A Tale of Two Cities

Some CUs with large and stable sponsors can hold a pretty steady course with significant advantages, while many CUs find themselves morphing, even looking like banks, to stay competitive.

By Peter Duffy

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Pete Duffy's columns on finance run the second Thursday of every month.

Since the late 1990s, many credit unions have made major changes to the way they market themselves. They've had to make these changes to respond to competitive pressures, to changes within their original sponsor and to regulatory constraints.

In other words, these CUs have appropriately responded to factors outside their control in an effort to preserve their franchise.

Among other changes, these credit unions have expanded beyond their original fields of membership through the addition of select employee groups; TIP (trade, industry or profession) charters; and community charters. Some of this is a result of military base closings, unhealthy sponsors (where significant downsizing of employees has occurred), changing sponsors and merged sponsors. These sorts of CUs faced concentration risk (being overly reliant on an unstable/shrinking member base) and *had* to change. This is the CU city that "*has not" the advantage of a large, stable affinity group.*

CUs with large and stable sponsors haven't had the same worries. The CU with a large and stable sponsor has enjoyed a marketing advantage in that its sponsor was not only large and growing but the employee base was more naturally inclined to "bank" with the CU. This natural marketing synergy has advantages in business accrual while also providing *significant cost advantages.* These CUs have required significantly fewer branches and in some cases the sponsor "sponsors" floor space for some or all of the branches for free or drastically reduced rent. These CUs enjoy an average *169 basis point advantage in operating expenses.* This is the CU city that *"has" a natural advantage.*

Therefore, I believe, the CU movement has been and is evolving into a tale of two cities: Traditional Ville (the "haves") and Metamorph Ville (the "have nots").

The data below is an extract of the CUs with greater than $100 million in assets (the 1,100 largest). These CUs represent 12 percent of all CUs and 78 percent of total assets.

(We drew a line at 3.17 percent operating expense to average assets (close to the movement average of 3.06 percent). We chose 3.17 percent simply because there were a number of Traditional Ville and Metamorph Ville CUs in the 2.75 percent to 3.25 percent range that have begun to morph the business model because they recognize the need to grow and diversify.

Data on the 1,100 Largest U.S. CUs (greater than $100 million in assets)		
	Haves (weighted average by assets)	**Have Nots (weighted average by assets)**
# of CUs/Total assets	440/$290.3 billion	736/$228.8 billion
Assets per credit union	$659.9 million	$310.9 million
Assets/branch	154,195	57,441
Total loans/total shares (%)	72.1	82.2
Operating expenses/average assets	2.29	3.98
Net interest margin/average assets	2.81	3.68
ROAA (%)	1.09	0.89
ROAE (%)	10.44	9.02
Efficiency (%)	43.27	60.72
Cost of Int Bear Liab (%)	1.89	1.44

Traditional Ville credit unions have plenty of business opportunity within their original fields of membership and have grown to significant size in part because they have smartly taken advantage of a somewhat captive, loyal audience, while enjoying a significant advantage in servicing that membership at *much lower overhead expense.*

The memberships in these CUs are happy with their service, or they presumably would have turned elsewhere. Still, it would be interesting to see what market share these CUs have. Have they leveraged their cost advantage to achieve leadership share of the loan and deposit business of the membership?

In Metamorph Ville, credit unions haven't had the same luxuries. They have had to reinvent themselves and will continue to need to "morph" into institutions that can produce sufficient size and sufficiently reliable earnings to remain viable to customers. This is unavoidable because the market forces of the business (the consumer and the competitor) have relentlessly driven net interest margin to 30 basis points *below* operating expenses for the average CU in town. The Metamorph Ville CU has had to invest in costly branch expansion in an effort to "reach" more potential customers/members, while experiencing the same net interest margin erosion that all CUs and banks have felt.

In Traditional Ville CUs, net interest margin is 52 basis points *above* operating expenses, *yet their margins are 87 basis points less than CUs in Metamorph Ville's.*

In one way, this reflects Yankee ingenuity at its best. Despite the cost and marketing disadvantage in Metamorph Ville, the CUs there have generated a better net interest margin and have ROA much closer to Traditional Ville than you'd think—given Traditional Ville CUs have a *169 basis point advantage in operating expenses.*

Metamorph Ville CUs have really had to hustle and have demonstrated some gutsy decision making in the face of declining margins.

CUs in Traditional Ville don't have nearly the cost pressures as those in Metamorph Ville. They have lower overhead and require less spending to keep their members happy. In other words, they don't have to make the same commitment in branches, staff and ATMs to attain and keep member business. Look at the assets per branch for Traditional Ville CUs (the haves) vs. Metamorph Ville CUs (the have nots).

Traditional Ville CUs probably feel less pressure to change charter or merge, while the others are looking for options and alternatives that will create and maintain a competitive edge, including the option for secondary capital (even if it means leaving the movement).

I predict Traditional Ville CUs will have to morph their business model as well. In fact, I have recently met with a few who have already begun to add branches and investigate business loans, as they believe they now have concentration risk as well as the belief that incremental earnings in a flat margin business will come from growth and diversity of product offerings.

Metamorph Ville CUs didn't wake up one day and say, "Let's rock the boat."

Metamorph Ville CUs woke up one day and said, "We better adjust the business model or we're in danger of losing relevance (and competitiveness) with the membership."

Good for them. They decided to take more control of their own fate.

Thus, Metamorph Ville CUs have become entrepreneurial as they expand FOM, change charter, market business loans and attempt to rely less on consumer loans as a staple. By doing so, the credit unions of Metamorph Ville exercise their freedom of choice to protect the franchise.

Industries other than CUs/banks have similar margin pressures and therefore equally important decisions to make.

For example, United Airlines has painfully stopped contributing to the employee pension plan. United didn't *want* to stop pension contributions. The company's margins simply couldn't afford it anymore. This is due, in part, to the way the competitive landscape has changed for the airline industry. New low-price competitors threaten the company's business. Before Jet Blue, United's round trip air fare between New York and Los Angeles was $384. After Jet Blue began flying, United had to adjust its airfare to $231. Something's got to give.

Few industries are "safe" from the impact consumers have had on margin as they continue to take advantage of the imbalance between supply and demand and drive the best deal they can. In all the conferences where I have been guest speaker, I have documented the impact an oversupply of lenders combined with a rate-shopping member has had on loan rates and therefore margins. Later, I will provide some graphs which depict this.

Credit unions in Metamorph Ville (and Traditional Ville, frankly) face many similar challenges in protecting the franchise.

Take a look at these market share statistics for CUs and banks.

	Top Banks Market Share	18,000 Banks/CUs Market Share
Credit Card Loans (Top 10 banks)	85%	15%
Mortgage Loans (Top 100 banks)	83%	17%

With 18,000 banks and CUs sharing 15 percent of the credit card business and 17 percent of the mortgage loan business while slugging it out with such finance giants as GE and GM on auto loans, margins have compressed while operating expenses trend up.

Members want the best deal on loans and shares and expect branches and ATMs on every corner. If they don't get it from their current FI, they will go to another.

Without some sort of intrinsic advantage, what is the CU to do? Die a slow death, merge, and/or morph the business model?

Traditional Ville CUs with a large single sponsor haven't had this worry to near the degree of Metamorph Ville CUs.

With a reported 145 CU mergers since January, it's clear many CUs are thinking of merger as a viable option. Take a look at the attached graph depicting the CU roster change since 1985. We have seen a steady decline from over 18,000 CUs in that year to fewer than 9,000 (8,945) today.

Another way to look at bank (down from 14,000 to 9,000) and CU industry consolidation is as a race to recapture pricing power on loans and shares. For the last decade, the consumer has had all the power. Take a look at the following graph, which shows that even in years when rates go up, loan yield goes down.

Now take a look at this graph, which is where we see a clear indication of consumers leveraging their "power" on loans and shares (margin) while fully expecting you to make their lives easier from a convenience standpoint (operating expenses via ATMs and branches). There is no longer a spread between net interest margin and operating expenses, and many CUs have operating expenses *greater* than net interest margin.

The preceding three paragraphs represent the average of the Top 1,100.

CUs in Metamorph Ville are dealing with this evolution in various ways they feel suit their staff and membership. According to a recent news report, Discovery Federal Credit Union in Reading, Pa., converted to a community charter and started targeting a special niche of new membership—students at local colleges and universities—as a way to use the new charter to expand/diversify its membership base. This is an example of a Metamorph Ville CU seeing the handwriting on the wall and "morphing" the model, *rather than doing nothing.*

As you know, some CUs are thinking of converting, or have begun to convert, to a thrift or bank charter. If their membership approves the move, they will have enabled growth and continued momentum on their marketing plans unencumbered by regulation and capital constraints. This move will give the CU the ability to grow services and branches that the members demand. Until legislative vote approves regulatory changes to risk weighting and provision for secondary capital, *some* CUs' "morphing" efforts may include the exercise of their right to convert.

Unless your CU is in Traditional Ville and enjoying an incredible operating expense advantage, you must be thinking of merger and "morphing." Morphing does not necessarily require conversion; there are financial competitiveness steps a CU can take that ease the transition. (And, frankly, plenty of the Traditional Ville CUs should be taking those steps as well).

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