unions with assets over $100 million. Credit unions leaders fear the Utah tax legislation will become a model for other states and the US Congress, and divide the credit union movement thus weakening its resolve against taxation. Already, elements of the bill are on the drawing board in other states.

In an ironic twist to the Utah bill, a last minute compromise shut down the business lending programs of the large credit unions targeted by the tax bill, thus adding to the precedent of connecting credit union powers to taxation. Credit union negotiators apparently opted for a lending prohibition versus taxation, putting these large credit unions at a significant competitive disadvantage. The Utah lending restriction could be more costly and have a more profound impact on members than simply paying a tax. Ultimately, a weaker economy (and a desperate legislature concerned about the risks of business lending and tax revenues) could lead to compromises that both tax credit unions and limit powers.

The Utah action is indeed an indicator of what is to come on the National level, as multiple states act to mandate Congressional action on credit union taxation and powers. In short, to avoid taxes, large credit unions will likely face compromises that could lead to further restrictions on powers. Other items on the radar include requiring that “excess” reserves be distributed, dramatic grants of power to influence credit union activities for dissident groups and social organizations, and public disclosure of director and officers financial and travel benefits. Because of the stampede these measures might cause from NCUSIF, it’s a good bet the compromises would come with a moratorium on exiting the fund - a move that would find support at both NCUA and at least one large credit union trade association.

The US Congress in 1998 voted a compromise that put capital and business lending limits on all federally insured credit unions. For those credit unions that found these limits restrictive, Congress provided a streamlined path to the mutual bank charter and FDIC insurance of accounts - a path that is easier to implement than conversion to private insurance.

Converting to a bank charter does require a commitment to pay taxes, but because of the significantly expanded powers and better consumer awareness, credit unions with growth opportunities and the management to seize these opportunities are confident the conversion can be made without compromising member services, independence, and a strong commitment to employees and the community. They reasoned that taxes, like any other business expense, are manageable.

Finally, in some credit union boardrooms, patriotic values, ethical principles, and the negative public relations impact of remaining a credit union and avoiding taxation are being evaluated during the deliberations about converting. Concern has surfaced regarding the public outcry about Enron's and Ingersoll-Rand's effort to avoid taxes by setting up offshore corporations. The public relations "nightmare" created by these events was significant.

The ethics of retaining a tax exemption given the changes in the financial services business was raised in the Utah debate. In Utah, tax revenues for school children was a topic. Many are forced to wonder: Will credit union directors unwittingly be labeled as "anti-American" during the struggle to justify keeping the credit union exemption?

In conclusion, if taxation or some combination of events would lead your credit union to a bank charter, keep in mind the experience of the large credit unions in Utah. Compromise can lead to some unintended results - like the prohibition on business lending - as trade association negotiators and politicians set on keeping everybody happy bargain away your future. Today, the path for a federal credit union to a mutual bank charter is clear and well tested, but a last minute compromise could close the door.

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 author: Alan D. Theriault, President, CU Financial Services, at 800-649-2741.

Flood of mergers (continued from page 1)

By acknowledging these dire realities, before the situation becomes critical, the management of a smaller credit union (under $50 million) can discuss a merger deal from a position of strength, and even gain the benefit of a merger with a mutual or stock bank. In many markets, the merger with a bank increases member convenience because of a larger branch structure and an expanded menu of services. Credit union employees can gain greater health and retirement benefits and job opportunities. Under-funded retirement programs can be repaired.

By merging with a mutual or stock bank the board of directors can continue to play a role, but now as paid advocates of the membership, complete with 15 year retirement programs; and even greater participation is possible by joining a holding company structure and tapping the marketing, capital, technological, human resources, and other efficiencies of the holding company, much like the largest credit union in the world, $75 billion Caisse Populaire des Desjardin. Another option, merging with a stock bank, allows a smaller credit union (under $25 million) to provide members with the opportunity to convert their ownership stake into an equity position that can be transferred to their children or liquidated to increase net worth.

In conclusion, a flood of mergers is inevitable because of NCUA rules and more importantly economic conditions. Some markets are extremely competitive as large credit unions launch programs to acquire members from smaller credit unions. To prepare for the future by considering all your strategic options, including the merger with a bank, contact Alan Theriault at CU Financial Services - 800-649-2741.

For member owned banks

Capital Options Available Today

Mutual banks currently have the ability to increase regulatory capital in a number of ways. The most common method is to form a mutual (non-stock) holding company *[some former credit unions have done this with the help of CU Financial Services]* which would own all the stock of the subsidiary stock bank. The holding company could then get a "commercial loan" from a bank, insurance company, wealthy investor, or pension fund *(by pledging the stock of the subsidiary bank)* and the money could then be down streamed into the bank, thus boosting "core capital".

For holding companies of larger institutions, an alternative is to form a "trust" funded by loans. The "trust" offers shares to institutional investors, and down streams the proceeds to a subsidiary bank creating "core" regulatory capital. Also, for large and small mutual holding companies, stock can be offered to members and the mutual (member ownership) structure is retained as long as the holding company retains 51% of the stock. Variations of the above mentioned techniques exist as well as a couple less popular alternatives.

In conclusion, if your institution is expecting "alternative capital" to be a part of the solution for your future development, you should take steps to convert to the mutual charter <u>now</u>. The process of going from a credit union to the marketplace for regulatory capital requires sound strategic planning, experienced advisors, and time to execute. Call Alan Theriault @ 800-649-2741 for more information.

Consultant to credit unions considering conversion to a mutual savings institution charter.
CU Financial crafted the first state chartered credit union conversion, and is advisor to many subsequent applicants.
Alan D. Theriault, at 800-649-2741; E-Mail: atheriault@cufinancial.com; Web site: www.cufinancial.com
CU Financial Services * P.O. Box 1053 * Portland, Maine 04104 * Telephone: 800-649-2741 * Fax: 202-478-0935

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CU Trades

Stop defections; Sell Hope

Standard operating procedure: (1.) Send a letter to Congress; (2.) Send a press release to the trade press about the letter to Congress; (3.) Have a conference about the letter and press release; (4.) Put dissidents on the conference committee.

Standard operating procedure: sell *hope*; buy another year. Today's hope: rekindle the "Renaissance Commission's" *hope* with the "Regulatory Relief" *hope*. Another year goes by. Meanwhile the risk of doing nothing increases.

Letters and press releases exclaim that the credit union charter has multiple impediments, and the facts prove that the "credit union charter" fails to support the modern day "mission" of a larger progressive credit union. Financial services have evolved, marketplace pressures intensify, and the needs of devoted members have changed. The "mission" has evolved. Management needs a "charter" that supports a modern day "mission".

For over 22 credit unions, the solution was obvious. Convert to a federal thrift / bank charter and obtain a charter that supports a modern day "mission". The thrift charter offers:

- **an unlimited field of membership,**
- **support of real estate and business lending,**
- **capital raising options,**
- **lower regulatory capital requirements,**
- **corporate structure flexibility,**
- **a progressive regulator, and**
- **FDIC insurance.**

Risk of doing nothing

State Credit Union Trap - Charter switch law

The exodus from the federal credit union charter to a state credit union charter in the states of California, Texas, and Florida validate claims that the federal credit union charter no longer supports the "mission" of many credit unions. Many acknowledge, however, a move to a state credit union charter only provides temporary relief; and some predict that a move to a bank charter will soon be necessary.

Unfortunately, the path to convert from a state credit union charter to a bank charter, in many states, is unclear, making conversion impossible without a new state law. Two states just passed laws to make a conversion to a bank possible, but the state rules (influenced by the credit union lobby) make it more costly than conversion from a federal charter. Converting back to a federal credit union charter may be impossible because of narrow field of membership rules, hence state chartered credit unions may find themselves indefinitely, "trapped in a state credit union charter".

In addition, new state laws to provide for conversion to a bank charter would likely be opposed by state credit union trade associations, and onerous provisions are likely to be added to any attempted conversion bills.

Another possible scenario involves state CU Trade Associations bargaining with state legislatures to exchange credit union taxation for laws that would keep credit unions trapped in the state credit union charter. Consequently, state credit unions would be permanently faced with both growth limitations and taxation.

Avoiding a PCA Crises

Members provide more capital; join management in ownership

Organized in 1994, Allied Pilots FCU grew fast, demand for its innovative services was brisk. Pilots and crew members from outside the field of membership wanted to join. Prompt Corrective Action (PCA) would put the brakes on growth, while credit union rules prevented the expansion of services to new pilot groups. Then, the tragedy of September 11 strikes the airline industry, adding to capital and growth concerns.

Management, however, was ready. A plan to convert to a mutual savings bank had been executed just 11 days before the terrorists acts, and a move to increase regulatory capital was underway. By the end of December 2001, members stepped up and purchased shares that qualified for regulatory capital. Now the institution is in a position to more than double in size and to expand its innovative services to new pilot groups.

The net result of the move is to give both members and management a true equity stake in the organization, much like a worker and consumer owned cooperative. (See story below.)

Regulatory Relief

Unlikely for 2002 Session

Although the Republican regulatory relief bill, which is likely to include a few NCUA sponsored provisions, may pass the US House, no companion bill exists currently in the Democratic Senate. Furthermore, during an election year, Senate Democrats are unlikely to allow many Republican victories. Already a list of bills from the 2000 session, and several new initiatives as a result of the September 11 tragedy are stalled. Reality: another Congress, another year; more *hope*.

Best of Both Worlds

Worker & Member Ownership

According to recent articles in the National Cooperative Business Association's monthly newsletter, many companies today are marketing their ownership status as a tool to attract and keep consumer business, and as a tool to keep employees. Brochures talk about the benefits of <u>employee ownership</u>; likewise, many cooperatives, credit unions included, boast about the benefits of <u>member ownership</u>. Surveys show that consumers endorse both marketing pitches.

In practice, the best of both worlds are "member owned" and "worker owned" businesses / cooperatives. But, how can this work with insured financial institutions? With the mutual thrift charter and a mutual holding company. The mutual thrift charter provides the option for organizing a progressive financial institution that benefits both consumers and workers (including directors). At the holding company level employees can share ownership directly, with equity options, or through an Employee Stock Ownership Plan (ESOP). For more information contact Alan D. Theriault at 800-649-2741.

The "Cooperative" Banking Charter

A one day, economically priced ($125) seminar designed to provide up to date information about the mutual bank charter and FDIC insurance.

- Charter differences and business opportunities
- Expanding your boundaries
- Why many are making the move
- Why the opportunity justifies the tax outlay
- Keeping the philosophy alive while serving the community & your members

<u>Call 800-649-2741 for registration or details</u>

February 27, 2002 * Washington, DC (afternoon session)
April 17, 2002 * Boston, MA
May 13, 2002 * Chicago, IL
July 17, 2002 * Seattle, WA
September 5, 2002 * Philadelphia, PA
October 24, 2002 * Denver, CO

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Largest offering to date

Members prepare to acquire stock of Pacific Trust Bank

In a bid to continue to expand its rapidly growing San Diego franchise, Pacific Trust is planning to raise capital from its membership in an offering of equity which is expected to be well over twice the size of the largest offering by a former credit union. It will be the fifth former credit union to raise equity from its membership, after moves by IGA Federal, BUCS Federal, Affiliated Federal, and Allied Pilots.

Raising capital in a stock offering to membership is a way to solve Prompt Corrective Action (PCA) compliance issues. The first part of the solution comes from the lower capital requirements enjoyed by banks. Banks need only maintain a 5% capital ratio versus the 7% requirements imposed upon credit unions. In other words, to stay well capitalized a modeled credit union can only grow to $70 million in assets while a bank can grow to $100 million. The difference in earnings and expanded powers can easily pay the price of taxation.

Should more capital be needed, a mutual can convert to stock (as proposed by Pacific Trust) and in a typical scenario, more than double its current capital. If less capital is needed, partial offerings or debt offerings can be arranged.

Members of a mutual get the first chance to buy stock in a mutual to stock conversion. Stock may also be purchased by a member's retirement account. Well known financial analyst, Peter Lynch from the Fidelity Funds, in his book on investing says the initial public offering (IPO) of the stock of a mutual institution is the common man's IPO because not just the big investors and institutions get to buy in at the bottom as is the case with many IPOs.

Members owning stock in their bank are also known to be strong supporters of bank programs, much like credit union owners support their institution. Those members that fail to buy stock in the IPO continue to maintain "liquidation rights" in the institution. The rights have value similar to the value of the liquidation rights they "owned" as members of the mutual or credit union.

Credit Unions Converted to a Bank Charter

	CU Name * Merged	Assets Mil. est.	Members	Status Mar 1, 2002
1	Affiliated Federal (TX)	47	1250	Bank 6/1/98
2	AGE Federal (GA)	300	41000	Bank 7/1/01
3	Atlantic Coast (GA)	376	41000	Bank 11/01/00
4	AAL Member (WI) *	172	58714	Bank 6/30/01
5	AAL (WI) *	38	8000	Bank 6/30/01
6	Allied Pilots FCU (IL)	92	7500	Bank 9/1/01
7	AWANE Bank (NH)	38	2200	Bank 5/1/96
8	Beacon Federal (NY)	223	34000	Bank 7/1/99
9	BUCS Federal (MD)	85	11306	Bank 3/1/98
10	Carolina Federal (SC)	49	2756	Bank 8/1/99
11	Caney Fork Coop (TN) *	0.3	186	Bank 11/28/00
12	Citizens Community (WI)	113	25000	Bank 12/10/01
13	Community Schools (MI)	35	12316	Bank 2/1/02
14	I.G.A. Federal (PA) *	179	25000	Bank 7/1/98
15	Kaiser Federal (CA)	248	34254	Bank 11/1/99
16	Lusitania SB, FSB (NJ)	126	6517	Bank 9/1/95
17	Ohio Central Federal (OH)	49	16337	Bank 6/1/98
18	Pacific Trust (CA)	309	31223	Bank 1/2/2000
19	Profess. Teachers CU (TN) *	1	536	Bank 7/31/01
20	Rainier Pacific (WA)	464	29900	Bank 1/2/01
21	Roper Employees FCU (SC) *	7	2500	Bank 3/1/01
22	Synergy Federal (NJ)	297	20100	Bank 5/1/98
	Totals	3248.3	411,595	

Former CU

Heritage forms Mutual Holding Company

Heritage Bank of the South, (GA) (formerly AGE FCU) which converted from a credit union July 1, 2001, recently formed a federal mutual holding company to facilitate business acquisitions and to be better positioned to execute combinations with credit unions and mutuals. The move to a holding company structure involved organizing a new depositor owned (mutual) federal corporation and converting the bank into stock form. All of the stock of the bank is owned by the mutual holding company and the ownership interests of depositors are unchanged.

Since Heritage Bank's regulatory capital exceeds 14% *(to be well capitalized a bank need only maintain a 5% capital ratio, while a credit union must maintain 7%),* millions of dollars of capital were left at the

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holding company level to be available to execute business strategies which are off limits to credit unions and banks, like investing in the stock of other banks, and to boost the capital of credit unions which choose to partner with Heritage under the holding company umbrella. The holding company can invest in operating companies, like insurance firms or broker / dealers, which do business with the general public and which can also sell products to bank depositors. Some holding companies even invest in SBIC's, which are venture capital firms, subsidized by the US Small Business Administration.

The primary opportunity that comes with the holding company structure is the growth and savings that result when credit unions or banks merge to generate operating efficiencies. The savings that result can be passed on to depositors, the community, be used to improve the compensation plans, and to improve working conditions of employees. Often services like marketing, internal audit, human resources, data processing, and plant and equipment management can be shared among the subsidiaries. Compensation programs and management contracts can be strengthened by the holding company entity.

Heritage joins $1.8 billion Guaranty Bank (WI) and $7 Billion Third Federal Capital (OH) in offering credit unions an alternative to the typical credit union to credit union merger. The merger models of these progressive mutuals include guarantees that the "credit union" philosophy which applies to members, employees, and the community will be retained. In addition, programs are designed to keep former credit union directors involved and to compensate them in accordance with Bank director compensation and retirement programs.

CU Financial Services and the advertisers in this newsletter are advisors to these progressive institutions. For more information please call Alan Theriault @ 800-649-2741.

Coast to Coast Services

Guaranty Bank is seeking to partner with credit unions

Guaranty Bank is an $1.8 billion mutual savings bank in Milwaukee, Wisconsin with a national lending operation. Fifty four branches in Illinois and Wisconsin deliver competitive deposit and loan services to the communities covered. Four subsidiaries operate in 32 states providing first mortgage and home equity products. For example, a satellite office in California originates over $1.3 billion in mortgages, while an office in Massachusetts brings in over $600 million. A skilled team of secondary market professionals work daily to hedge a mortgage pipeline larger than the lending volume of credit unions and banks many times Guaranty's size. The unique lending and deposit acquisition programs are successful because of the focus on the member and the entrepreneurial spirit of the employees.

As validated by the recent merger announcement of the second and third largest credit unions in Canada, *(see related story on page 3)* Guaranty's management expects merger interest among credit unions on this side of the border will increase. Therefore, programs are being put in place to help facilitate discussions with credit unions large and small. In addition, programs and joint ventures are being designed to help deliver quality loan products, like mortgages, home equity loans, and business loans to credit union members.

Guaranty's holding company structure will permit a credit union to combine with Guaranty, tap the products, services, capital, and support structure, yet remain an independent entity retaining its own name, management, and board of directors. The holding company provides a structure for raising regulatory capital, without becoming a publicly owned bank.

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CU Trades

Do they define your mission correctly?

Dan Mica says that banks and Congress have "defined" a mission for credit unions that restricts growth and leads to taxation. So, credit union lobbyists are busy trying to "redefine" the mission and reverse the impact. Thus, the political "spin" argues that credit unions exist to serve the low income and that directors should not be paid. What are the consequences of the CU trade "spin"?

Does your credit union fit the mission that's being defined by Dan Mica? Will the rhetoric lead to more scrutiny of your operations by nonprofit groups looking for your support (funds)? Do your members agree that their credit union's mission is to serve low income people and neighborhoods? Would paying your directors lead to more or less benefits for members and management? Is business lending within the fabric of the credit union mission? Is NCUA equipped to supervise the credit union push into commercial lending? Do consumers fail to understand credit unions because of the name? Is your capital sufficient to support growth and seize opportunities? These questions are being asked.

For decades, commercial banks were known for commercial loans and deposits, thrifts for their community focus and real estate lending, and credit unions for unsecured lending and payroll deduction. Today missions overlap and product lines are blurred, but success follows a clear definition of "mission"; and an institution should seek a charter that supports its mission.

Progressive financial institutions recognize that a "charter" or business license should follow an institution's mission and business. That's why thrifts convert to commercial bank charters and commercial banks to thrift charters. That's also why credit unions convert to thrift charters. *(Since bank directors are compensated, and credit union directors are not - the occasional bank to a credit union conversion is an aberration.)* Rather than investing political effort on "charter renaissance", banks just jettison the inappropriate charter for one that better supports its mission.

Should your institution be paying its directors, making more business and real estate loans, expanding its geography, increasing regulatory capital, buying banks, benefiting from the merger wave, or getting more mileage for your marketing efforts? If so, maybe your mission is better supported by a bank or thrift charter. To learn more, call Alan Theriault @ 800-649-2741.

Starts with Education

Webinar - Get the facts from the phone and your computer

Although the mutual charter may not be appropriate for every credit union, education is the first step to learning whether the charter might work for your institution. By utilizing a high speed Internet connection and a voice conference call, CU Financial can bring to your management team or board of directors the information and talent needed to get up to speed regarding this emerging credit union charter option.

The "Webinar" as it is called by some, is a multimedia / interactive seminar that brings the presenters to your offices in a cost effective way. The typical configuration involves gathering your participants in a conference room equipped with a data projector, computer, high speed Internet access, and a conference phone. Prior to the meeting, CU Financial provides you with a secure web link via e-mail, and delivers handouts by express mail. The link takes you to a computer in the offices of CU Financial. A telephone call connects your participants with the voices of a CU Financial executive, a Washington attorney experienced with the conversion process and, if desired, an executive from a converted mutual. You learn the facts - your questions get answered - you connect with those that can help you act. Simple. To schedule your private "Webinar", call Alan Theriault at 800-649-2741.

Sign of the times

Giant Canadian CU Merger

Directors of the second and third largest credit unions in Canada just announced their agreement to merge driven, in part, by the need to generate competitive efficiencies and increase market share. The resulting institution will have combined assets of around CA$6 billion.

Although US rules prohibit merging most healthy US credit unions, the economics driving the merger trend are the same in the states. US credit unions are also no stranger to mergers as the number of credit unions are expected to drop below 10,000 this year after peaking at around 22,000 just over two decades ago.

US credit unions of any size, however, are permitted to merge with mutual savings banks, and four such mergers have occurred; others are being contemplated. Credit unions that would consider a merger with a mutual include those with multi-state operations which face diminishing returns from serving their primary sponsor and select employee groups. Also, those wanting to more efficiently break into serving their community by improving consumer awareness are interested in the trend.

For credit union managers that recognize a merger is inevitable, making a deal with a mutual enhances benefits for members, employees, and directors. The healthy credit union can deal from a position of strength and negotiate benefits for membership, plus an assumption of more liberal employee compensation plans. The compensation and retirement plans enjoyed by the directors at the mutual may also be assumed by the credit union directors; hence providing another tool for getting a merger proposal off the board room table.

Are you prepared

Growth Can Be Nonlinear

We've all seen the charts with the positively sloped line depicting steady consistent asset growth. However, the fastest growing institutions often grow very differently. For these institutions being ready to take advantage of an opportunity, be it a merger or expansion into a new area, results in a leap that lifts the growth line to a new level.

So it can be for credit unions making the move to the mutual thrift charter. The thrift charter permits acquisitions of banks and bank branches and mergers with other mutuals and credit unions. It also permits alternative capital which can support nonlinear growth. It also permits the holding company structure which is similar to the structure employed by Canadian credit union Caisse Populaire des Desjardins in Quebec, Canada. This $75 billion assets credit union is several times larger than the largest credit union in the US, and it even operates a federally chartered thrift in the United States.

CUNA's Bill Hampel explained during a recent debate reported by CUNA'a "News Now" that, "..., our (credit unions') competitive advantage does not derive power from our tax exempt status." The former credit union managers that moved to a mutual charter and assumed the tax obligation along with many managers of taxable credit unions in Canada and Australia would agree with Hampel. Some would argue that the tax exemption was actually a hindrance. Canadian credit unions enjoy a significantly higher market share vs. their US counterparts, validating the claim that US credit unions pay a "hidden tax". The preoccupation with the tax exemption, in the eyes of some, is a crutch that ultimately supports mediocre linear performance. Building a business model dependent on a tax subsidy is risky business, they argue.

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FAX Update

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Looming?

CU Public Relations Debacle & State Taxation Threat

Is it anti-American for Enron to avoid taxes by setting up offshore corporations? Or, a company, like Ingersoll-Rand to reincorporate in Bermuda to avoid taxes on foreign income? Some think so according to a recent article in Institutional Investor. "I find it appalling. I think the term 'Benedict Arnold' is appropriate," said Jack Bogle, founder of Vanguard Group, the country's second largest mutual fund company. "Companies can rationalize the moves legally. They can rationalize them financially. But some critics say there are greater values and principles at stake than saving a few million in taxes," the article continued.

With many states struggling to find revenues to fund "homeland security" and education costs; and to replace revenues because of bankruptcies and taxation limitations, state chartered credit unions are listed as potent sources of tax revenue, according to recent reports in the Credit Union Times and CUNA News Now. Massachusetts and Texas are among the states targeting state credit unions. In the past, some Utah legislators have said that state credit unions are failing to do their share to fund education, forcing teachers to use their own money to buy school supplies. Abundant levels of capital and rhetoric about wanting to serve the under-served are also attracting the attention of social groups looking for their slice of credit union prosperity.

Some directors of credit unions that converted to the thrift charter considered the ethics of retaining a tax exemption given the changes in the financial services business. They reasoned that taxes, like any other business expense, are manageable. Many believe that the US credit union tax exemption is part of the reason US credit unions have captured only a tiny market share, while Canadian credit unions, which are taxed, enjoy a much higher market share. Indeed, US credit unions face a "hidden tax".

Public outcry about Enron's and Ingersoll-Rand's, effort to avoid taxes by setting up offshore corporations created public relations "nightmares" in the corporate boardroom. Will credit union directors unwittingly be labeled as "anti-American" during the struggle to justify keeping the credit union exemption? Banks, thrifts, and business cooperatives consider it part of their "social mission" to support the country's infrastructure by paying taxes. In some credit union boardrooms, the patriotic values and principles at stake by remaining a credit union and avoiding taxation are being visited during the deliberations about converting to the mutual charter.

	CU Name	Assets	Members	Status
	* Merged	Mil. est.		Apr 10, 2002
1	Affiliated Federal (TX)	47	1250	Bank 6/1/98
2	AGE Federal (GA)	300	41000	Bank 7/1/01
3	Atlantic Coast (GA)	376	41000	Bank 11/01/00
4	AAL Member (WI) *	172	58714	Bank 6/30/01
5	AAL (WI) *	38	8000	Bank 6/30/01
6	Allied Pilots FCU (IL)	92	7500	Bank 9/1/01
7	AWANE Bank (NH)	38	2200	Bank 5/1/96
8	Beacon Federal (NY)	223	34000	Bank 7/1/99
9	BUCS Federal (MD)	85	11306	Bank 3/1/98
10	Carolina Federal (SC)	49	2756	Bank 8/1/99
11	Caney Fork Coop (TN) *	0.3	186	Bank 11/28/00
12	Citizens Community (WI)	113	25000	Bank 12/10/01
13	Community Schools (MI)	35	12316	Bank 2/1/02
14	I.G.A. Federal (PA) *	179	25000	Bank 7/1/98
15	Kaiser Federal (CA)	248	34254	Bank 11/1/99
16	Lusitania SB, FSB (NJ)	126	6517	Bank 9/1/95
17	Ohio Central Federal (OH)	49	16337	Bank 6/1/98
18	Pacific Trust (CA)	309	31223	Bank 1/2/2000
19	Profess. Teachers CU (TN) *	1	536	Bank 7/31/01
20	Rainier Pacific (WA)	464	29900	Bank 1/2/01
21	Roper Employees FCU (SC) *	7	2500	Bank 3/1/01
22	Salt City Hospitals FCU (NY) *	8	4000	Pending
23	Synergy Federal (NJ)	297	20100	Bank 5/1/98
	Totals	3256.3	415,595	

Myths vs reality

Alternative Capital for CUs?

Fast growing credit unions, large and small, are anxiously following developments related to alternative capital for credit unions. Credit unions hovering around 7% capital levels are learning that NCUA must act decisively to sanction violations - its the law. Banks only need 5% to be well capitalized and the difference results in a competitive disadvantage - a "hidden tax". Credit Union trade associations continue to offer "hope" that "alternative capital" is a possibility, despite NCUA's insistence that under federal law it is not.

2 Even if “alternative capital” was a possibility for credit unions, a critical questions remains unanswered. Who would buy these uninsured investments in the regulatory capital of a credit union? Members? Other credit unions? Corporates? The answer is none of the above.

Members: offering the investment to members, likely would only be possible by following strict disclosure rules established by the Securities and Exchange Commission (SEC). Offerings of this sort are likely to be economical for only the largest credit unions, say over $100 million, because of cost and liquidity considerations, and only to the wealthiest members. During the savings and loan crises a certain California thrift, that failed, offered “alternative capital shares” to depositors and many unsophisticated investors suffered. Congress is unlikely to set the stage for a replay. Even if it did, credit union directors and CEOs may want to think long and hard about the risks of this scheme. The CEO of the unnamed California thrift spent time behind bars.

Other Credit Unions & Corporates: No again. The Federal Reserve Board would come “unglued” by a NCUA sponsored program to “daisy chain” insured deposits into capital of credit unions. Banks are prohibited from such activities because of the systemic risk to the insurance fund.

Potential sources might include, public investors, insurance companies, foundations, trusts, mutual funds, etc. However, they are often prohibited from owning more than 5% of any single investment offering with the dollar amount limited to no more than 5% of the investor’s funds; minimum investment levels and industry concentration limitations might also apply. Consequently, obtaining suitable amounts of investment capital, from these sources, will involve a significant distribution effort; and since credit unions remain largely unknown and misunderstood among investors, the amount of lifting to go from the concept of “alternative capital” to the reality could be paramount.

What about mutual banks?

Mutual banks currently have the ability to increase regulatory capital in a number of ways. Size and structure limitations do exist and finding investors remains an issue, but today its being done. As a mutual bank, subordinated debt may be offered, but it only counts as capital to meet the risk based capital requirement - not the “core” minimum of 5%. A mutual bank, however, may form a subsidiary (REIT) funded with mortgages and offer investments in the subsidiary with the result of generating “core” capital. From a cost, liquidity, and marketing perspective, the minimum size offering Wall Street pays attention to is $20 million; and since the offering generally can’t exceed 25% of resulting “core” capital, only the near billion dollar credit unions could play in this game.

The route that works for smaller mutuals is to form a mutual (non-stock) holding company *(a couple of former credit unions [with the help of CU Financial Services] have done this)* which would own all the stock of the subsidiary stock bank. The holding company could then get a “commercial loan” from a bank, insurance company, wealthy investor, or pension fund *(by pledging the stock of the subsidiary bank)* and the money could then be down streamed into the bank, thus boosting “core capital”. Some limitations exist, but the dollar amounts of borrowing would be more manageable - even in the million dollar range.

For holding companies of larger institutions, an alternative is to form a “trust” funded by loans. The “trust” offers shares to institutional investors, and down streams the proceeds to a subsidiary bank creating “core” regulatory capital. Also, for large and small mutual holding companies, stock can be offered to members and the mutual (member ownership) structure is retained as long as the holding company retains 51% of the stock. Variations of the above mentioned techniques exists as well as a couple less popular alternatives.

3 In conclusion, if your institution is expecting "alternative capital" to be a part of the solution for your future development, you should take steps to convert to the mutual charter now. The process of going from a credit union to the marketplace for regulatory capital requires sound strategic planning, experienced advisors, and time to execute. To get the facts about these and other opportunities for your institution, including joining a "federation" of former credit unions with economies of scale and ready access to capital, please call Alan D. Theriault at (800) 649-2741.

Not so fast

"I'll convert just before retirement?"

The CEO of a credit union recently joked that right before retirement she would convert the credit union to a stock institution and "cash-out"; implying conversion is a "get rich quick scheme" for management. In fact, management benefits may take as long as 7 to 10 years to phase in *(and must be disclosed and voted on by the membership)* before the benefits of a stock conversion are maximized. Furthermore, much of the value must be earned by increasing the performance of the institution.

After converting to stock, your neighbors, friends, and credit union members are the stockholders. This means they start being more concerned about the price of the stock than the cost of designer checks. *(They also recognize that the more business they give the institution (which they own) the better the stock price.)* Your salary becomes public information. Your directors start reading the meeting materials and miss fewer meetings. Some will even ask questions. All will ask where the stock is trading.

The mutual charter or the stock banking charter may not be appropriate for all credit unions. Misinformation about these strategic options is sometime circulated by groups that fear the loss of revenues when a credit union converts. Before casually discounting the effort, the risks, or the benefits, and criticizing those that have, please be informed. You may be surprised that your membership will value your pioneering efforts, and thank you for helping to make a significant contribution to their net worth. If you want to learn more call Alan Theriault @ (800) 649-2741.

Cost Cutting

OTS Moves to Streamline Examinations

CU Financial Services, because of its experience in advising a majority of those converting to the thrift charter, was recently asked by The Office of Thrift Supervision (OTS) for ways to streamline the process of a credit union conversion to a mutual charter.

In addition to improving the credit union conversion process, the OTS, the primary regulator of most converting from the credit union charter, is planning to combine its consumer-compliance exam with its overall examination. Thrifts will perform their own "self-evaluation" on compliance issues before the official OTS examiner completes the general exam for safety and soundness. The OTS has kept the compliance and safety-and-soundness exams separate for over 10 years. The new move is part of a cost-cutting effort at OTS. However, depending on conversion volume, the time table for converting is not expected to increase.

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Phantom CAP

CUs Face CRA without Rules

Despite CAP's repeal, credit unions are now facing an unwritten regulation that has replaced CRA "lite" and the result could lead to an imposition greater than banks face with CRA. The impact could lead to lower CAMEL ratings for those that fail to follow the NCUA Board's unwritten cues and field examiner guidance, which some complain is inconsistent.

The "Phantom CRA" rules were recently stated by CUNA's Mica who said the repeal of CAP "in no way diminishes the responsibility credit unions have, and one we readily accept, to serve all within our entire fields of membership, including those with low and moderate incomes." In a separate statement, NCUA's Dollar warned that credit unions, "have to put their money where their mouth is by establishing and maintaining a physical presence" in the dozens of low-income communities they have added to their FOMs over the past two years.

In contrast with bank CRA, a body of regulation and practice is in place so that an institution can self-evaluate compliance, and even the most negative rating does not affect a CAMEL rating. (Only a tiny fraction of banks fail CRA tests.) The rhetoric by credit unions to defend their CRA performance also is raising the antenna of social groups looking for their slice of credit union prosperity.

List exceeds two dozen

Two more file to convert to a mutual savings bank

Two credit unions, one on the West Coast and one on the East Coast recently filed to convert to a federal mutual savings bank. The list of credit unions making the move now exceeds two dozen. Both of the credit unions making the move, $125 million Credit Union of the Pacific (WA) and $25 million Northeastern Engineers Federal Credit Union (NY) are active real estate lenders seeking to maintain a successful lending philosophy, increase services, and expand their geography.

A credit union conversion to a bank charter is still a pioneering move although many expect it will become a contagious idea. As advisor to the majority of credit unions making the move, staff of CU Financial Services are often asked: why aren't more credit unions converting? The answer is best explained by what sociologists call the diffusion model, which, "according to the authors of "The Tipping Point", is a detailed, academic way of looking at how a contagious idea or product or innovation moves through a population.

The authors use the example of a new corn seed introduced in Iowa in 1928. Although superior to seed used by farmers for decades before, it took many years for the new seed to be widely accepted. First the "Innovators", the adventurous ones, led the way followed by the "Early Adopters", or opinion leaders, those respected, thoughtful people who watched and analyzed what those wild "Innovators" were doing, then followed suit. Then came, the "Early Majority" and the "Late Majority", the deliberate and skeptical mass, who would never try anything until the most respected of the farmers had tried it first. They caught the seed virus and passed it on, finally, to the "Laggard", the most traditional of all, who see no urgent reason to change. Plotted on a graph, the corn seed example formed a perfect epidemic curve - starting slowly, tipping just as the "Early Adopters" started using the seed, then rising sharply as the "Majority" catches on, and falling away at the end when the "Laggards" come struggling in.

The book and the corn seed research does a good job explaining innovations that find their way into credit union practice from checking accounts to business lending. However, unlike the corn farmers, the credit union "Majority" may face the risk that the bank conversion innovation gets derailed by credit union trade associations and others, like NCUA, who fear their jobs are on the wrong side of the curve. The memory of NCUA's 1995 onerous conversion regulations should be a lesson about what some will do to protect their economic turf.

Reg Relief

CUNA Says Pay Volunteers - Allow the Public to Invest

In an about face, CUNA lobbyists are now arguing that credit union directors should be paid and that the public should be able to invest in the equity of credit unions. During the HR-1151 debates, a few years ago, CUNA claimed that volunteer directors and the prohibitions against equity capital justified the credit union tax exemption. It is what makes credit unions different than banks was the claim. A few state laws permit a modest payment to directors.

Today, CUNA's new positions validate the actions of the 22 credit unions that converted to a bank charter. Bank directors are paid and mutual savings banks may access alternative capital. Credit unions, however, remain at a competitive disadvantage because they must operate at higher capital levels and because they are penalized for real estate and business lending. Some describe these limitations as: the "hidden" credit union tax.

CUNA's arguments in favor of alternative capital and director compensation mirror the reasons banks pay directors and tap the capital markets. The lobbying should help silence the few critics who claim that conversion to the bank charter is motivated by greed. Meanwhile, members continue to approve conversion to the bank charter and subsequent capital raising efforts.

The House Regulatory Relief Bill which proposes these bank-like revisions to the Federal Credit Union Act must still get approval from the full House of Representatives. Even with the approval, the bill lacks a companion measure in the Senate and the credit union provisions are opposed by some former credit union allies and others, including smaller credit unions. In brief, as reported in the February edition of this newsletter, "Regulatory Relief" is a dead issue for this Congress. Key credit union allies oppose CUNA's position. The Democrat controlled Senate lacks an interest in the measure. The Senate is unlikely to support anything which might look like a Republican victory.

Unfortunately, even if efforts to pay credit union directors succeed, some aging credit union directors will lose out. The bill proposes allowing a mandatory retirement age and limits compensation to only those directors that are gainfully employed.

On the Defense

Preparing to Compromise

In what is promoted as a victory for credit unions, CUNA recently hired a tax specialist who used to work for the ABA. The hiring is an indication that CUNA may be preparing to compromise about taxation. The weakening economy and increasing state and federal deficits and costs puts credit union net income on the political radar making its defense difficult both politically and morally. In some states, school teachers are lobbying to tax credit union profits in order to help improve student welfare. Police chiefs are likely to be lobbying for funding to better protect and defend against terrorist action.

3 Capitol Hill is the land of compromise. Compromise may bring some surprises for growing credit unions. For example: if credit unions are taxed, some say the major advantage of the credit union charter will disappear causing a mass exodus to the mutual bank charter. Knowing this, CUNA, NAFCU, and NCUA are likely to promote a moratorium on conversions in order to protect the insurance fund and their jobs. Greater credit union powers may result, but these powers will not match bank powers, and the consumer confusion and awareness related to credit unions will remain. Furthermore, how then will a credit union justify its conversion to a bank charter once any apparent advantages disappear? At that point the argument that the move to a bank is motivated by greed becomes easier to substantiate. Who will lobby for the progressive credit union's right to become a bank? The bank lobbyists will consider credit union taxation a victory, and the loss of dues revenues from a credit union turned bank will be the sacrifice. Hence, the credit union team that expects to evolve into a bank will be trapped in a credit union charter. The lesson: the "right moment" to convert may never arrive.

Alternative capital critical for some

42% of NAFCU Members Would Need to Raise Capital

A recent survey of NAFCU members concluded that an astounding 42% expect to need capital soon in order to maintain growth, to meet Prompt Corrective Action Requirements (PCA), and for various other reasons, the Credit Union Times reported. CUs must maintain a higher capital ratio than banks and are prevented from accessing the capital markets without converting to a bank charter, a move a few credit unions have made.

The weak stock market and the war against terrorism generated a flood of deposits into progressive credit unions causing capital ratios to drop into the caution area. Also the accelerating trend of member migration from smaller credit unions to larger credit unions, in order to obtain enhanced services, puts pressure on the capital ratios of the larger, many of which are NAFCU members.

A few credit unions solved the capital problem by converting to a bank charter and by asking members to invest in an Initial Public Offering (IPO). Others converted and organized a holding company which is authorized to borrow money that could be downstreamed as regulatory capital.

Like the adage that money is easy to borrow when you don't need it - capital is easy to get when you don't need it. The process of converting to a bank and accessing the capital markets takes time to prepare and execute. Best to Call CU Financial Services today if you suspect that you may need regulatory capital in the next few years.

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Former CU: Pacific Trust

Over $60 Million Raised in IPO

$300 million Pacific Trust Bank, a federal credit union until January 2000, recently tripled its capitalization in an oversubscribed offering. Like other converting credit unions, the stock promptly traded at a 20% premium generating a good gain for participating members.

The $60 million in new regulatory capital raised allows the former credit union to grow to four times its former size as a credit union - to over $1 billion in assets. Pacific Trust Bank is a community-oriented federal savings bank operating through eight full service offices located in San Diego and Riverside Counties in California. The community benefits of fresh capital can be measured in many ways including expanded locations, more loans for businesses and developers, and additional growth opportunities for existing and new employees.

The shares of First Pactrust Bancorp, Inc., a holding company organized to facilitate the offering and the growth of the business, is traded on the NASDAQ National Market System under the symbol "FPTB". The subscription offering was managed by Keefe, Bruyette, & Woods, Inc. Silver, Freedman & Taff, L.L.P. acted as special counsel to the Bank. CU Financial Services was advisor to Pacific Trust FCU during its conversion from a credit union.

In a public statement, the Board of Directors, Officers and Employees of Pacific Trust Bank and First PacTrust Bancorp, Inc. expressed their gratitude for the overwhelming support for the offering by their customers, pledged their best efforts toward the opportunities ahead, and looked forward to serving the needs of their customers and new stockholders.

CEO & Directors:

Salary imbalance is corrected by converting to a bank

Currently, for the same reasons banks pay directors and tap the equity markets, credit union lobbyists are pushing for changes to the credit union paradigm (and laws) that prevent appropriate officer and director compensation and access to the capital markets. These efforts validate the efforts by the two dozen credit unions that converted to a bank charter, those that are planning the move, and the dozens which moved or are planning to move to private insurance.

Across all peer groups, salary surveys report that credit union CEOs are paid much less cash compensation than Bank CEOs. For example, according to numbers reported in Credit Union Magazine, the CEO of a $100 million credit union earns 39% less compared to a Bank CEO; for credit unions over $1 billion in assets the number is 57%. The gap (about 20%) is smaller for credit unions between $100 million and $1 billion. Similar comparisons apply to other senior managers, and the gap widens when comparing retirement benefits.

Poor market share and an industry preoccupied with addressing political issues like field of membership overlaps or generating the appearance of serving the underserved, to retain a tax exemption, are in part the consequence of these compensation gaps. In contrast, according to credit union industry reports, banks control over 97% of deposits and dominate the mortgage market, a key service demanded by younger members. In addition, banks are expert in service to low and moderate income groups with over 98% obtaining "satisfactory" or "outstanding" ratings after CRA examinations.

Correcting the compensation imbalance will require a broad based paradigm shift, starting with director compensation; after all, getting a raise from an unpaid director is destined to meet with resistance. Credit union regulators too may put up barriers. Daily talk about the “nonprofit structure” and “service to members” influence a culture that promotes an artificial ceiling on management compensation. Rather than fight current credit union paradigms and risk getting trapped in a charter that fails to address a current mission, (see related story) or the future needs of members, some management teams have converted their institution to a mutual bank or stock bank charter. As a stock bank, long time credit union members are given the opportunity to capitalize on the equity build up, while continuing to have an ownership stake. Management, including directors, get to be compensated like bankers and executives from other industries. As a mutual bank, the cooperative ownership structure remains, but the competitive disadvantages of credit unions, like consumer awareness, lack of access to capital, penalties for real estate and business lending, and the statutory requirement to hold more capital go away. Compensation methodologies can mirror what’s in place at stock banks, thus correcting an imbalance.

Members vote to convert to a stock bank because they are able to significantly increase their net worth by purchasing shares as part of the initial public offering (IPO). Directors and management are also able to access the IPO shares on the same basis as members.

[EDITORS NOTE: Feb. 2006 - The above is a single article within the context of nine years of newsletters posted on this web site containing hundreds of additional pages of educational material related to conversions. Parts of this article have on occasion been taken out of context, altered, and reprinted (without permission) by critics of the conversion process. Therefore, I have withdrawn the paragraphs often misused. The context of this article should be viewed in light of discussions and press reports, at the time of the writing and among credit union leaders, related to safety and soundness concerns because of the inability of some credit unions to pay directors. Federal credit unions are permitted to pay only one member of the board of directors, although some federal credit unions will rotate the position so over time every member can be paid. State chartered credit unions in at least 12 states are allowed to pay their directors. Credit union leaders were complaining about how difficult it was to attract talented (unpaid) replacement directors because of the increasing complexity and risks involved in running a credit union. Also, some complained that many of these unpaid directors failed to recognize how difficult it is to attract management talent because credit unions lack the compensation tools available to banks. Currently, a national credit union trade association is seeking to change the rules so federal credit unions can pay their directors.

That being said, the critics of conversion are hoping to generate the illusion that this firm uses this article like a carrot - luring the donkey to the conversion table. It is reprehensible that these critics would insult and

Conversion to a Federal Mutual Savings Bank

- Member ownership continues
- Vision & Mission maintained
- Positive reception at OTS & FDIC
- Lower capital requirements
- Unlimited field of membership
- SBA & USDA
- Compensation flexibility
- Holding company powers - merger growth
- Full range of products
- RE & Business Loans: trained examiners
- Increased marketplace credibility
- Use of 1% deposit
- Unlimited branching authority
- State law preemption
- Maintain control of future direction

even defame their peers by such ridiculous assertions. Maybe the critics are the ones so easily misled?]

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

FDIC and Private Insurance

Defections Raise NCUSIF Concerns

Some credit unions with NCUSIF insured deposits are leaving the NCUSIF for private insurance or FDIC insurance. Recently, members of $2.8 billion Patelco Credit Union (CA) voted to abandon NCUSIF making the credit union the largest defection to date. Others are expected to follow. Almost two dozen credit unions have converted to FDIC insurance by moving to a bank charter. The conversion to private insurance (or FDIC) facilitates mergers, a move to a commercial bank charter, and/or the issuance of capital stock since NCUA loses its jurisdiction over an institution once it is privately (or FDIC) insured.

Defections from the NCUSIF fund reduce NCUA revenues and may weaken or destabilize NCUSIF. Some claim the moves also help make the case for taxing credit unions. NCUA Board Member Deborah Matz criticized Patelco's move and implied that private insurers might not be able to cover large losses. She said, "I am not sure depositors fully understand the distinction between private insurance and having the backing of the full faith and credit of the U.S. Government." Most states require credit unions and banks be federally insured.

Many claim that if credit unions are taxed, a flood of conversions to banks would occur. Unfortunately, larger credit unions, which are the most likely to be taxed and the first to convert, also provide the core financial support to the NCUSIF. Hence, to prevent destabilizing NCUSIF, taxation may arrive with a moratorium on conversions - thus trapping many in a taxpaying credit union charter. Faced with the prospect of taxation - credit union trade associations are likely to argue in favor of preventing bank conversions to "protect" NCUSIF. Bank trade associations are unlikely to invest much effort to prevent such a moratorium; therefore, those hoping to convert to a bank may be disappointed. A precedent restricting switching insurance funds has its roots in the old savings and loan fund, which for many years prevented savings banks from moving to the "bank insurance fund" and ultimately required payment of high premiums and expensing a 1% recapitalization deposit.

State and Federal Deficits

Taxation? More NCUA Scrutiny

State chartered credit unions across the country are facing the prospect of state taxes and more scrutiny by NCUA. Also, federal budget deficits because of reduced tax revenues and spending pressure for military activities and homeland defense, make all large credit unions a target for federal income taxes. Those seeking tax revenues from credit unions view efforts to retain a tax exemption as unpatriotic and claim that school children are being deprived of needed resources as well. The publicity may result in embarrassment for some credit union directors.

NCUA has made it clear that it intends to make sure state chartered credit unions continue to be supervised in the face of state budget cuts. Speaking to a group of state chartered credit unions and regulators, NCUA Director Deborah Matz expressed concern about the impact budget shortfalls in the states could have on the dual chartering system. Many states are facing budget cuts, Matz said, but that should not keep state regulators from continuing to examine state-chartered credit unions as in the past. She asked state regulators to "do what you can within your state bureaucracy to keep every penny that credit unions contribute for regulatory oversight and to work closely with NCUA." She emphasized that NCUA examiners are "ready, willing, and able" to help "when state treasuries are low." Some believe that NCUA's efforts to justify the overhead transfer rate and handle over staffing will result in greater NCUA involvement during the examination process of state chartered credit unions.

Converting from a Credit Union

FAX Update

Also consultants on matters pertaining to Business Lending * Regulatory Enforcement * Mergers * CUSO Organizations

News for those interested in remaining informed about credit union conversions;

Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco, CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com; Vol. 22 No. 7 **October 25, 2002**

CU of Pacific

Members Overwhelmingly Support Bank Conversion

Typical of the almost two dozen bank conversions to date, members of Seattle based CU of the Pacific overwhelming approved a move to the bank charter. Eighteen percent of the members voted: result 77% in favor. Compared to many member referendums the response was strong. Clearly a poll of 18% of the members provides a sound indication of the will of the membership. Frequently, political commentators declare the will of the voters by a sample smaller than 1%.

Nevertheless, credit union trade associations are pushing a few members of Congress to require a minimum quorum of as high as 50% - the level imposed by NCUA in 1995. In 1998, as part of HR-1151, Congress decided it was sound public policy to allow credit unions to convert to banks, thus providing the flexibility to escape credit union growth & product restrictions and assume a tax obligation. In addition, legislation is being sought to prevent compensation to directors after converting to a bank. Since banks typically compensate their directors, such restrictions would handicap those seeking to execute mergers or accelerate their service to the community by tapping the capital markets to fund expansion.

Large CUs Only:

Mica Calls for D.C. Meeting

The CEOs of large credit unions are expected to travel to Washington, DC in early November for a special CUNA briefing, and likely an appeal for unity, constraint, and money. During the 2003 session, large credit unions will be a target on Capitol Hill and in many state capitals. Consumer groups, bankers, and the IRS will question whether larger credit unions are doing enough to justify their tax exemption. Hence, certain members of Congress are sending signals that they are likely to introduce credit union legislation during the 108th session. In the Senate, Banking Committee Chairman, Paul Sarbanes, D-Md, recently ordered a GAO study of credit unions, a signal that the Senate may consider a bill.

Clearly, large state chartered and federally chartered credit unions are under the microscope of both banks and consumer groups. Large community chartered credit unions continue to grab members from smaller credit unions accelerating their demise as the total number of credit unions now falls below 10,000. Taxation, however, is viewed, by the CU trades as the number one threat to the credit union system, despite the fact that credit unions in other countries pay taxes and are thriving, and that smaller credit unions would continue to be tax exempt. Among the legislative risks faced for progressive credit unions includes taxation, few new powers, and being forced to remain in the NCUSIF fund. (See related story below.)

Is a Bank Charter in Your Future?

GAO Study may lead to Conversion Moratorium

In September the Senate Banking Committee Chairman Paul Sarbanes, D-Md, ordered the Government Accounting Office (GAO) to conduct a study of credit unions. Some believe the study could be a first step toward a Senate bill to re-characterize large credit unions in order to gain tax revenues and appease bankers. In contrast to the tax discussions during the budget surplus year of 1998, when HR-1151 was debated, the next Congress faces deficits. Congress and many state legislatures are likely to be turning over every stone in search of tax dollars.

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According to political observers, a proposal resulting in taxes affecting just 10% of the credit unions is likely to surface. Although numbering only 1,000, these credit unions are the most profitable and fastest growing. Controlling about 75% of credit union assets, their profile deviates from the median credit union. Many are capturing market share from the smaller 9,000 credit unions, alienating that group. Without the support of the 9,000; and, facing banking groups efforts to "limit competition"; this small group of fast growing credit unions *(likely re-characterized as "credit associations")* may end up getting squeezed into a box resulting in taxation and only modest new powers. Mutual savings banks had to wait over 20 years after being taxed before gaining any significant new powers.

In addition, because the group provides substantial support for NCUA and the NCUSIF, the legislation may include prohibitions on leaving the NCUSIF, in order to preserve the safety and soundness of the fund. *(The precedent: savings banks were prevented from leaving the Savings Association Insurance Fund (SAIF).)* Already NCUA is expressing significant concern about $2.8 billion Patelco Credit Union's (CA) shift to private insurance. Consequently, the many credit union executives that threaten to convert to a bank, if taxed, may find themselves trapped in a less desirable "*credit union like*" charter. Who will argue their case for conversion to a bank? Credit union trade associations and the NCUA will be content with the status quo. Smaller credit unions, with the pressure for taxation gone, will have no incentive to defend the larger. Bank trade associations are unlikely to lobby for the right of the 1,000 to convert to a bank; it would seem self serving, and may be opposed by bankers that resent helping former credit unions. Arguing on your own behalf will be met with accusations of "Enron" like greed and the belief that the few new powers bargained for are sufficient for now.

Since HR-1151 streamlined the process of converting to a bank charter, members have overwhelmingly supported the move, regulatory approvals have been swift, and the pioneering institutions have prospered. *(The voting process is simpler than converting to private insurance since only a majority of members voting need to approve of the move; and the NCUA board's approval is not required.)* Congress, during the HR-1151 debates, recognized that significant restrictions were being placed on credit union growth by the bill; so a streamlined escape route was crafted for those institutions seeking to shed credit union restrictions. Critics, however, recognizing the legislation "*opened the barn door*" want to make the process more difficult. Should legislation be introduced during 2003, critics are likely to attach amendments to make conversion to a bank charter more difficult. Unfortunately for those planning a conversion *someday*, such a bill could result in a bank conversion moratorium, since bank regulators are reluctant to act on new applications if pending legislation might change the application process. It appears the window of opportunity may be closing. Advice: file an application before the Bill is introduced.

In addition to complacency, the desire to amass more tax free capital keeps some from taking the conversion step. However, $300 million Pacific Trust Bank, a former credit union, just completed an IPO raising over $60 million in regulatory capital, tripling its net worth. The capital boost, and FDIC's lower capital requirements, allows the institution to leap

Conversion to a Federal Mutual Savings Bank

- Member ownership continues
- Vision & Mission maintained
- Positive reception at OTS & FDIC
- Lower capital requirements
- Unlimited field of membership
- SBA & USDA
- Compensation flexibility
- Holding company powers - merger growth
- Full range of products
- RE & Business Loans: trained examiners
- Increased marketplace credibility
- Use of 1% deposit
- Unlimited branching authority
- State law preemption
- Maintain control of future direction

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to another level of community service and grow to over $1.5 billion in assets. As a credit union it would take over a dozen years of retained earnings to match the potential of Pacific Trust.

Advice from Stephen R Covey's book: ***"First Things First"*** may apply for some facing the bank conversion decision: (1.) "Let go of paradigms that are popular and pleasing, but based on illusion". (2.) "Let go of extrinsic sources of security".

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.

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Debate Topics

Bank Charter; Capital; Taxation; Small CU vs. Large

Debates provide a forum for listeners to learn about options. Today credit union CEOs and CU Trade association executives are debating the need for regulatory capital, conversion to a bank charter, taxation, and the value of small credit unions versus large. In reality the needs of individual credit unions and unique communities are varied. One choice may not serve all.

Regarding the choice of a bank charter, an institution's charter should follow its mission. Many credit unions face diminishing returns from serving select employee groups - survival may demand a switch to serving a broader community, access to more investment products, loan offerings, and the acquisition of customers typical of a bank and better served by a bank charter. Director compensation may be needed to attract and maintain a slate of directors willing to invest the time and take the risks required of community based institutions, again an option with a bank charter.

Since banks are allowed to operate with less regulatory capital than credit unions, the value of the tax exemption is diminished. Likewise, an aging membership may see diminishing value in a credit union charter or even a mutual bank charter as a member's needs evolve toward building capital. Members may vote to withdraw their ownership equity by converting to stock, rather than allow others to "inherit" their earned capital. The choice to make a switch needs to be preserved.

Access to the capital markets can provide tremendous benefits to a community because of the leverage designed into the banking system. For an institution that has growth opportunities and the talent to execute, a regulatory capital injection provides the structure to multiply loans, investments, jobs, and access. The community benefits of deploying this extra capital can be enormous. For example, in the mid-eighties, $60 million Peoples Heritage Bank (ME) converted from a mutual institution to the stock form, and just over 25 years later it is over $22 billion in assets and employs hundreds of people within the community that originally voted for the conversion. Many community depositors have become wealthy, in part, because of their participation in the original IPO.

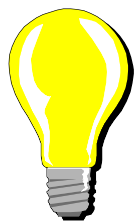
Some credit unions pay a price for their tax exemption, and the price may be increasing as NCUA's directors lobby credit union executives to accept new obligations by serving under served areas and to fund charitable organizations or groups promoting economic initiatives. Maintaining higher levels of capital also has a cost, especially when net interest margins shrink. The result is a credit union limited to providing a consumer value proposition very similar to a tax paying bank.

Lastly, the debate about small versus large is also typical to the banking world. By virtue of their size and efficiencies, small banks share many of the same struggles of small credit unions, including the challenges of regulation, technology, and staffing. Nevertheless, those that want to survive will find a way, the others will merge or go out of business.

The flexibility to decide what is best for your credit union is important to preserve. Debates are sometimes orchestrated by critics in an effort to protect their subsidy. A wise listener will always study the motivations of the speakers and the organizers of the forum. The facts will speak loudly and should always be acquired, validated, and viewed independent from the critics and promoters. For those studying the merits of a bank charter, The "Conversion Guide to the Cooperative Banking Charter" is one resource that can help provide the facts. For a copy contact: Alan D. Theriault at 800-649-2741.

Questions - lead to options

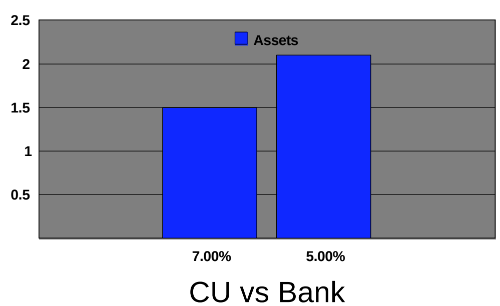
- Have member needs changed since the CU act - model?
  - Different world: payroll deduction - 401 K (tax law) - equity investments - developed middle class - more options (suppliers) - equity (net worth) growth vs. consumption
- How will the "blending" of banking - insurance - investments & regulation affect members? the future? 5 years - 10 years - 15 years
- How do members - the public - employees - trade associations view our mission? ownership? What's important?
- Do members benefit from growth?
- What comes first the "charter" or the "mission"?
- How important is the tax "subsidy"?
- Can our "vision" & "mission" extend to all consumers?



Federal Mutual Bank & Federal Mutual Holding Company

PRO	CON
• Member ownership continues • Vision & Mission maintained • Maintain control of future direction • Positive reception at OTS & FDIC • Unlimited field of membership • Full range of products • Trained examiners (large institutions) • Increased marketplace credibility • Use of 1% deposit • Unlimited branching authority • State law preemption • SBA & USDA • Compensation flexibility • Holding company powers - merger growth	• Members must approve • Employee learning curve • Subject to income tax and CRA • Conversion cost • Conversion requirements

What does your Capital "Buy" in Assets? Service to more people?: $10 million in capital



Why many are acting now?

- Business involves change - the bigger you get the farther ahead you must look - know your destination - strategic
- Waiting in Line
- NCUA Deposit?
- FDIC entrance fee? - Merrill Lynch
- Future conversion restrictions
  - Larger vote requirement - NAFCU
  - Director compensation restrictions - Reg. Relief
  - IRS treatment of conversion - (offshore corporations)
- Opportunity cost; momentum

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Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco, CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com; Vol. 21 No. 1 / **January 15, 2001**

Mutual Conversion Recap

List & Size Growing

$375 million Rainier Pacific Credit Union (WA) started the year as the first state chartered credit union to convert to a "state" mutual charter, making it the thirteenth US credit union to make this proactive and trend setting move. As a Washington State mutual, Rainier Pacific gains the many advantages of a Washington State banking charter; a charter that has allowed Washington Mutual (WM - NYSE) to grow into a $188 billion regional powerhouse employing 30,000 people and serving 5 million consumers. To date, Rainier is also the largest credit union to convert.

In November, $325 million Atlantic Coast FCU started operation as a federal mutual thrift, a first for the State of Georgia. Another Georgia credit union, $266 million AGE Federal, is in the voting process. By June, four more credit unions will have completed their conversion to the mutual charter increasing the count to 17. At least two additional credit unions are early in the application process and several are likely to start the process during the first half of 2001. (See the complete list at www.cufinancial.com)

Consumers ask ...

What's a credit union?

Credit union league sponsored surveys on the east and west coasts reveal another hidden cost of the credit union charter ... lack of consumer awareness. Is it about "credit" or "unions"? The title "credit union", some conclude from the survey, fails to communicate the modern financial services model. The surveys highlight the tough marketing challenge faced by credit union marketing departments and field mortgage originators.

According to a survey commissioned by the California CU League, banks are the "top-of-mind" consideration when consumers think of financial institutions. For example, only two out of 10 nonmembers of credit unions know the products and services credit unions offer, and only half can name a local credit union. "With statistics like that, credit unions seem trapped forever into being minor league players," said one observer.

In addition, credit union turmoil in the Far East, Europe, and Mexico add a negative perception which needs to be overcome. And, in regional markets where credit union competition is fierce, battling the perception that "all credit unions are alike," makes it difficult for progressive credit union managers to differentiate.

To reduce the negative impact, some put the words "credit union" in small print and adopt names that sound like "bank" names. A few bold and pioneering leaders, convert to the mutual charter, manage taxation, and thrive. The members are indifferent. In fact, the first credit union in the US calls itself a "bank"... St. Mary's Bank. And, the tax paying credit union in Canada whose name translates from French into "people's bank" has grown to over $75 billion, over six times the size of number one $12 billion Navy Federal.

As more credit unions convert to the community charter and broaden their field of membership, these marketing obstacles act like hidden taxes on credit union earnings. In contrast, banks (mutual banks included) have the advantages of consumer awareness and FDIC insurance, which is recognized around the world. Businesses, charitable organizations, municipalities, and immigrants are more likely to keep their business with banks, because of the familiarity and US Government guarantee. For credit unions revising their business models to include commercial loans and serving a community, the mutual banking charter may offer a sound alternative to the uphill battle to change consumer awareness, while maintaining a cooperative operating philosophy.

What's a Credit Union for?

For Serving Members or Serving the Movement?

Credit unions, like mutual savings institutions, were organized by individuals interested in improving their personal standard of living. Hence, the primary concern of credit union directors should be to promote the financial interests of the members, not the interests of the movement, the trade associations, or the credit union regulator, as noble as their purposes might be. Nevertheless, some are preoccupied by lobbying designed to reinvigorate the "movement," and, a few criticize those who elect a different path.

The Credit Union Renaissance Committee testimony is confirming what many credit union leaders have learned; that is, for some, the credit union charter lacks the flexibility to respond to market conditions and the needs of both the members and the communities served. Understandably, the "merlins" of the credit union movement promise deliverance and demand that followers have faith and patience. Don't worry about "political gridlock." We know people in Washington. We have influence. We have new blood at NCUA. We have a letter from the President. Look at the HR-1151 "victory."

The reality, however, is that opening up the Federal Credit Union Act will be painful and the effort is loaded with risks and costs. Some say the "C" on the US Capitol stands for compromise, and if anything gets accomplished it could take years, and result in far less than promised. Look at the compromise required to get HR-1151 off the table. Nevertheless, the effort is being justified and respected as a business decision and worthy of investment.

However, some will decide to go a different route because **the mutual banking charter offers <u>today</u> all the tools necessary to respond to contemporary financial dynamics, including operating subsidiaries, service corporations, holding companies, capital options, and broad real estate and business lending authority.** The decision to convert to a mutual charter to gain additional

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flexibility, rather than pay the lobbying costs and invest the emotional energy in a protracted fight is also justified. The decision is a legal one for a credit union board of directors to consider and implement. Congress, as part of HR-1151, and in recognition that the bill was putting "handcuffs" on credit union growth, made this a legal option for credit unions. Congress also devised a cost effective path for a federal credit union wanting to gain the benefit of the mutual charter. Although the decision to convert fails to support the efforts of the credit union trade associations and the NCUA, the pioneering and proactive boards with the vision and courage to convert to a mutual are doing so because the move supports the historical purpose for which credit unions, and mutuals, were organized.

Growth Requires Capital

Success comes fast for new mutuals

Mutual institutions interested in growth are able to merge with other mutuals or even credit unions. It is also possible for a mutual to acquire a bank, a bank branch, or deposits. The management of the new mutuals which converted from a credit union charter are already exploring many opportunities to grow. In some cases the opportunities may require capital.

NAME	Members	Assets	Status
Affiliated (TX)	1250	28	Bank 6/1/98
AGE FCU (GA)	38545	266	Voting
Atlantic Coast FCU (GA)	41000	310	Bank 11/1/00
AWANE Bank, FSB (NH)	2200	33	Bank 5/1/96
Beacon Federal (NY)	30000	186	Bank 7/1/99
BUCS Federal (MD)	11306	70	Bank 3/1/98
Caney Fork Coop (TN)	186	0	Merging
Carolina Federal (SC)	2650	23	Bank 8/1/99
Community Schools (MI)	12316	35	Pending
I.G.A. (PA)	25057	211	Bank 7/1/98
Kaiser Federal (CA)	34254	197	Bank 11/1/99
Lusitania SB (NJ)	6517	101	Bank 9/1/95
Ohio Central (OH)	16337	41	Bank 6/1/98
Pacific Trust (CA)	31223	280	Bank 1/1/00
Rainier Pacific (WA)	34738	375	Bank 1/1/01
Roper FCU (SC)	2200	7	Merging
Synergy (NJ)	20100	238	Bank 5/1/98

The need for capital to fund rapid growth is available to mutuals in a number of ways. A mutual may establish capital raising subsidiaries or may form a holding company and borrow money to down stream into the thrift; and / or, like business cooperatives, do a partial or full stock offering. If a mutual offers stock, faithful members get the first opportunity to buy stock, and continue to "own" the institution. Those members that fail to buy stock are awarded a proportionate share of a "liquidation account" in the institution, under rules established by the regulators. If the institution is later sold or merged with another thrift or bank the "liquidation account" is carried over. Like a credit union, the only claim members have to the net worth of a thrift is during a liquidation.

Of the credit unions switching to a thrift charter, one has formed a mutual holding company, one has converted to 100% stock ownership and later announced a friendly merger with an institution of equal size in its market area. The merger is expected to expand the range of services and increase the efficiency of the combined firm. A third has announced plans to convert to 100% stock ownership in order to raise capital to fund several growth initiatives.

From Stephen R. Covey's
"First Things First"

"Let go of paradigms that are popular and pleasing, but based on illusion."

"Let go of extrinsic sources of security"

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Moral Dilemma Strikes CU Boardrooms

Larger Credit Unions Evaluate Their Impact on the Smaller

Alarming information from recent NCUA data that indicates small credit unions are going out of business is causing executives and directors at some large credit unions to consider ethical issues, as well as the business reasons, for retaining their tax exempt status. Could an unintended consequence of our growth policies actually be contributing to the demise of smaller credit unions, they ask? It is no surprise that ethics and morality are often a consideration in the board rooms of progressive credit unions. Many credit union board meetings and annual meetings begin with prayer; and many directors are devout individuals who also privately ask for divine direction when administering credit union matters.

The impact of a large credit union operation on both urban and rural communities and on smaller credit unions and even smaller community banks is becoming an issue in the board room. Some are asking: Have we taken the tax subsidy for granted? Could our need to make million dollar loans to support our infrastructure, and a ferocious demand for deposits from multiple sources, result in harm to others? Are our values being compromised by efforts to defend our tax exempt status? Are smaller credit unions being used inappropriately to defend our tax subsidy? Is a nagging fear of failure, or even greed, keeping us from facing the challenge of taxation? Are the tactics and facts being used to respond to a call for taxation honest?

According to research released by Callahan & Associates, a well known Washington, DC based credit union consulting firm, December performance numbers show that credit union members at thousands of credit unions are slowly liquidating their involvement. Many credit unions with fewer than $20 million in total assets are experiencing negative share growth and their membership growth is less than half the national average, Callahan reports. Thinner margins, increasing operating expenses, and slow response to the demand for new services make it difficult for small credit unions to produce value for their members. The conclusion according to Callahan; "71% of credit unions (almost 7,000) are going out of business."

Some executives at small credit unions believe that large credit unions are capturing their members, and broad community expansions are threatening the tax subsidy needed to ensure the survival of small credit unions. Being forced to invest scarce resources and utilize their personal time to defend a tax exemption every two years is a complaint. Some wonder, since much of the state credit union league dues come from a few large credit unions, whether the needs of the smaller are honestly being served by being "poster children" for the larger. ***(Continued on Page 3)***

Powerful consumer franchise formed

Credit Union Mergers with Mutual Savings Banks

Merging a credit union with a mutual offers an exciting option for credit union members, since mutuals are known for their real estate lending prowess and community focus, while credit unions are known for their consumer & auto lending skills and service philosophy. "Putting the two together creates a powerful member oriented franchise," according to Alan D. Theriault, President, CU Financial Services, adviser to the Roper Employees FCU and Carolina Federal Savings Bank merger.

According to the January 2001, US Department of the Treasury study comparing credit unions with other depository institutions, "mutual thrifts are federally insured depository institutions most similar in structure to credit unions, because like credit unions, mutual thrifts generally do not have corporate stock, are not for profit entities, and are owned by their depositors, or members, rather than shareholders." Therefore, like credit union mergers, no exchange of shares of stock or other purchase transaction is associated with a merger. Over 700 mutually owned savings institutions, some over 100 years old, with combined assets of almost $200 billion are serving communities around the country. “The mission of these mutual institutions, like the mission of credit unions, play a vital role in supporting many communities,” Theriault adds.

In 1998, Congress authorized federal credit unions to merge with mutuals in acknowledgment of the need for more “community based” financial institutions and in recognition that recent changes to the credit union charter imposed significant limitations on credit union expansion. “These mergers are influenced by a sweeping nationwide trend of consolidations among credit unions. In just over a dozen years, the number of credit unions have declined from about 22,000 to almost 10,000. In the next 10 years the number should be 5,000 according to industry experts,” said Theriault.

Callahan & Associates, states that 71% of credit unions are going out of business. According to Callahan’s research, recent performance numbers show that credit union members at thousands of credit unions are slowly liquidating their involvement. Many credit unions with fewer than $20 million in total assets are experiencing negative share growth and their membership growth is less than half the national average, Callahan reports. Thinner margins, increasing operating expenses, and slow response to the demand for new services make it difficult for small credit unions to produce value for their members. Also, Callahan reported, many larger credit unions are suffering from the same market-driven changes as are the smaller ones.

Clearly, many credit unions should explore the possibility of merging with a mutual. The merger of a mutual and a credit union addresses several significant needs faced by both institutions. Credit unions need skilled mortgage lending personnel to address increasing demand by members, because mortgage loans are the fastest growing product among credit unions. Also, mutuals are able to help credit unions address the nuances of expansion into the community, since mutuals have deep roots in their communities, and credit unions are adopting community charters in droves. In addition, mutuals are looking to diversify into auto lending and consumer lending, and credit union personnel bring these important lending skills to the table. Federal and State regulators of mutual institutions are also more experienced than credit union regulators at addressing investment and loan products, corporate structure, and compensation issues which are required to be competitive. Mutuals also have the tools necessary to address the changing financial landscape including the ability to form mutual holding companies and operating subsidiaries which enhance product offerings and attract personnel.

Dramatic changes in the financial services business because consolidation, legislation, technological advances and litigation results in strong competition for both credit unions and banks. Bringing new products and services on-line is costly, hence, many institutions, will find that a merger will quickly provide an expanded menu of products and services without the capital expenditure otherwise necessary.

The mission of mutual savings institutions parallel the mission of credit unions. Mutuals were organized primarily to offer real estate loans, while credit unions focused on unsecured loans and loans for consumer goods. Mutuals and credit unions were organized by individuals, statesmen, and merchants during the 1800s and 1900s to encourage thrift, prudent borrowing, and to help member / owners to improve their standard of living. The first credit union in the United States, organized in 1909, is called St. Mary's Bank, and is one of the largest in New Hampshire. The first mutual was formed in 1816 in Massachusetts.

(Continued from Page 1: Moral Dilemma)

Although equally devout and introspective people can come to different conclusions about retaining a tax subsidy; both the business reasons and the ethical issues should be examined.

The directors of Sacred Heart Federal Credit Union in Charleston, South Carolina, which converted to a federal mutual savings association in 1999 and changed its name to "Carolina Federal", are among those that considered both the business and ethical issues and decided to change their charter, and pay taxes. The character of two of these directors was recently revealed in a letter to the editor written by one after the recent and premature death of the other. The letter, written by Clarence J. Shahid the 88 year old founder of Sacred Heart described the deceased fellow director and board chairman as an "astute and dedicated businessman ... a fine, Christian gentlemen and a man of deep faith, Joe Lavelle was always ready to give of himself to help others. His life was devoted to his fellow man, and he leaves an example that we all can imitate." Mr. Shahid's example is also worthy of imitation. He founded the credit union over 40 years ago to help serve the needs of under served people in downtown Charleston. In the back of Mr. Shahid's department store local people knew they could get a fair deal and find somebody to listen and help. The examples of both Mr. Lavelle and Mr. Shahid will continue to live for many years in the board room and offices of Carolina Federal which proudly displays its mutual savings bank license.

Mr. Shahid spoke of Mr. Lavelle as being the driving force in the merger of Carolina Federal with Roper Employees Federal Credit Union. The merger will allow both institutions to grow to five times the size of the former Sacred Heart credit union and continue its legacy of service to people in the Charleston area. The night the Sacred Heart Board approved the conversion to the mutual thrift charter, 87 year old Mr. Shahid spoke with excitement about the conversion and how he always knew the day would come when a bank charter would be needed to carry out the mission beyond his lifetime. "I only wish I was 10 years younger!" he said.

Soon 17 credit unions will have converted from the credit union charter, with well over 100 directors and executives examining the merits of the move, and accepting its challenges. Tens of thousands of members also voted to make the change, accepting the cost of taxation as a price to pay for the tangible and intangible benefits. Their pioneering efforts are paving the way for reinvigorated thinking among cooperative deposit taking financial institutions. Although the decisions of these pioneers may be criticized by a few, their bold moves were not made in haste, but flowed from deep concerns for the ethical considerations, as well as the economic. The mission of mutual savings institutions parallel the mission of credit unions, yet the mutual charter permits much greater flexibility and opportunities for growth as explained in this newsletter and during the charter options conferences around the country.

Congress: Consumers: Members:

Enough! Change the charter.

In 1998 Congress revised the credit union act to reverse the impact of a negative Supreme Court ruling. However. the law clearly put limits on credit union expansion, capital formation, voluntary mergers, and imposed tougher capital standards than banks or thrifts. After enactment, it was business as usual for some credit unions. But, for other credit unions, Congress recognized that the new law would be too restrictive, and added a section to the legislation that allows a streamlined path for a credit union to change its business license or charter to a mutual savings institution license or charter.

The message: "if the credit union charter fails to support your mission, switch to the mutual savings institution charter." In some states around the country, the same message is also being sent to state chartered credit unions asking for more powers. And the message from the HR-1151 mandated treasury study: "mutual thrifts are federally insured depository institutions most similar in structure to credit unions, because like credit unions, mutual thrifts generally do not have corporate stock, are not for profit entities, and are owned by their depositors, or members, rather than shareholders". The mutual charter has virtually all the powers a growing credit union needs, in fact the fastest growing part of a credit union loan portfolio is real estate loans, the product segment mutual savings associations were formed to address.

Preventing taxation is the primary objective of CUNA's Renaissance Commission and many politicians may signal their support. However, expanding powers is another story, and the likelihood that credit unions will gain equal powers with banks and thrifts, given the ability of a credit union to convert to a thrift, remains a toss up. Politicians may fear that the expanded powers will shift revenues away from tax paying entities and cause harm to the effort to implement a personal and business tax cut, which it believes will help continue to stimulate the economy. In order to maximize a cut in taxes the administration will be on the hunt for cost savings, and new revenues.

Soon seventeen credit unions will have converted to the mutual thrift charter. The benefits of the move are many. Conversion removes the inertia in the board room and the executive suite caused by waiting for a Supreme Court ruling, HR-1151 passage, NCUA rules, litigation over NCUA rules, and now the uncertainty over reopening the Federal credit union act. The opportunity costs of waiting are huge and the distraction affects morale and employee energy, and allows for excuses rather than member service and performance.

Conversion enhances consumer awareness making product marketing more efficient. The average man on the street, the immigrant, the small business owner, the nonprofit executive, the town or city manager, are all comfortable dealing with banks and they recognize and trust FDIC insurance coverage.

Product and market flexibility, better consumer awareness, motivated employees, lower capital requirements all combine to help increase revenues and pay taxes while continuing to serve members in the manner they are accustomed. The conversion to the mutual charter for most is a transparent and welcomed event. Each conversion vote resulted in an overwhelming majority in favor of the move. The limitations faced by the credit union charter combine to simulate a "hidden credit union tax". Although the exact amount may be harder to calculate then the tax due as a mutual, a price is being paid by some which remain a credit union.

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Nonprofit Mutual Holding Company

First Groundbreaking Partnership Announced

In a first of its kind transaction, a former credit union will become part of Third Federal Savings, a $6.6 billion mutual bank (non-stock) holding company. The transaction, which does not involve the exchange of stock or other consideration, means the former credit union members will become owners of the larger institution, much like the merger of two credit unions. The difference, however, is that the former credit union (turned mutual) will retain its banking charter, board of directors, corporate identity, and management philosophy.

According to a report in the March 14, 2001 Credit Union Times, Robert Hughes, President / CEO of Ohio Central Savings said the former credit union enjoyed rapid growth since converting from a credit union and keeping up with capital was an issue. Third Federal Savings has almost $300 million in excess capital, some of which can be funneled into Ohio Central to fuel additional growth. In addition, since Third Federal is primarily a real estate lender, Ohio Central's consumer lending expertise can be utilized to cross sell Third Federal's mortgage customers. The result is a powerful full service consumer banking franchise.

Although the holding company structure is unique in the United States, the Canada based credit union, Caisse Populaire des Desjardins (translates as "peoples bank") has grown to a $75 billion deposit taking cooperative using a similar holding company structure. Caisse Populaire's founder, Alphonse Desjardins is widely known as the "father" of US credit unions having helped organize St. Mary's Bank, a New Hampshire state chartered credit union calling itself a "bank". Mutual savings institutions in the US are just starting to utilize their holding company powers and many similar combinations with credit unions are expected in what could become a fast growing model for member owned deposit taking cooperatives.

CU Financial Services is an advisor to credit unions and mutual savings banks interested in external growth by partnerships, joint ventures, mergers, acquisitions, and denovo branching. For more information contact: Alan D. Theriault, president, at 800-649-2741.

AGE FCU & Roper Emp. FCU

Members Say Convert

In late February, members of $266 million AGE Federal Credit Union (GA), by a large margin, voted to convert to a federal savings bank charter. The move positions the community chartered credit union to take a more active role in supporting the growth and development of the communities it serves. After starting operation as a thrift on May 1, 2001, AGE will be the second Georgia credit union to convert, and the 16th nationwide. On November 1, 2001, $325 million community chartered Atlantic Coast FCU started operation as a thrift serving several communities in Georgia and Florida.

2 On March 1, 2001, the merger between Roper Employees Federal Credit Union (SC) and Carolina Federal Savings Bank became effective. The combination provides Roper members two new banking locations and access to expanded services including an active secondary market mortgage operation. The move also positions Carolina Federal, which converted from a credit union in 1998 and quickly doubled in size, to again double its asset size. Merging a credit union with a mutual savings bank is likely to become more popular as credit unions seek to become more involved in their communities and more active mortgage lenders. Mutual banks are often well entrenched in their communities and highly skilled at mortgage lending. By pairing credit unions, which are known for consumer lending, with mutual banks, powerful consumer franchises will be launched.

NAME	Members	Assets	Status
Affiliated Bank (TX)	1250	28	Bank 6/1/98
AGE FCU (GA)	38545	266	Bank 5/1/01
Atlantic Coast FCU (GA)	41000	310	Bank 11/1/00
AWANE Bank, FSB (NH)	2200	33	Bank 5/1/96
Beacon Federal (NY)	30000	186	Bank 7/1/99
BUCS Federal (MD)	11306	70	Bank 3/1/98
Caney Fork Coop (TN)	186	0	Bank 11/28/00
Carolina Federal (SC)	2650	23	Bank 8/1/99
Community Schools (MI)	12316	35	Pending
I.G.A. (PA)	25057	211	Bank 7/1/98
Kaiser Federal (CA)	34254	197	Bank 11/1/99
Lusitania SB (NJ)	6517	101	Bank 9/1/95
Ohio Central (OH)	16337	41	Bank 6/1/98
Pacific Trust (CA)	31223	280	Bank 1/1/00
Profess. Teachers FCU (TN	535	1	Merger
Rainier Pacific (WA)	34738	375	Bank 1/1/01
Roper FCU (SC)	2200	7	Bank 3/1/01
Synergy (NJ)	20100	238	Bank 5/1/98

"Groupthink"

Distorting judgments

Author Irving Janis, in a book entitled "Groupthink" discusses symptoms that can distort judgments and behaviors. These include: 1.) An illusion of invulnerability; 2.) An unflinching belief in the morality and rightness of the group; and 3.) Stereotyped views of adversaries as either evil or incompetent. The book explains that corporate organizations often suffer from "groupthink" which can lead managers to make poor judgments. Care should be taken to avoid becoming a victim of "groupthink". Examples of the disastrous effects are evident in business, the military, and in government.

Many credit union executives are spending a great deal of time and money meeting and making lists of the powers credit unions need to survive in the rapidly changing financial services business. Among the items discussed include the ability to raise capital, the need to pay directors, greater business lending authority, regulatory flexibility, unlimited merger authority, and an unlimited field of membership. The "groupthink" implies that it is entitled to approach governing bodies and demand satisfaction. However, the reality is different as recent events in the Utah legislature proved. Credit union proposals got shot down for the second time in several years. These

3 events and others around the country should sound a warning about the risks and costs of pursuing more credit union powers.

The Utah credit union proposals generated competing bills to require credit unions to convert to a taxable charter and to publicly disclose the salaries of top executives and the expenses and travel budgets of members of the board of directors. The disclosure of salaries and expenses of management was characterized as a "transparency bill" much like what is required of some nonprofit and charitable organizations.

The opportunity cost of waiting for legislation to allow credit unions to make the sound business decisions required to be a competitive deposit taking financial institution can be significant. Clearly, getting accommodating legislation will be a daunting task, especially since the laws permit the streamlined conversion to what is characterized as the nonprofit mutual savings bank charter.

Conversion to a mutual bank charter enhances consumer awareness making product marketing more efficient. The average man on the street, the immigrant, the small business owner, the nonprofit executive, the town or city manager, are all comfortable dealing with banks and they recognize and trust FDIC insurance coverage.

Product and market flexibility, better consumer awareness, motivated employees, lower capital requirements all combine to help increase revenues and pay taxes while continuing to serve members in the manner they are accustomed. The conversion to the mutual charter for most is a transparent and welcomed event. Each conversion vote resulted in an overwhelming majority in favor of the move. The limitations faced by the credit union charter combine to simulate a "hidden credit union tax". Although the exact amount may be harder to calculate then the tax due as a mutual, a price is being paid by some which remain a credit union.

Is the decision to join the "groupthink", or to invest in serving members better as a mutual?

OTS - Mortgage loans

New Rules will Reduce capital requirements

The Office of Thrift Supervision (OTS) the primary regulator of non-stock savings banks just proposed a rule to lower a thrift's capital burden. Compared to CUs, thrifts are allowed to operate at lower capital levels yet remain well capitalized. By shifting the loan-to-value classification from 80% at origination to 90% at all times, a greater portion of a 1-to-4 family residential mortgage portfolio qualifies for the 50% reduction in the standard capital charge.

In other words, thrifts will be able to increase assets with less capital, hence generating greater earnings ability. "Our research suggests that residential loans are generally subject to a disproportionately high capital burden, relative to other types of loans," OTS director Ellen Seidman said.

Also the proposed rule will eliminate the 4 % liquidity requirement for thrifts. The change acknowledges the existence of immediate sources of liquidity through the Federal Home Loan Bank System and other sources of liquidity gaining popularity with progressive thrifts. The change will eliminate the need to hold low yielding investments to address liquidity needs that could be satisfied by borrowing.

Consumers Union to Congress:

"It might be time for Congress to take another look at that (credit union) special treatment"

According to a leading credit union newsletter, a powerful consumer group, and HR-1151 supporter, is now suggesting Congress reconsider the "special treatment" credit unions receive in legislation. "Soon, there many be no real distinctions between credit unions and other financial institutions", Frank Torres, Consumers Union's legislative counsel, wrote in a letter to Rep. John LaFalce, ranking member of the House Financial Services Committee

Poet Robert Frost on Conversions

"The Road not Taken"

So far members from 16 credit unions have taken the road to the mutual charter. Today the conversion process is tested and efficient. Choosing the mutual bank road is easier than it may appear. Maintaining the status quo could be the most costly road.

100 Yr. Old New Zealand CU

Converting to Banking Charter

The banking charter is gaining popularity among credit unions in other countries. Recently Sydenham Money Club announced plans to change its charter to a building society charter, reported the CU Times. Credit unions in New Zealand have common bond requirements, borrower deposit limits, and are not allow to do business with companies and trusts. Primarily a real estate lender, Sydenham will be able to expand its lending activities beyond personal real estate loans and grow faster after the change

Atlantic Coast's Focus Groups

Former Credit Union members say: "Call it a Bank".

Member and nonmember focus groups organized by Atlantic Coast Federal, which converted from a credit union in November, agreed the "credit union" label failed to tell the whole story about credit union services. Members and nonmembers said that in their minds a "bank" was better able to handle their comprehensive financial needs. Credit unions were viewed primarily as a place to get a car loan.

Business people meeting in separate focus groups agreed that credit unions are seldom considered as a serious alternative for business checking account or business borrowing relationships. In brief, if an institution wants to obtain business relationships, call it a "bank". The focus groups confirmed findings released by credit unions associations on the east and west coast that despite large numbers of people reported to be credit union members, general awareness of what a credit union is and what it does is poor. Herein lies one of the most significant costs of remaining a credit union ... consumer awareness. Like a hidden tax, the marketing and educational challenge faced by a credit union looking to diversify is significant.

Highlights of the Thrift Charter

- •Unlimited field of membership
- •Member "ownership" continues
- •FDIC insurance * No FDIC Premiums for most institutions
- •Federal preemption * Nationwide branching authority
- •Mortgage & business lending encouraged
- •Commercial lending OK (also: real estate development permitted, equity kickers, etc.)
- •Prepayment penalties allowed, longer loan terms on second homes, commercial property loans, no requirement to make small consumer loans & unsecured loans, etc.
- •Mergers with mutuals & credit unions allowed
- •Ability to acquire deposits, banks, subsidiaries, etc.
- •Business & commercial loans to directors and officers OK
- •Permits one-member one-vote, or voting based on deposits
- •Members may vote by proxy running to BOD
- •Greater ability to attract qualified staff and directors
- •Increased credibility in the marketplace
- •Federal Home Loan Bank membership automatic
- •SBA & USDA licensing automatic
- •Use of 1% NCUSIF Deposit
- •Signals maturity of the organization
- •Capital raising options
- •Regulators experienced with mortgages, business loans, technology, and leading edge financial services.

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Count: almost 2 dozen

Four new conversions pending

Four credit unions with assets ranging from $40 million to $170 million filed to convert to a mutual savings bank during the second quarter of 2001 bringing the total count to 22 conversions and filings, representing over 200,000 members and about $2.7 billion in assets. The activity continues to validate the importance of charter options as both community credit unions and those with a national membership make the move.

Community chartered credit unions switching to the mutual savings bank charter find that the demand for real estate lending and business lending, in addition to enhanced consumer awareness justifies the move. Although taxation is noted as a negative, most agree that credit unions face "hidden taxes" caused by charter constraints and poor consumer awareness. Also, savvy managers point out that betting the future on a business model dependent on a tax subsidy is risky.

On May 22, 2001, $110 million Citizens Community FCU (WI) filed to convert to a federal mutual savings bank charter. In addition to improving member services by eliminating the restraints on the types of products it can offer, the conversion will allow the institution to broaden its geographic area of service. In 1997, a majority of members voting elected to convert to a state mutual savings bank charter, but the approval was reversed by NCUA rules that required a minimum fifty percent of the total membership to vote in favor within 30 days. In 1998, as part of HR-1151, Congress replaced these punitive conversion rules with rules typical of other financials. Now, a majority of those voting can approve the conversion during a 90 day time frame.

Deposits and loans of two additional Wisconsin credit unions are being merged into a federal savings bank started by the Aid Association of Lutherans (AAL), a mutual benefit society and sponsor of the credit unions, which have combined assets over $200 million. Validating the conversion move by others, the materials provided to members stated, "AAL believes a bank provides many opportunities beyond those which can be provided by a credit union."

Single & Multi-sponsor CUs

Facing Diminishing Returns

Although improving the penetration of a credit union's existing sponsor group is arguably a sound way to grow, at some point even best efforts generate diminishing returns. Executives at some occupational group credit unions are reporting that as select employee group (SEG) penetration levels increase, incremental growth becomes painfully expensive.

Adding additional SEGs may sound like a solution, but growing by this method may <u>not</u> be cost effective. Also, the larger desirable groups are already represented, and smaller groups are hard to efficiently serve. Converting to a community charter appears to be a solution for some, but for others its unworkable because certain growth segments of the existing field would have to be abandoned, and / or because the community available lacks enough of the desired characteristics for growth.

The streamlined conversion rules allow the credit union philosophy to be taken to every part of the community (and nation). As a mutual, an institution can continue to serve a sponsor's employees, yet diversify by buying or starting branches or banks anywhere, thereby managing concentration risk and geographic diversification; good insurance in case a sponsor company stumbles.

Since mutual savings banks can operate separate divisions or own deposit taking subsidiaries, some single sponsor credit unions are investigating the merits of serving their current employee group under one label and launching a new division or subsidiary to serve the community. The effort allows the firm to leverage its capital, infrastructure, and management resources. The incremental revenue generated would help to maintain cost effective services and pass along revenues to the core group. In addition, because of compensation philosophy and regulation, some credit unions have a difficult time recruiting management and directors. In contrast, mutual banks offer programs to compensate managers and directors much like a stock company would; and board members can come from outside the sponsor group.

Advisory team reports

Conversion business is steady

The team of advisors supporting this newsletter, now in its fourth year of publication, report that interest in conversion to the mutual savings bank charter remains steady. "Silver, Freedman, and Taff, L.L.P., (SFT) a Washington, DC based law firm representing financial institutions, Keefe, Bruyette, and Woods (KBW), a leading Wall Street firm focused on serving financial institutions, GS Financial Printing, a leading financial printer and proxy solicitor, and CU Financial Services, a strategic planning and implementation firm, have been involved with well over a majority of the conversion applications", according to Alan D. Theriault, President, CU Financial Services. "Credit union managers working with the team enjoy access to a well tested conversion process that increases the chance of success and controls costs," Theriault said.

The conversion process starts with education. Employees and directors quickly learn that the mutual savings bank charter is much like a credit union charter. The member's ownership interest is virtually the same, and one member, one vote can be retained. The facts also show that mutual savings banks, thrifts, or cooperative banks have a long history of compassionate and high quality service to communities and to their members.

CU Financial Services helps educate employees, directors, members, and the media about this emerging trend and helps management model the long range impact of the switch. "In several cases credit unions seeking advice on conversions, reported that other law firms, accounting firms, or advisors billed thousands for material CU Financial gives away for free", Theriault added. "The ability to convert to a mutual bank is one of the most exciting developments for credit union members since share drafts," he continued.

Mutual Savings Banks

Considering credit union mergers

After CU Financial Services announced it was advisor to the ground breaking merger of a credit union into a federal mutual savings bank, mutual banks around the country took notice and requested information about the transaction and possibility of it working elsewhere. Shortly thereafter a second transaction was announced, and now CU Financial has identified a number of mutuals, some over 100 years old, and located across the country, seeking to partner with credit unions.

3 Merging a credit union with a mutual offers an exciting option for credit union members, since mutuals are known for their real estate lending prowess and community focus, while credit unions are known for their consumer and auto lending skills and service philosophy. Putting the two together helps create a powerful "member focused" franchise. Both credit unions and mutual banks are owned by depositors so no exchange of shares of stock or other purchase transaction is associated with a merger.

Under current accounting rules the merger of a credit union and a mutual generates some positive financial consequences that help justify the move and position the combined firm for growth. After the merger, the credit union management and directors often will continue to help grow the combined entity and adopt the compensation and benefit programs of the mutual.

The mutual consolidation models discussed below are likely to become well known as the nationwide trend of consolidation continues:

- The Carolina Federal Savings Bank ($26 million, SC) model involved the direct merger of Roper Employees FCU ($7 million, SC) and consolidation of accounts. All employees were retained. Members of the Roper Board of Directors were invited to serve on an advisory board of Carolina Federal, but the Roper name was phased out. The two institutions operated in the same market so members gained immediate benefits from additional locations and expanded services. Roper was able to eliminate the costs of duplicating these programs.

- The HomeTown Bank ($650 million, NC) model involved the direct merger of three mutuals into a single regulated institution but with separate divisions, with distinct names and distinct advisory boards. Back office operations were consolidated generating cost savings.

- The Third Federal Capital Corporation ($6.5 billion, OH) model involves the merger of the Third Federal holding company and the Ohio Central ($40 million, OH) holding company. Ohio Central will operate as a wholly owned subsidiary of Third Federal with its own bank charter and board of directors. Cost savings are not as great with this model, but access to shared resources, like capital & customers, will help accelerate growth.

- A Canadian model, Mouvement Caisse Populaire des Desjardins ($75 billion) is the largest deposit taking mutual in Canada with a broad range of subsidiaries including insurance, banking, investments, and public finance. Deposit taking subsidiaries operate under the holding company structure and share resources with each other generating cost savings. The strength of the combined entity also allows entry into businesses which would otherwise be out of reach.

Insurance companies including State Farm, Nationwide, TIAA-CREF, and fraternal benefit societies like Aid Association to Lutherans are institutions which are owned by customers and have a structure designed to support subsidiary operations.

Clearly, dramatic changes in the financial services business because of consolidation, legislation, technological advances and litigation results in strong competition. Bringing new products and services online is costly, so many will find a merger will quickly provide an expanded menu of services without the capital expenditure otherwise necessary. Combinations also generate efficiencies and can solve management succession issues.

Although mergers among credit unions are occurring at a rapid pace, most are small institutions. The merger of larger, healthy, credit unions face regulatory restrictions, and also credit unions are unable to put appropriate financial incentives on the board room table to get deals to a decision. These issues are all solved by merging with a mutual savings bank. Therefore, expect more mergers of credit unions into mutuals in the months ahead.

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Missing from Renaissance Committee "wish list"

Director Compensation

Despite numerous reports about the difficulty attracting directors to the CU board, and the significant time demands, regulatory compliance demands, and liability assumed by directors, the Renaissance Commission concluded that directors should not be paid. Director compensation was likely sacrificed to help preserve the #1 objective ... preserve the tax exemption.

During HR-1151 CU lobbyists argued that among the reasons CUs were not taxed included the lack of access to the capital markets and unpaid directors. The argument now is that capital options are necessary. However, as CUs grow in size and offer broad and complex services, a director's time requirement increases; and, the ability to pay director fees increases.

Charitable organizations, business cooperatives and many non-profits, like hospitals, recognizing the effort involved, and the need for diversified talent, will compensate directors with annual salaries, retirement benefits and travel benefits. Many believe that compensation leads to better meeting preparation and attendance, and a moral obligation to "pay attention" partly because they are being paid to do so. Directors take time away from work and their families; and compensation helps recognize the effort.

Mutual banks which operate with the same management philosophy as CUs, generally provide annual salaries for directors, retirement benefits, and travel benefits. Also, in an effort to attract quality senior management, some provide performance based compensation plans that mirror what is common among stock institutions.

Certain practices designed to circumvent director compensation prohibitions are expected to be scrutinized as CUs become more transparent. *(Legislation to make public all payments on behalf of CU directors & managers was proposed by one state legislature during 2000.)*

Some practices could lead to legal action against directors. For example, the practice of billing the institution for first class air travel, then traveling economy, could lead to cries of foul and subject board members to civil and criminal penalties, plus restitution. Another practice, the rotation of the single paid director position, could subject the board to charges that the charade is a violation of compensation prohibitions. Also, should a director die before his turn on the rotation, his estate suffers, and the lack of a pension plan makes it difficult to compensate the family. The Supervisory Committee also could face complaints for letting these practices continue, knowing their purpose.

Certainly not all CUs can afford to pay directors, and volunteer directors are critical during the growth stage. But, like the practice at larger financials, cooperatives, and charitable organizations, directors should have the option to be paid for the risk they assume, and the time committed to an enterprise that benefits many.

Similar Heritage Acknowledged

Mutual Banks and Credit Unions

Conversion to the mutual bank charter is gaining acceptance among CU leaders as education about mutual banks filters through the movement and the topic of the mutual bank charter is discussed. Acknowledging that CUs and mutual banks have the same heritage with the same founding fathers, the World Council of Credit Unions coordinated a historic meeting recently among CU leaders and mutual bank leaders, according to the CU Times. Twenty five representatives, many from billion dollar CUs and mutual banks, from around the world sat down to discuss shared values, differences, and mutual challenges.

The areas of commonality are strong. Both CUs and mutual banks are member owned and not for profit. Both are sources of tremendous financial strength for their individual countries, the Times reported. Worldwide, CUs represent over 93 million members with $500 billion in deposits. Mutual banks have about 76 million in constituents and $1 trillion in deposits.

In 1998, validating the similarities between mutual banks and CUs, Congress passed a law which streamlines the conversion from a credit union charter to a mutual bank charter. The law, part of HR-1151, further recognized that HR-1151 put "handcuffs" on CU growth by imposing higher capital standards than banks and limiting business lending. By adopting a mutual banking charter, CU members remove growth and product impediments related to CUs and set the stage for broader service to the community and to members.

As of July 1, 2001, 18 CUs have switched to the mutual bank charter, 3 are voting, and another pending. Also, CU Financial Services is advising a number of CUs which will announce in the future. Mutual banks operate on a not-for-profit basis, but like CUs in other countries, they do pay taxes. Those converting from a nontaxable CU charter report that taxes are being managed like any other business expense. The growth, diversification, and improved consumer awareness helps pay the taxes. Plus, savvy business managers agree that operating a business model dependent on a tax exemption is risky.

Why Convert?

Reasons for Conversion to Mutual Bank or COOP Bank

First, the opportunity to serve a broader base of members. CUs are limited in their member base to those that are associated with groups approved by the National Credit Union Administration ("NCUA"). Recent Congressional Legislation (HR 1151) has restricted the ability of many CUs to grow. While the answer for some CUs has been to switch to a community based charter, others are determining that a bank charter, either federal or state would be more beneficial.

Second, CUs are switching because the NCUA penalizes them for real estate and business lending. Under new capital rules issued by the NCUA, capital requirements are stringent for CUs which are primarily real estate lenders. This 'penalty' does not apply to a mutual bank. Business lending, which includes lending secured by non-owner occupied residential, is strictly limited.

Third, a few CUs have left because the capital requirements of the NCUA, while having been increased pursuant to the provisions of HR 1151, are greater than the capital requirements for banks and do not offer any alternatives for compliance other than through earnings growth. Some CU leaders hope to rectify this problem, but, at the present time there is no practical solution. A mutual bank can increase its capital in several ways, including but not limited to, the issuance of debt or pledged deposits, the formation of a non-stock mutual holding company and issuing debt or preferred stock, and then down streaming of the proceeds to the bank itself, thereby creating regulatory capital.

Fourth, as CUs shift to a community focus, many find that consumer awareness of their products and services is poor. Business owners, municipalities, and nonprofit corporations are generally more comfortable dealing with a "bank". Hence, product marketing and growth is difficult and expensive. FDIC insurance and the "bank" name on the door have broad consumer acceptance.

For CUs with a sound marketing opportunity and progressive management, the combination of reasons discussed offset the benefit of the tax subsidy, and allow the institution to address the changing needs of their constituents.

3 Mica admits *CUs too weak to move bill through Congress*

Some believed that the Renaissance Committee would open the curtain to a “credit union modernization bill”, but CUNA’s Dan Mica’s recent interview in the CU Times should serve to dash any hopes that changes will come anytime soon. Although acknowledging the success of the HR-1151 lobbying, Mica told CU Times, “I don’t think we’re ready for a major legislative battle at this time.”

“Are we strong enough to go up there and move a major bill through Congress right now without amendments? Absolutely not,“ Mica told the Times. Mica also suggested that credit unions might not have a proper perspective of the time it takes to push legislation through Congress. The banks worked well over 20 years for the Gramm-Leach-Bliley Act, which modernized the banking industry and allowed them to branch into other services like insurance.

On the state level, legislation proposed by Utah Credit Unions was shot down, after being met with opposing legislation that proposed state taxes for larger credit unions and public disclosure of executive salaries and director travel expenses. As credit unions expand their mortgage businesses, enter businesses involving securities, trusts, insurance, and launch data processing and technology enterprises, it’s a good bet competitors from these industries would join with bankers to stem expansion or impose taxation.

The Times article also acknowledged the division among credit unions, and Mica stressed that division could undermine success of any Congressional initiatives. However, many agree that smaller credit unions are not threatened by taxation, but could sorely use the relief in other areas as proposed by the Renaissance Commission. Yet, the Commission makes preservation of a tax subsidy its number one priority, providing a benefit for larger credit unions, some of which are quickly gaining market share at the smaller’s expense.

Conversion Update

NAME	Members	Assets	Status
AAL (WI)	58741	173	Bank 6/30/01
AAL Members (WI)	8000	38	Bank 6/30/01
Affiliated Bank (TX)	1250	28	Bank 6/1/98
AGE FCU (GA)	38545	266	Bank 5/1/01
Annmt Pndg	7500	71	Voting
Atlantic Coast FCU (GA)	41000	310	Bank 11/1/00
AWANE Bank, FSB (NH)	2200	33	Bank 5/1/96
Beacon Federal (NY)	30000	186	Bank 7/1/99
BUCS Federal (MD)	11306	70	Bank 3/1/98
Caney Fork Coop (TN)	186	0	Bank 11/28/00
Carolina Federal (SC)	2650	23	Bank 8/1/99
Citizens Community (WI)	25000	109	Voting
Community Schools (MI)	12316	35	Pending
I.G.A. (PA)	25057	211	Bank 7/1/98
Kaiser Federal (CA)	34254	197	Bank 11/1/99
Lusitania SB (NJ)	6517	101	Bank 9/1/95
Ohio Central (OH)	16337	41	Bank 6/1/98
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Profess. Teachers FCU (T	535	1	Voting
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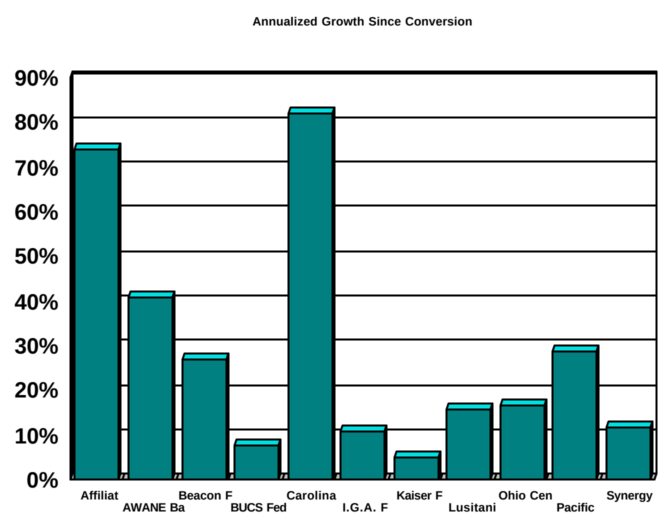
Roper FCU (SC)	2200	7	Bank 3/1/01
Synergy (NJ)	20100	238	Bank 5/1/98



Converting from a Credit Union

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Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco, CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com; Vol. 21 No. 6 / **September 3, 2001**

Mutual Holding Company Facilitates

Capital growth, M&A

Federal mutual savings banks are allowed to reorganize into a holding company structure, much like Caisse Populaire des Desjardins, which has grown into a $75 billion Canadian banking powerhouse. The move aids mergers & acquisitions, diversification, and allows the institution to raise regulatory capital, but remain a cooperative.

The reorganization involves moving the member voting rights to the top Holding Company level and exchanging the bank's mutual charter for a stock charter. The Mutual Holding Company *(or a wholly owned (mid-tier) subsidiary Holding Company)* will at all times retain at least 50% ownership of the stock Bank subsidiary.

The structure facilitates the acquisition of other financial institutions, including credit unions, thereby increasing the cooperative's owner / member base and market for its financial services. By consolidating redundant activities and sharing resources at the holding company level, acquisitions are more cost effective.

As a capital stock savings bank, the reorganization will structure the Bank in the stock form used by commercial banks, most major business corporations, and a majority of savings institutions. As such the move will enable the Bank to enhance its franchise and to compete more effectively with commercial banks and other financial institutions for new business opportunities.

The structure will provide greater organizational and operating flexibility; and allows the Holding Company to borrow funds on a secured or unsecured basis, and to issue debt to the public or in a private placement. The proceeds of such borrowings or debt offerings could be contributed to the Bank to increase its capital or for other purposes. Such access to the capital markets will make it possible to be more responsive to possible future changes by the regulatory agencies in the oversight of financial institutions.

Some are expecting over 5,000 credit union mergers to occur during the decade. Merging a credit union into a mutual savings bank offers an exciting option for credit union members, since mutual banks are known for their real estate lending prowess and community focus. Real estate loans are the fastest growing credit union product and numerous credit unions are eyeing community charters.

A mutual holding company structure allows the target institution to retain its community focus, management team, directors, and culture while sharing in the efficiencies of a larger organization. Generally, the target will adopt the compensation programs of the holding company, including incentive plans, phantom stock option plans, director retirement / emeritus plans, and travel polices. *(Studies show that bank executives and directors are better compensated than their credit union counterparts.)* By merging with a mutual bank, credit union managers and directors can make up lost ground, at no expense to the membership, since the efficiencies and purchase accounting rules help reconcile the differences.

If a merger is in the future of your institution, you owe it to yourself and your members to add mutual banks to the list of candidates. Already, four former credit unions have elected to merge with mutuals. Mutual banks located across the country are interested in the trend. Many are also looking for management talent to come along with the merger, and a few progressive mutuals are looking to move into new areas of the country or ramp up their consumer lending activities, so an exchange of talent and staff are often part of the considerations. The day will come when a coast to coast cooperative bank will exist and the merger of credit unions will help make it possible. For more information, or help with your merger strategy, contact Alan D. Theriault at 800-649-2741.

California

State CU Conversions Slow

Federal credit unions in California are finding it now takes longer to convert to a state credit union than to a federal mutual savings bank. Expanding the field of membership is also meeting with delays. CU Financial Services reports that the approval time to convert to a bank takes about 6 to 8 months, assuming the candidate is a well managed institution. However, this process could slow as well should the federal bank regulators and the FDIC find their pipeline full. Also, pending legislation, regulatory changes, economic conditions, or legal action could impact the future speed of the process.

More importantly some credit union executives could find themselves trapped in a state charter. Some states do not currently have a path for a credit union to become a bank. Flipping back to a federal charter may not be an option since the federal field of membership rules are sometimes more restrictive than the state rules. In a few states credit unions wanting to move to a bank charter had to go to the state legislature for permission; a time consuming, costly, and controversial process.

Strategic Planning Critical

Raising Capital Takes Time

Some credit union executives are confident that some day they will be able to tap the capital markets. However, converting to a bank charter takes time and raising capital could extend the timing. Also, since investors will study the credit union's historical performance, conversion and capital raising is always easier when the institution's fundamentals are strong, and it is in compliance with the current regulatory scheme.

Three former credit unions successfully went to their members and raised capital in a mutual to stock conversion transaction. In each case members aggressively purchased the stock offered, and helped continue the member ownership structure. However, in each case the timing exceeded one year from the initial conversion, and no credit union has yet to make the move starting from an undercapitalized position, although at least one is in the process; and at least one attempting to make the move, in a single step, was turned away and faced significant delays in its business plan execution.

Credit unions facing PCA concerns yet enjoying solid growth opportunities and strong management are advised to contact CU Financial Services well before capital becomes an issue. A few years is like a lifetime in the financial services business and in order to capitalize on opportunities, advance preparation is critical. For more information about PCA and capital raising opportunities for cooperatives, please contact Alan D. Theriault at 800-649-2741.

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Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco. CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com: Vol. 21 No. 7 **October 16. 2001**

Choking effect

PCA starting to have an impact

Many are acknowledging that Prompt Corrective Action will quickly start to choke credit union growth. Fast growing credit unions, generally those most responsive to serving their membership, are the first to feel the pinch. The rapid asset build up because of the stock market decline and the rush to "safe haven" deposits are elements adding to the pressure. Margins which are being squeezed because of the plunge in yield on short-term investments, make it more difficult to build capital from earnings to keep up with growth demands. The concern is magnified because declining capital levels during a recession tends to panic NCUA examiners. Several credit union trade association economic analysts say to keep capital at 9% to be safe, almost twice the 5% level banks can operate at and still be well capitalized. Since banks can run at lower capital levels than credit unions and be well capitalized (5% vs. 7%) much higher efficiencies are achieved despite taxation.

In the aftermath of September 11, 2001, NCUA has warned it will be keeping close tabs on credit unions which might be directly affected by the event. The fear is that the failure of just one large credit union could have a devastating affect on the movement as has been observed when large credit unions in other countries failed. A major hit to the NCUA deposit fund would also catch the attention of Congress which may soon be looking for new sources of taxes to fund both the relief effort and the terrorist battle. A preoccupied Congress also means any credit union "renaissance" legislation is years from consideration and passage.

A visionary credit union directly affected by the terrorist attacks, Allied Pilots Association FCU, had on September 1, 2001, just converted to a mutual charter. One week after the attack they filed to increase regulatory capital both to allow for funding future growth and to strengthen the institution's foundation. Mutual institutions have many ways to increase regulatory capital that are prohibited for credit unions.

In the face of this economic downturn, many agree that credit unions with marginal capital are going to face some tough battles arguing their capital management plans with NCUA. Being forced to curtail growth and operate at higher capital levels than bank competitors affects the membership's ability to bank with the institution. Employees are hurt too, because cuts may need to be made in areas of compensation and workplace tools.

Trend Continues

Mutual Conversions gain credibility

The mutual conversion trend continues to warrant a closer look by credit unions with good management and growth opportunities. The 20 pioneers of the trend are being rewarded with broad member acceptance and solid growth. Even the early critics, who at one time claimed that management greed was the only reason for the move, are now acknowledging that converting to a mutual is a viable option for credit unions. The move can be justified for various reasons, including better consumer awareness, an unlimited field of membership, broader investment powers, and improved tools for attracting management and directors. Combined, these reasons help mitigate the loss of a tax subsidy. Since HR-1151's fine print put serious restrictions on credit union growth, many now acknowledge that credit unions face a "hidden tax".

Recently four large community credit unions have switched to the thrift (mutual) charter, surprising some who at first believed that a community charter would solve all credit union problems. Lower capital requirements, regulatory acceptance of real estate and business lending, and broad holding company and subsidiary powers are among the reasons community chartered credit unions make the move. In addition, marketing dollars are better spent since many community, business, political, and nonprofit corporation leaders are more comfortable dealing with banks. The credit union mission is not always understood by outsiders.

The most recent community credit union to get member approval was Citizens Community FCU ($110, WI), which after being prevented by NCUA from obtaining a charter in 1997 - despite a a member mandate, returned this year to get member approval a second time. In July, $300 million AGE Federal Credit Union (GA) converted and changed its name to HeritageBank. During 2000, community chartered institutions including $425 million

Rainier Pacific (WA) and $360 million Atlantic Coast Federal (GA) converted from credit unions.

Director perk

Travel: losing its appeal

"Been there, done that", is the response when trying to attract some new directors based on the travel perk. Many desirable candidates already travel widely for their occupation or prefer jaunts to their vacation home. Domestic and international travel in the aftermath of the terrorists attacks and ongoing threats, for other candidates, starts to sound more like work without pay, than a perk. A pay check or retirement benefit, plus the travel benefit, is the customary way directors at stock cooperatives, nonprofit companies, charitable institutions, and stock institutions are handled.

Director compensation also helps highlight the focus demanded from a director at complex institutions. Meeting preparation is important. The need to understand a new regulation, the launch of a new product or subsidiary, or complex employment agreements requires more time than contemplated by many volunteers. Many larger credit unions can well afford to pay their directors and go to great lengths to provide them travel and recognition; but for some, proper incentive is more than a Hawaii vacation, its cash or retirement benefits; and without proper incentives in place for each individual board member, and without quality talent on the board of directors, the institution and its members can suffer.

Mutuals are non-stock banking corporations with a service philosophy much like the service philosophy of credit unions. Like credit unions, some are better at execution than others. Mutuals, however do pay their directors. Some pay only a modest meeting fee while others have complex deferred compensation and director retirement plans in place. In return, directors are expected to be prepared for meetings, handle the challenges of taxation, and be prompt in responding to the demands of the institution and addressing the needs of depositors. Since it is true that bank executives are paid better by their boards than credit union executives, some wonder if it might be related to the compensation, or lack thereof, of their respective boards.

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Outgrowing a CU Charter; Member needs changing

PCA & Regulatory Issues negate tax subsidy

Some pragmatic CU leaders conclude that successful credit unions have outgrown their regulatory and legislative structure. For example, PCA requires CUs to maintain higher capital levels than banks, and limits CU growth and product flexibility. CUs also lack the benefits from financial modernization legislation, since NCUA is inexperienced with emerging banking, capital, and corporate structures, like the use of holding companies. Some believe these impediments easily negate the benefits of a tax subsidy.

Some trade association leaders promise what is likely a "false hope" ... that someday NCUA will "catch up" or that the CU "lobbying machine" will get laws passed to allow credit unions to tap Wall Street or other sources for capital, much like business cooperatives do. Business coops, however, pay taxes ... so acquiring comparable benefits will come at the price of taxation.

Moreover, Congress already has enacted a cooperative banking charter -- *the mutual bank (thrift) charter* -- with capital raising options, unlimited membership potential, product and market flexibility, and holding company options. In fact, the Senate Committee which revised HR-1151 recognized some CUs might need relief from HR-1151's restrictive provisions and opened a "streamlined" escape route to a "cooperative" banking charter. CU members now may adopt a mutual charter and FDIC insurance.

With relief already in place via the mutual charter, Congress is likely to question whether new credit union legislation does more to help justify the existence of "lobbying organizations" than provide technical relief to a few credit unions facing hurdles. Furthermore, the politics around new legislation may result in a *high* cost to many credit unions that are less affected by PCA or by other HR-1151 growth limits.

Member needs are changing fast. Banking is changing fast. However, some nostalgic "lobbying organizations" and NCUA, are changing slower, or some claim -- going in reverse. Marketplace dynamics, especially with the "Y2K bug" crushed, will not wait.

Credit union managers need to clearly understand their options. The mutual banking charter is a cooperative charter, *much like a credit union charter,* that warrants consideration. Clearly, common sense dictates that your "mission" should determine the appropriate charter, rather than let an outdated "charter" dictate your mission.

2 Members from eleven credit unions decided to switch to the more flexible "mutual banking" charter, kindling a trend that is likely to continue. Several credit unions are in the application process, and many are considering this option.

Progressive credit unions justifiably can boast about their leading edge operations and modern member services, but when attached to a restrictive charter; frustration, disappointment, and lack of relevance will creep into the boardroom. The conferences & services offered by CU Financial are designed to provide important information about the "cooperative banking charter". During 2000, take time to seriously consider adopting a charter that follows your mission. If you are not currently in touch with CU Financial on this issue, you likely are lacking some of the facts and many important decision making resources.

11th to Convert to "Cooperative Banking Charter"

Pacific Trust Bank starts operation

Pacific Trust FCU completed its conversion Jan. 1 to a federally chartered savings bank. With $230 million in assets, it is the largest credit union conversion ever to a bank. The conversion makes Pacific Trust the largest mutually owned bank based in California. Pacific Trust made the move to serve a wider population and to broaden its product offerings. CU Financial Services serves as advisor to the institution. Silver, Freedman, & Taff, L.L.P, a Washington, DC law firm, provides legal representation. For more information contact: Alan Theriault, CU Financial Services - 800-649-2741; www.cufinancial.com

From Stephen R. Covey's
"First Things First"

"Let go of paradigms that are popular and pleasing, but based on illusion."

"Let go of extrinsic sources of security"

For more information, please call CU Financial Services or the following professionals:

Silver Freedman & Taff	***Keefe, Bruyette & Woods, Inc***	***GS Financial Printing, Inc.***
1700 Wisconsin Avenue, N.W Washington, DC 20007 202-295-4502 * Fax: 202-337-5502	211 Bradenton Avenue Columbus, OH 43017 614-766-8400 * FAX: 614-766-8406	*A Georgeson Shareholder Communications Company* 2300 Computer Ave. Ste I-10 Willow Grove, PA 19090 Tel: 888-805-6300
Robert Freedman, Esq.	Patricia McJoynt	Steven M. Begley
The firm represents credit unions on a variety of matters, including advising them on charter options.	Provides investment banking and financial advisory services to financial institutions including credit unions.	Graphic Design * Financial Typesetting * Annual Meeting Materials * Conversion Disclosure Printing & Mailing

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West Coast NCUA Examiner Issues PCA Warning:

Progressive CUs Must Plan to Double Capital

The Credit Union Journal recently reported that NCUA officials are calling on credit unions to build their reserves because of new minimum capital standards. *"If you are a progressive credit union that plans to double assets, for instance, you must also plan to double reserves,"* Leslie Thomson, supervisory examiner for NCUA's west coast Region Six told the Volunteer Leadership Institute's conference in Honolulu, recently. She warned CUs to be alert to the new minimum capital standards required by HR-1151.

According to Alan D. Theriault, president of CU Financial Services, "dramatic increases in reserves can only come by curtailing growth, and/or decreasing member benefits." PCA requires CUs to maintain higher capital levels than banks, and limits CU growth and product flexibility. CUs also lack the benefits from 1999 financial modernization, since NCUA is inexperienced with emerging banking, capital, and corporate structures, like the use of holding companies, Theriault said. Many industry leaders believe these impediments negate the benefits of a tax subsidy.

1800 Credit Unions at Risk .... Is yours?

NCUA's Dollar Questions Whether Secondary Capital is Appropriate for Credit Unions

NCUA refused to authorize any form of 'Secondary Capital" as part of PCA. According to a CU Times report: "*There are many details yet to be determined as to whether or not it (Secondary Capital) is workable and appropriate,"* said NCUA Board member Dennis Dollar on the subject, *"and I think the credit union community must come to grips with whether it is something that they feel is both consistent with credit union philosophy and in credit unions' best interests."* Dollar added, *"The statute defines what capital can be calculated under PCA. We cannot regulatorily go beyond what the statute specifies."*

Federal Regulatory Annual Operating Fees

Size Millions	NCUA	OTS	OCC
20	5,618	8,670	13,380
100	28,090	29,958	38,570
200	56,180	50,532	59,034
1,000	180,738	182,832	197,566
2,000	235,505	314,512	339,246

Some trade association employees are promising that secondary capital is the solution to PCA. In contrast, the Senate Committee which revised HR-1151 recognized that some CUs needed relief from the restrictive provisions and added a “streamlined” escape route to the “cooperative” banking charter, and FDIC insurance.

Congress years ago enacted a cooperative banking charter -- *the mutual bank (thrift) charter* -- with capital raising options, unlimited membership potential, product and market flexibility, and holding company options. Politics around new legislation *(to allow “secondary capital”)* may lead to taxation. CUs, less affected by PCA & HR-1151’s growth limits, are likely to oppose secondary capital. The mutual thrift charter, however, already permits several forms or secondary capital, which are discussed during the “Cooperative Banking Charter Conference”.

CUs Warned: Civil Money Penalties May Result

Member Eligibility to be Tested

The Credit Union Journal recently reported that CUs are being cautioned to insure the eligibility of new members because of the possibility of civil money penalties for eligibility violations under HR-1151. The American Institute of Certified Public Accountants (AICPA) in its annual audit risk alert, urged auditors to determine whether their CU clients have established adequate new member screening processes as part of their annual audits. The AICPA also notified credit union auditors of new requirements for member business loans (MBLs); chartering policies; credit union investments and CUSOs and NCUA's new supervisory audit rule.

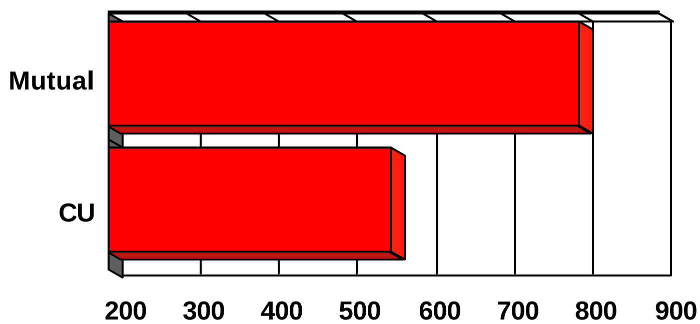
Hidden CU Tax

PCA Capital Requirements Costly

Progressive CUs are finding that PCA capital requirements result in a “hidden tax”, reducing the value of the credit union tax subsidy. To cope with PCA, CU’s will give up earnings on investments and lose product and market flexibility, hence, limiting growth and reducing the value of a tax subsidy. Banks face capital requirements, but the levels are lower, and FDIC, OTS, & OCC are better equipped to examine institutions that hold assets which, under NCUA rules, makes a CU “complex”.

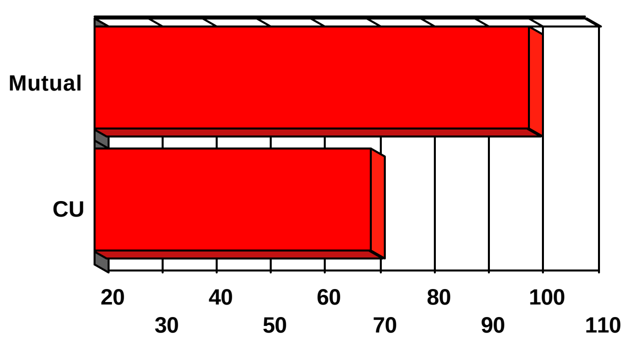
3. As competition from non-banks *(partly as a result of "financial modernization")* heats up and cost pressures increase, banks & credit unions will be forced to allocate capital aggressively, increase leverage, and utilize non-deposit liabilities to maintain earnings. PCA limits the growth of progressive CUs and helps increase the attraction of the thrift or bank charter. Congress, as part of HR-1151, streamlined the conversion process from a CU charter, acknowledging that for some, an evolution to the thrift or bank charter was inevitable.

What $5 million in Capital Buys in Earnings
80 bp after tax Thrift vs. CU



Lower leverage converts into softer earnings for a CU.
A flat yield curve & competition pressures earnings.
Taxes can be managed by using leverage.

What $5 million in Capital Buys in Assets
Thrift vs. CU



Credit Unions must hold more capital than a thrift.
The capital disadvantage means less assets.

Former Credit Unions & Those Converting

NAME	Members	Assets	Status
Affiliated (TX)	1250	13	Bank 6/1/98
AWANE Bank, FSB (NH)	2200	25	Bank 5/1/96
Beacon Federal (NY)	30000	165	Bank 7/1/99
BUCS Federal (MD)	11306	71	Bank 3/1/98
Carolina Federal (SC)	2650	20	Bank 8/1/99
Community Schools (MI)	12316	35	Pending
I.G.A. (PA)	25057	179	Bank 7/1/98
Kaiser Federal (CA)	34254	190	Bank 11/1/99
Lusitania SB (NJ)	6517	94	Bank 9/1/95
Ohio Central (OH)	16337	33	Bank 6/1/98
Pacific Trust (CA)	31223	228	Bank 1/1/00
Synergy (NJ)	20100	216	Bank 5/1/98

Wisdom from Bill Gates:

Perhaps the greatest test of a business leader's long-term thinking comes when structural change looms. When your business appears extremely healthy, it's difficult to behave as if you are in a crisis. That's why one of the toughest parts of managing, especially in a high-tech business, is to recognize the need for change and make it while you still have a chance. You have to be vigilant to spot a sea change in advance, and it's not always easy to face up to one.

When a company's competitive environment is changing, it's very helpful if the leader gets up and says, "Let's get ahead of this. Let's avoid denial. Let's take some of our resources and really get our arms around this." Unfortunately, this happens too infrequently.

For More information, or to receive a free subscription to "Converting from a Credit Union", please contact:
Alan D. Theriault, at 800-649-2741; E-Mail: atheriault@cufinancial.com; Web site: www.cufinancial.com
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West Coast demand for Conversion Information

San Francisco Office Opens

CU Financial Services recently opened a satellite office in San Francisco. The office will help address the needs of West Coast CUs studying the conversion to the thrift charter, looking at expanding business lending programs, and those seeking growth in areas like investment services and trust services.

According to Alan D. Theriault, president, the firm is working with many CUs West of the Rockies, and helped with the mutual thrift conversion of both San Diego based Pacific Trust FCU and Pasadena based Kaiser Permenante FCU. "The office makes our resources more accessible to CUs on the West Coast," Theriault said. "Since our first CU conversion, we've received steady interest from West Coast institutions. We expect this emerging trend to catch on quickly in the West and move eastward."

Competition on the West Coast from all types of financial institutions is particularly keen. CUs must be quick to address new trends and to introduce and expand new services. Competition and cost pressures caused by high consumer expectations increases the pressure for growth and for a charter that permits operation at lower capital ratios as well as options for increasing capital.

A surprise to some

CU Employees Push for Conversion to a Mutual Thrift

In what is a surprise to some, veteran tellers, mortgage originators, marketing personnel, and other CU employees are quick to endorse a move to the thrift charter. A few had expected more resistance to a charter flip. One CU executive reasoned that front-line people are quick to see what's going on with competition and recognize that members are more interested in the service they receive rather than the type of charter, or even the institution's name.

CU Financial Services
New: San Francisco, CA Office
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San Francisco, CA 94104
Voice: 415-933-8690 * FAX: 415-358-4506
Toll Free Voice: 888-846-5204

Constant lobbying of members for political support of the CU charter is seen by some as a distraction to the real business at hand ... providing quality financial services.

Educating employees about the similarities between the non-stock mutual charter and the credit union charter helps eliminate the confusion about the switch and eases concerns about the evolution. "The thrift charter makes their job of adding new accounts and selling new services easier," said one CU executive.

Other reasons included better recognition of FDIC insurance, the elimination of the time consuming process of identifying how certain members may qualify for credit union services, and the ability to offer more flexible loan products. During the conversion process, CU Financial works closely with staff to help with education and transition issues. The firm also helps introduce employees, management, and directors to the new institutional support networks like the Mortgage Bankers Association and America's Community Bankers, a trade association serving over 700 mutuals around the country.

CUNA's Mica:

Challenged by Mutual Conversions

Conversions to mutual savings banks, demographic changes, and banker attacks were listed among the challenges identified by CUNA's Dan Mica in a recent editorial in Credit Union Magazine. Although only 11 credit unions have reorganized as mutual savings institutions, CUNA's strategic planning team has identified the trend as being worthy of its attention.

Acknowledging that mutual savings institutions are member owned cooperatives, some CU leaders believe CUNA, state trade associations, and corporates should support reorganization to the mutual charter by continuing to provide services to CUs that convert. CUNA has been an active supporter of the cooperative movement and the National Cooperative Business Association, a National trade association which includes many taxpaying cooperatives.

In contrast, NAFCU, fearing the loss of dues as CUs convert to the mutual charter, is seeking to impede conversion by promoting legislation making the process more costly to the membership. Recently, NAFCU announced it would seek to reverse HR-1151 conversion flexibility. Congress recognized that with the passage of HR-1151 some CUs may not be able to live with the restrictions imposed. Hence, the law provided an efficient escape route to the mutual thrift charter, reversing NCUA's 1995 punitive conversion regulation. CUs may now convert to a mutual after giving members three notices of a special meeting called to vote on the measure. A majority of those voting, either by ballot, or at the special meeting carry the measure.

The Increasing Gap between Rich and Poor

Activists Push for CUs to close gap

Press reports about the widening gap between rich and poor energize activists to push for more help from "non-profits" to fill the gap. CUs are becoming a target as a "social mission" is highlighted and promulgated. CU's are urged to replace the services now provided by "payday lenders", but without the revenues to manage the risks.

With over $40 billion in net capital and a high profile tax subsidy, CUs should expect aggressive lobbying for funding of activities to "close the gap". The message from the NCUA chairman about the CU "mission" will no doubt live on long after he leaves NCUA. One CU analyst reasoned that given the chairman's passion for the subject, his influence might be exerted even after leaving office; perhaps as a spokesman for the "social mission" lobby.

Some Claim: *PCA a Disaster*

Capital Options are Critical

Leading CU consultants claim that without capital options PCA will strangle CUs sitting on growth opportunities. According to one consultant, "these organizations (credit unions) will only have two choices: slow death or convert to a more flexible regulatory environment." NCUA's chief examiner David Marquis states: "PCA is a disaster. It does nothing for CUs".

Currently the mutual thrift charter offers a more flexible environment including levels of capital much lower than PCA requirements. A mutual thrift is deemed well capitalized at 5% versus 7% for credit unions. The difference in growth possible by adopting a thrift charter is profound. For example, a thrift with $5 million in capital can grow to $100 million and be "well

3. capitalized" while a credit union must check growth at around $70 million. The additional leverage, among other powers, allows for greater earnings to manage tax liabilities and fuel additional growth. Furthermore, the mutual charter allows the formation of a holding company which is authorized to borrow funds or issue securities that may be counted as regulatory capital. Also, a mutual may form various types of operating subsidiaries that lead to a boost in capital.

In contrast to the position taken to justify a tax subsidy during the debate on HR-1151, some CU trade association leaders are now arguing that credit unions, like banks, should have access to the capital markets. NCUA's board, including Dennis Dollar, who is generally supportive of aggressive initiatives, is cautious ... questioning the appropriateness of secondary capital for natural person credit unions. Some believe allowing secondary capital, like paying board members, helps justify credit union taxation.

Why Act Now?

Changing Landscape May Threaten Conversion Window

Eleven pioneering credit unions are now operating as thrifts while others are at various stages of conversion. For those which converted in the last few months the process was fast, efficient, and cost effective. The streamlined conversion rules, part of HR-1151, removed the fear of failure. Members interested enough in the conversion to exercise their democratic right to vote can decide the transaction in a process typical of charter conversions completed by most financial institutions.

The mutual thrift charter has proven itself to be a cooperative charter that supports the historical mission, philosophy, and heritage of credit unions. For members & management of converted institutions the change remains mostly transparent to members and staff. Asset growth continues and any member defection is rendered insignificant by the rapid growth after shedding field of membership restrictions.

But, some states lack a clear path to convert to a mutual, hindering the process. California, for example, does not provide clear statutory authority for converting from a state chartered CU to a mutual savings association, yet CU managers continue to box themselves into a charter with serious growth limitations. For example, by the end of this decade almost 50% of the membership will be self-employed, yet the CU charter hinders business & real estate loan growth. Furthermore, the 1999 Financial Modernization Act greatly expanded competition, yet the CU charter prohibits the use of holding companies, operating subsidiaries, and capital raising options. Also, CUs face limits on mergers and restricted leverage that could help counteract the impact of thinning margins caused by competition and cost pressures.

Why act now? Busy regulators could slow the conversion process as they digest the impact of "Financial Modernization". Also, asset shifts into the FDIC fund and away from NCSIF may cause NCUA to slow the return of the NCUSIF deposit or heap on costs related to conversion. The FDIC, is already facing a large influx of deposits from brokerage firm banking affiliates, like Merrill Lynch. Big transfers into FDIC insured deposits could lead to admission fees. Currently, for converting CUs, transferring to FDIC is free and the NCUSIF deposit is quickly returned.

CU trade associations and NCUA are likely to fight to protect their dues and operating fees by working to make the mutual conversion process more costly to your members. For now, Congress has spoken and provided a path that is both fair and efficient. That could change.

Has your institution properly investigated the merits of the mutual charter? Has your board of directors executed its fiduciary responsibility to members in this regard? Are you planning to convert to a state charter that could "box" your institution into a future which could "strangle" your growth? Unless your institution is working with CU Financial Services, it may be acting without all the facts about the benefits of conversion. To learn more about the flexibility of the mutual cooperative banking charter contact CU Financial Services at 800-649-2741, or on the West Coast call toll free 888-846-5204.

"A CU's ability to convert to a mutual is the most exciting thing to happen to the cooperative & CU industry since share drafts or mortgage loans. Now we can take our services anywhere!"
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Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco, CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com; Vol. 20 No.4 / **May 2, 2000**

May Increase Cost of CU Conversions

FDIC Considers Entrance Fees

The FDIC is considering charging an entrance fee for new banks and thrifts. The fee could affect credit unions planning to convert to a mutual thrift charter. Currently, for converting CUs, transferring to FDIC is free and the NCUSIF deposit is quickly returned. "FDIC doesn't even charge for its eligibility exam," according to Alan Theriault, President of CU Financial Services and adviser to the majority of credit unions converting to the mutual charter.

Concerns about the rapid flows of money into the FDIC deposit insurance system were raised recently when Merrill Lynch & Co. announced plans to move as much as $100 billion from uninsured money market funds into FDIC insured accounts at two commercial banks it owns.

"Less than $2 billion of credit union deposits have moved over to FDIC", said Theriault, "but more are on the way." The flip side of the concern, according to Theriault, is with NCUSIF. "As credit unions abandon NCUSIF and demand the return of the deposit, NCUA may attempt to delay the return or impose withdrawal fees ... costly," he suggested.

Also, NCUA is likely to reexamine its operating fee structure because of the revenue lost by the large credit unions converting to state charters. Since fees for credit unions with over $2 billion in assets are about a third of fees charged to comparable banks and thrifts, some believe larger credit unions will face big operating fee hikes. Some credit union leaders claim the smaller are subsidizing the examinations of the larger institutions.

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> ***(CU Director)***

OTS operating fees are lower than NCUA's fees for institutions with assets between just over $100 million to around $1 billion. OTS fees are comparable for institutions from $25 million to just over $100 million; and higher for all others.

According to Theriault, "delaying the conversion to a mutual for another year to save taxes, or for whatever reason, could be costly. The current conversion rules for federal credit unions remove the fear of failure. I doubt the conversion process will be more economical than it is today." Depending on the circumstances, a $30 million to $100 million institution should pay just $100,000 to $150,000 in fees and costs to convert to a thrift charter that allows unlimited field of membership, product and market flexibility, and capital options.

Facing Reality

Credit Union Leagues consider allowing mutuals as members.

Attendees at the Colorado CU System annual meeting approved a bylaw amendment stating "a credit union that has converted to a mutual savings bank may retain its full membership in the league with all the rights and privileges related thereto." Carroll Beach, president of the Colorado CU System told CUNA's News Now, "our feeling was that if a credit union converted to a mutual savings bank … to serve their members better, then they should be able to continue membership in the organization," .

Noting that credit unions are in a different competitive world today, many credit union leaders are studying the facts and acknowledging that the mutual charter promotes the cooperative mission while allowing unlimited membership growth, product and market flexibility, and capital options.

While maintaining, (that) "we do not believe it is in the best interest of members to convert their credit union to a mutual savings bank", CUNA's Dan Mica, in a letter to CU Financial Services said:

"Ultimately, the decision belongs to credit union boards and their members regarding the structure of their credit union. After all, the members, as the owners, have the right to make these kinds of decisions."

"The Colorado CU System members should be praised for their vision and action," according to Alan Theriault, President of CU Financial Services, "it takes courage to be a pioneer; but, for obvious reasons, I'm not expecting widespread endorsement of the mutual conversion concept from credit union trade associations. I'll be content if they just stand back and let the credit union members decide."

America's Community Bankers

Mutual Savings Association Day

On May 23 & 24, 2000 come to Washington, DC, to meet with OTS regulatory agency staff, Congressional banking staff and your peers to discuss issues of importance to mutual institutions. Some of the issues that may be covered include: How to invest in technology? How to find qualified employees? What kind of compensation should be given? How to raise capital without converting to stock?

OTS Deputy Director Richard Riccobono will give his view of the OTS and mutuality. He will take questions and have a dialogue with the attendees. Also, FDIC Chaiman Donna Tanoue is invited.

Credit union representatives should contact Alan Theriault at CU Financial Services, 1-800-649-2741, for more information. Registration is free.

America's Community Bankers (ACB) is a national trade association representing over 700 mutuals (non-stock banks) with around $200 billion in assets, as well as stockholder owned institutions. ACB is involved in aggressively advocating for the mutual thrift charter. In addition to promoting "charter choice", ACB encourages innovative corporate structures including holding companies and operating subsidiaries.

ACB sponsors many programs designed just for non-stock financial institutions and for years its lending programs have attracted credit union employees from around the country.

Two More Credit Unions File

Georgia & Michigan CUs

Applications to convert to mutual charters are on file from two active credit union lenders. Community Schools Credit Union a $33 million Michigan State chartered credit union filed in December and $310 million Atlantic Coast FCU, a Georgia federal credit union filed in March.

Atlantic Coast has offices in Georgia and Florida and is an active real estate lender. The credit union board made the decision to convert after looking at expanding its federal CU charter and a state credit union charter. It concluded the federal thrift charter best met the needs of the membership.

For Robert J. Larison, CEO of Atlantic Coast FCU, the (credit union) philosophy is important and is supported by the cooperative thrift charter. "The money made by a thrift goes back to its owner / members. And, as a thrift we can have a higher percentage of assets in mortgages and mortgage backed securities." Like Atlantic Coast, Community schools is an active real estate lender.

CUNA's Bill Hampel recommends:

"9 % capital as an adequate level"

Despite the demands caused by narrowing spreads, increasing expenses, and fierce competition both on the asset side and the liability side of the balance sheet, a couple of credit union trade association advisors warn that credit unions should carry even more capital than required by Prompt Corrective Action (PCA). CUNA's Bill Hampel says, "I now recommend 8% as a minimum comfort level of capital and 9% as an adequate level."

Another trade association consultant, David Shakespeare, general counsel for the Pennsylvania Credit Union League says, "the single issue that I'm 'a-scared-of' most is PCA. There is a lurking fear that NCUA may pull out a lumberjack-size sledgehammer when a lighter mallet would be more appropriate." Shakespeare adds, "if credit unions really want to play it safe, they'll shoot for 9% (capital) so that they'll have enough cushion."

The need to carry extra capital negates the benefit of the credit union tax subsidy. A mutual thrift is deemed well capitalized at 5% versus 7% for credit unions. The difference in growth possible by adopting a thrift charter is profound. For example, a thrift with $5 million in capital can grow to $100 million and be "well capitalized" while a credit union must check growth at around $70 million. If 9% capital is required the credit union can only grow to just over $50 million.

After calculating the earnings possible at these asset levels, in the emerging financial services environment, it is obvious that the credit union must drastically increase fee income, cut expenses, curtail services, lower dividends, and raise loan rates just to stay solvent. The member benefits are diluted. The benefits of the tax exemption disappear. The thrift or bank competitor operating at higher levels of leverage becomes more relevant.

Currently the mutual thrift charter offers a more flexible environment in addition to levels of capital much lower than PCA requirements. The additional leverage, among other powers, allows for greater earnings to manage tax liabilities and fuel additional growth. Furthermore, the mutual charter allows the formation of a holding company which is authorized to borrow funds or issue securities that may be counted as regulatory capital. Also, a mutual may form various types of operating subsidiaries that lead to a boost in capital.

Leading CU consultants claim that without capital options PCA will strangle CUs sitting on growth opportunities. According to one consultant, "these organizations (credit unions) will only have two choices: slow death or convert to a more flexible regulatory environment." NCUA's chief examiner David Marquis states: "PCA is a disaster. It does nothing for CUs".

Another Pioneering Trend:

Merging a CU with a Mutual

What are the values of your deposit base, loan portfolio, your franchise? Banks sell branches for up to a 15% premium ... a $30 million branch brings a $4.5 million gain. Added to the members retained earnings of say 10% to support the branch, the $7.5 million number is a material amount. Yet, many CU merger deals are made with virtually no consideration for the real value being transferred to the acquiring institution.

CU Financial Services can work with you to identify and negotiate merger arrangements that secure a sound valuation for your members and management. The mutual thrift charter permits innovative programs designed to get mergers of healthy credit unions off the board room table. Many believe mergers are inevitable. With the proper team and tools in place, your institution can benefit from the trend.

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Conversion Trend Continues

$*360 million West Coast CU Announces Conversion to a Thrift*

Since the last newsletter, two more credit unions announced plans to convert to the thrift charter, a small Pennsylvania credit union, and a second credit union, the largest to announce so far, $360 million Rainier Pacific in Tacoma, Washington. Rainier will be among the first to convert to a state mutual charter, FDIC insured. So far the eleven former credit unions, one as small as $8 million in assets upon announcement, converted to the Federal Mutual Savings Institution charter supervised by the Office of Thrift Supervision (OTS).

John Hall, president of $360 million Rainier Pacific CU, told Credit Union Journal after announcing conversion plans, "we believe that the credit union charter has value but the credit union charter may not have the kind of value that Rainier Pacific desires, given our declared future,". He further suggested, “let’s not make this about one versus another - that we turned our back on the credit union philosophy”.

John Annaloro, president of the Washington Credit Union League, said all credit union leaders can empathize with increasing regulatory burdens, ongoing restriction of powers, new capital mandates via PCA, and a perceived diminishing in the opportunity to innovate. During the Credit Union Journal interview, Annaloro said, “It’s unfortunate, that when this happens some professionals within this industry - and the trade press - often rush to judgment by suggesting that the organization has become philosophically un-pure or there is a personal profit motive among the officers and directors.” He added, “I do not think that this is the case with credit unions in Washington.”

“A CU’s ability to convert to a mutual is the most exciting thing to happen to the cooperative & CU industry since share drafts or mortgage loans. Now we can take our services anywhere!” (CU Director)

NASCUS & others

Seeking Parity with Mutuals

The cheerleader for state credit unions, NASCUS, wants credit union managers to be able to decide who the credit union serves, much like a mutual savings association which has an unlimited field of membership. Also, NASCUS and several state credit union leagues want more liberal business lending rules, like mutuals currently enjoy. And regarding capital, the Washington State and California State credit union leagues want credit unions to have access to the capital markets to help meet NCUA’s PCA and “complex credit union” requirements. Mutuals already have access to the capital markets and enjoy lower capital requirements than credit unions. Some states also allow compensation for credit union directors, like mutuals.

In other words, these credit union lobbyists are seeking powers for credit unions that already are provided by Congress through the federal mutual savings association charter; no need for new laws ... no need for a new share insurance fund. For some members of Congress, pushing for powers which are already available, by converting to a mutual, may seem silly. Some credit union observers think that reopening the credit union act to the “compromising mind” of Congress may backfire.

After conversion,
NCUSIF Deposit Returned

FDIC Insurance is Free

For credit unions converting to the thrift charter, FDIC insurance is free. The FDIC does not charge for its eligibility examination. The FDIC does not require a deposit. After conversion the NCUSIF 1% deposit is refunded. The institution is free to invest the refund elsewhere. Also, some hope the FDIC will issue a rebate on its excess reserves, so a converted credit union may get a windfall to help offset the conversion costs. As long as the converted institution remains well capitalized, like most banks and thrift, future insurance premiums are waived.

The credibility and recognition of FDIC insurance coverage surpasses NCUSIF and any private insurer. Many immigrants, municipalities, business owners, and nonprofit institutions insist on doing business only with FDIC insured institutions.

NAFCU:

Converting CUs should pay to get their NCUSIF Deposit back

In an effort which would make conversion to a thrift or private insurance more costly, NAFCU is proposing NCUA charge a fee to leave the federal share insurance fund. One observer suggested the fee is nothing more than an attempt to slow the conversion process, and akin to charging a member for approaching the teller window and withdrawing his own money.

This proposal however, could cause problems for all federally insured credit unions since GAAP accounting may require every CU to mark down its share insurance asset by the amount of the exit fee. Refundability of the NCUSIF deposit is an essential criterion for considering the NCUSIF deposit an asset.

NAFCU believes that the exit fee is justified because the departing institution has "benefited" from the reserves in the NCUSIF prior to the mandated 1% deposit. An exiting credit union, however, may want to claim ownership of its pro rata share of those prior reserves and have those funds returned in addition to the 1% deposit.

Small CUs Revolt

CU Trades Hit Panic Button

Small CUs, fearing the loss of their marketing franchise and the threat that unrestrained growth will lead to taxation, are starting to oppose growth initiatives by their larger brethren, especially those seeking extended community charters. In popular CU states like TX, CA, NY and CT small CUs are organizing to stop the charter expansion of larger ones.

3. Also, the flight by FCUs to a state charter, in order to circumvent HR-1151 growth restrictions, raises concerns from credit unions doing business across state lines. Hamstrung by HR-1151 growth limits and/or the need for the legal authority of a multi-state federal charter, progressive FCUs are now studying the benefits of the federal mutual savings association charter.

Some trade associations are responding with efforts to slow conversions. Charter conversions upset the delicate balance of power among competing trade associations, but attempts to stop conversions are sometimes viewed as self-serving, and in competition with the interests of the membership. Also, fear of the conversion door being slammed shut could actually accelerate the conversion pace.

Efforts to hamper thrift conversion by onerous and costly conversion rules failed after Congress recognized that many credit unions might not be able to live with the restrictions in HR-1151 and legislated an "escape route" to a mutual charter. The mutual charter allows unlimited member growth, product and market flexibility, and lower capital requirements. Since HR-1151, federal credit unions have a streamlined and cost effective path to convert from a federal credit union to a mutual savings institution. The law also permits a credit union to merge with a mutual. Also, some state laws allow a state chartered credit union to convert.

A more subtle trade association tool to slow conversions ... the "committee / task force" ... is being utilized both to neutralize dissidents and provide hope to others that "relief" is on the way, hence stalling proactive decision making and maintaining the urgency to continue to pay dues. However, this approach also allows time for proactive credit unions to make their move. CUNA has recently launched such a committee implying that the committee findings will result in another HR-1151 style trip to Washington and more liberal laws. Unfortunately, politicians are unpredictable, and although hospitable and sometime optimistic, getting action is often like trying to "push a rope". New credit union legislation also introduces the risk of amendments like, taxation and CRA.

To succeed on Capitol Hill, CU lobbyists want small CUs to help argue the need and social benefits for the tax subsidy, since this is identified by credit union pollsters as being "sacred". The numbers, however, are hard to reconcile for some since around 2,000 credit unions control around 80% of credit union assets. Including a measure to leave 8,000+ credit unions untaxed neutralizes the smaller credit unions and puts taxation only on the table for the credit unions controlling the bulk of the assets. Such a measure might find some support and be viewed by Congress as both fair and logical. Some say the "C" in Congress & the "C" in Capital Hill stand for "Compromise" so legislation will be subjected to seemingly endless hearings and debate. The Treasury study ordered by HR-1151 remains a wild card and is expected to raise some of these issues. CU Trade associations are concerned that taxation would cause a "stampede" to the mutual charter in order to gain its credibility and benefits. So far around $2 billion in assets have moved or are slated for conversion.

~ Ralph Waldo Emerson~
(1803-1882, American Poet, Essayist)

Do not be too timid and squeamish about your actions. All life is an experiment. The more experiments you make the better. What if they are a little course, and you may get your coat soiled or torn? What if you do fail, and get fairly rolled in the dirt once or twice. Up again, you shall never be so afraid of a tumble.

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Strategic Planning and Implementation Services for Progressive Credit Unions; CU Financial Services, Portland, Maine & San Francisco, CA **Tel: 800-649-2741** WEB Site: www.cufinancial.com; Vol. 20 No. 6 / **August 15, 2000**

Ground Breaking Merger

Charleston, SC area CU Agrees to Merge with a Thrift.

Roper Employees FCU has agreed to merge with Carolina Federal Savings Bank. Carolina Federal is the former Sacred Heart of Charleston FCU which changed its name and started operation as a mutual just over one year ago.

Since both institutions are owned by depositors, no exchange of shares of stock or other purchase transaction is associated with the merger. The members of Roper Employees FCU will become members / owners of Carolina Federal.

The ground breaking merger will result in an institution with combined assets of approximately $32 million. The agreement is subject to approval of the OTS, the FDIC, and a vote of the members of Roper Employees FCU.

Since converting to a thrift in August of 1999, and gaining an unlimited field of membership, Carolina Federal has realized asset growth of almost 60%. In January, Carolina Federal acquired a local mortgage office of an Atlanta mortgage bank. To better serve members of the combined institutions, a full service branch is planned in nearby Mt. Pleasant

"The additional offices will make banking much more convenient for our members. In addition, our members will now have access to mortgage loans, home equity loans, A.T.M. services, money market accounts, credit cards, and other services that are much more efficient to provide by teaming up with Carolina Federal," said Oscar C. Rebula, CEO of Roper Employees FCU.

"It's really a "win-win" combination. After carefully considering our options for expansion, our board of directors agreed that the best decision was to align ourselves with another institution with a shared member philosophy, capital resources, and a strategic vision for continued success," Rebula added.

Dramatic changes in the financial services business because of consolidation, legislation, technological advances and litigation results in strong competition for both credit unions and banks, according to Alan D. Theriault, President, CU Financial Services, a credit union merger advisor. "Bringing new products and services on-line is costly, hence, many institutions, like Roper Employees FCU, will find that a merger will quickly provide an expanded menu of products and services without the capital expenditure otherwise necessary," he continued.

"The combination is influenced by a sweeping nationwide consolidation trend among credit unions. In just over a dozen years, the number of credit unions have declined from about 22,000 to under 11,000," Theriault continued. "In the next 10 years the number should be 5,000 according to industry experts," he said.

Increases Options for Members

HR-1151 Simplifies Merger Process

In acknowledgment of the need for more "community based" financial institutions and in recognition that HR-1151 imposed limitations on credit union expansion, Congress added a provision in HR-1151 that simplified the process for a credit union to convert to a mutual savings institution, thus allowing a subsequent combination with another

2

mutual. Mutuals do not face the same limitations on mergers that affect credit unions.

"HR-1151 forces credit unions to operate at higher capital levels than mutuals and imposed other limitations," Theriault said. In addition, credit unions are unable to access some of the benefits provided by the "Financial Modernization" act recently passed by Congress, limiting access to important corporate structure flexibility for competing in the new economy.

"Financial Modernization" and changes to the federal mutual charter proposed by OTS (see related article) should help facilitate the development of large and efficient "member owned" financial cooperatives modeled after the two tier holding company structure of $75 billion Mouvement des caisses populaires Desjardins in Quebec.

Why Change When We are So Successful?

"Through the years we have often chosen radically new directions when we were at the top of our game. We have understood the desirability and necessity of embracing change from a position of strength ... if we have the courage to be led by our vision, we can truly make a difference in our customers' lives. We can serve others, the community, and be proud of our profession and our company."

David S. Pottruck, President, Charles Schwab

The mission of mutual savings institutions parallels the mission of credit unions. Mutuals were organized primarily to offer real estate loans, while credit unions focused on unsecured loans and loans for consumer goods. Mutuals and credit unions were organized by individuals, statesmen, and merchants during the 1800's and 1900's to encourage thrift, prudent borrowing, and to help member / owners to improve their standard of living. The first credit union in the United States, organized in 1909, is called St. Mary's Bank, and is one of the largest in New Hampshire. Over 700 mutually owned savings institutions, some over 100 years old, with combined assets of almost $200 billion are serving communities around the country. The mission of these mutual institutions, like the mission of many credit unions, play a vital role in supporting many thriving communities.

Changes to facilitate Cooperative Mission

OTS to revise Mutual Regs

The Office of Thrift Supervision (OTS), the primary regulator for member owned (mutual) savings institutions, thrifts, and/or financial cooperatives is proposing new regulations and revisions which will help support member owned financial cooperatives.

The regulations are expected to result in fewer conversions of mutuals to stock form. Among the changes being discussed include liberalizing management compensation rules so mutual (non-stock) institutions can offer compensation plans that are competitive with stock institutions and expanding options for increasing regulatory capital without issuing voting stock.

Also, OTS plans to look harder at the business plans of institutions planning a stock conversion to

3 insure a plan exist for leveraging the new capital raised during the conversion process. The sum of changes are designed to modernize the charter and remove a perceived disparity between the non-stock charter and the stock charter, thus encouraging the growth and mission of member owned mutuals.

Favors Status Quo

SC League Warns its Credit Unions

Following the path of the Wisconsin CU League and the New Jersey CU League during the mutual conversion process by credit unions in those states, John Franklin, President of SC CU League, announced on August 8, 2000 that his league will "oppose the conversion of any SC credit union to any other type of financial institution, to include direct and indirect communications with the credit union's members." In contrast, at least one CU league permits converted credit unions to retain membership in the league. Most leagues are unlikely to interfere with corporate charter decisions, leaving the decision making to the credit union board and members.

Some question whether credit union dues should be spent to argue a position in conflict with the board and management of a league member or former member, and suspect that the policy may be an admission by the SC League that nothing more can be done to improve the credit union charter. At best the effort is viewed as an attempt to intimidate credit union boards and discourage proactive thinking. Will the policy set a precedent later empowering the CU League to circumvent the credit union board of directors and go directly to members on other matters, like use of league services, a branding or political campaign, or even league membership?

The conversion decision is within the judgment of the Board of Directors of the institution, subject to the approval of the members and regulators. The transaction and the process to inform the members is authorized and regulated by federal law. A conversion does not mean the institution will not continue to serve people of modest means. It gives the institution more flexibility to do so. The fact that a mutual thrift is taxed does not equate to higher fees and rates. Credit unions are effectively taxed now due to their limits on investments and higher capital standards than banks and thrifts.

The SC League policy raises ethical and legal questions. Can the league directly contact members without breaching a privacy obligation? Is indirect contact merely an illegal attempt to influence the vote outside of the regulatory process?

Canadian & Australian Credit Unions

Living with Taxes not so Bad

Credit unions in Canada and Australia pay taxes. The Credit Union Journal reported recently what two CU leaders from these countries had to say about taxation: CANADA: "Take your medicine. It's not that bad.". AUSTRALIA: that if taxed, credit unions can survive and even thrive; and that taxation should be viewed as just another expense. Additional benefits, according to the former CEO of Australia's CU Trade group, is the ability to operate on the same field as banks and the perception that a tax paying institution is no longer a "freeloader".

From "Grow to be Great"
by Dwight L. Gertz & Joao P.A. Baptista:

"Everyone would rather work in an environment where possibilities are more tangible than are limits - where hope matters more than fear. ... Working for a non-growth company is simply not fun"

Does HR-1151 offer more possibilities than limits? Isn't the Mutual Charter work the look? ed.

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Canadian Credit Unions

"Politics" delays "CU Renaissance" into Fourth Year

For three years credit unions in Ottawa, Canada, have been anxiously awaiting the passage of a financial services bill that may be delayed again for another six months, reported CUNA's News Now. Bill C-38 would clear credit unions to combine forces nationally to compete with major banks, and allows credit unions to expand.

Will this be the US credit union headline in 2005? The Canadian experience is a harbinger for what US credit unions are facing when promoting a "renaissance", except the US credit union hurdles are much higher, according to some observers. Canadian credit unions are already taxed, eliminating opposition based on a tax subsidy. The recent death of a bill as noble as the "faith based lending bill" is a clear indication of the cloud over credit union "renaissance".

For CUNA's Renaissance Commission, the tax subsidy for credit unions is "sacred", therefore efforts to implement sweeping "credit union financial modernization" is likely to meet with resistance not just from banks, but from mortgage companies, securities firms, insurance companies, and any other potential competitor that pays taxes, including other cooperatives. The revenues generated by the lobbying effort are no doubt appreciated by the credit union trades and politicians receiving the PAC contributions; and, the effort might buy a few more years of tax subsidy. **The downside potential is a compromise trap that taxes credit unions, limits their growth, and traps them in a credit union charter ... like Canadian Credit Unions**.

Several state credit union trade associations indicate they will go to great lengths to keep credit unions from converting to another banking charter ... so eleventh hour compromises that includes taxation, but keeps them as credit unions, is a temptation that can be satisfied under the pretense of preserving the credit union "philosophy". The changing character of the financial services business and the express wishes of the membership could take second place to the political posturing of the trade associations, some analysts surmise.

Strategic planning should give serious attention to an extensive review and analysis of other banking charters, including the mutual thrift charter. The wisdom of maintaining a business model which depends on a tax subsidy should be questioned. Already, many credit unions are hitting their limits of growth and member acquisition. For credit unions converting to the mutual thrift charter ... "renaissance" no longer depends on the whims of Congress ... it is a reality today.

Dan Mica Admits:

Banks Have Regulatory Advantage

While taking care to avoid directly pointing out the benefits of the mutual banking charter, CUNA's Dan Mica recently focused a lot of attention on what he sees as a positive regulatory revolution at other agencies. According to the Credit Union Times, he talked about the "new paradigms" in the regulatory process and applauded the changes at the Office of the Comptroller of the Currency, the Federal Reserve and the Federal Deposit Insurance Corporation.

"We are seeing major changes throughout the regulatory process and at other regulatory agencies in Washington. A great example is at the Comptroller of

Currency's office ..." Mica said. Comptroller of the Currency Jerry Hawke has brought people on staff to ensure that the agency's regulations "are not overly burdensome, do not create unnecessary problems, unnecessary restraints, or unnecessary regulations on those that they regulate." "What a breadth of fresh air," Mica said of the OCC's approach. He also commended FDIC chairwoman Donna Tanoue's plans to simplify capital standards for small community banks.

Since a dozen credit unions have voted to convert to the federal mutual banking charter, it would have been noteworthy for Mica to highlight the sweeping improvement going on at the Office of Thrift Supervision (OTS), the primary regulator for federal mutual thrifts, or cooperative banks. (Both credit unions and mutual thrifts are member owned cooperatives.) For example, while NCUA is increasing the capital standards and call report requirements, OTS is modernizing. In addition, OTS recently launched an initiative to make the mutual charter more competitive with stock banking charters. The effort is expected to speed the organization of a mutual holding company, increase cooperation among mutuals, and enhance management compensation flexibility, capturing some of the benefits enjoyed by $75 billion Mouvement des caisses populaires Desjardins in Quebec. Over the last five years the OTS charter has become the charter of choice among progressive credit unions, non banks, brokerage firms, and insurance companies pursuing the benefits of “financial modernization.”

Almost $1 billion converting

Atlantic Coast - Rainier Pacific - AGE Federal

Three credit unions with almost $1 billion in assets are soon to start operating as mutual thrifts. $315 million Atlantic Coast FCU (GA) members recently approved the conversion and the institution should commence operation by November 1. $375 million Rainier Pacific CU (WA) members are now voting. $266 million AGE FCU (GA) filed to convert in September. Rainier and AGE should commence operations with a new banking charter during the first quarter of 2001.

Many other credit unions are at various stages of consideration and implementation according to Alan D. Theriault, President, CU Financial Services, the leading advisor to credit unions considering charter options. In the mid 90’s, CU Financial implemented the first conversion of a state chartered credit union to a federal mutual thrift. The firm also advises credit unions getting involved with business lending, mortgage lending, and addressing punitive regulatory issues.

“We are in a dynamic banking environment. To stay at the top of the game, credit union managers must adopt radically new directions,” Theriault said. “Bank financial modernization ignites volcanic trends that the credit union charter is just <u>not</u> equipped to address. Wishfully thinking about the future as a credit union or fearing the after tax net earnings math after conversion to a taxable entity, could result in a major setback for progressive credit unions," Theriault continued. "The conversion process to the mutual thrift charter is streamlined and tested ... CU Financial has the model ... and it works smoothly, but the winds of Congress might change," Theriault warned.

NAME	Members	Assets	Status
Affiliated (TX)	1250	28	Bank 6/1/98
AGE FCU (GA)	38545	266	Pending
Atlantic Coast FCU (GA)	41000	310	Bank 11/1/00
AWANE Bank, FSB (NH)	2200	33	Bank 5/1/96
Beacon Federal (NY)	30000	186	Bank 7/1/99
BUCS Federal (MD)	11306	79	Bank 3/1/98
Caney Fork Coop (TN)	186	0	Merging
Carolina Federal (SC)	2650	23	Bank 8/1/99
Community Schools (MI)	12316	35	Pending
I.G.A. (PA)	25057	211	Bank 7/1/98
Kaiser Federal (CA)	34254	197	Bank 11/1/99
Lusitania SB (NJ)	6517	101	Bank 9/1/95
Ohio Central (OH)	16337	40	Bank 6/1/98
Pacific Trust (CA)	31223	251	Bank 1/1/00
Rainier Pacific (WA)	34738	375	Voting
Roper FCU (SC)	2200	7	Merging
Synergy (NJ)	20100	238	Bank 5/1/98

Theriault noted that increasing loan demand, thinning margins, and rapid cash inflows from a softening stock market could cause some credit unions to hit the capital wall, resulting in lost opportunities. Already confusion in the marketplace about a credit union's ability to offer commercial and municipal deposit accounts and make loans restricts the growth opportunities of many credit unions. "Furthermore, talk of private insurance schemes, especially in light of credit union failures around the globe, may spook commercial depositors and borrowers, hence, allowing startup community banks to seize this profitable market that in some areas is up for grabs," Theriault said.

<u>Credit Union CRA</u> - Failure to meet your NCUA examiner's community service expectations could mean a poor CAMEL score. Among other things, poor CAMEL scores could delay a State charter or a thrift charter conversion. Another reason to have options.

OTS to Improve Mutual Regulations

Comment: Permit Corporates to act as Bankers Banks

In an October comment letter to the Office of Thrift Supervision (OTS) CU Financial Services asked OTS to allow mutual institutions to use the services of and make investments in corporate credit unions. CU Financial suggested: "mutuals should be allowed to retain investments, make investments, and / or utilize the services of "corporate" credit unions, should a corporate desire the business ... "

Upon conversion to a thrift charter, investments in corporates are divested. Some mutuals, however, may want to stay involved with the corporate. Investments in the capital shares of corporates present a unique problem to solve during conversion to a thrift. Some corporates are asking for long term commitments to capital shares. Credit unions that may need to convert to a thrift charter in the future should make sure the terms of the investment provide an exit clause should the institution decide to leave the credit union charter.

From Stephen R. Covey's
"<u>First Things First</u>"

"Let go of paradigms that are popular and pleasing, but based on illusion."

"Let go of extrinsic sources of security"

For More information, or to receive a free subscription to <u>"Converting from a Credit Union"</u>, please contact:
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