

## Back to the Future

*Market realities are appropriately causing CUs to re-think the value of 'tax free.'*

By Peter Duffy

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In the 1990s, many credit unions appropriately began morphing to reduce reliance on both their original fields of membership and on consumer loans. By placing branches in local communities, the costly effort to seek new customers began. *This was the right decision and you can't look back, even if you wanted to.*

Time has proven you correct. Reliance on a field of membership that was stagnant or declining would have meant your CU would likely be merged by now (and will mean merger for many who didn't act soon enough).

The math of the business no longer supports inaction.

Now CUs must turn their attention to the decisions that will best enable growth and earnings. We have been referring to this as challenging "sacred cows." One such sacred cow is taxation. "Tax free" has lost its luster because it has led to the regulatory tax that now puts net interest margin and operating expenses at an *aggregate negative 9 basis point spread for CUs above \$100 million in assets. Said another way, CUs are unprofitable without fees.*

Regulation is impairing CU competitiveness and leading to a tarnish of the brand that made you famous ... while distracting you from the battle that really matters: increasing market share.

Despite rhetoric to the contrary, banks get this joke. Did you notice the trend on customer satisfaction among banks and CUs? CUs still hold an edge but the lead is dissipating. There used to be as much as a 20 percentage point difference between CUs and banks in terms of the percentage whose customers say they are "very satisfied." The latest poll showed the difference to be 8 percentage points (2005 American Banker/Gallup survey).

While there is a slight erosion of "very satisfied" for CUs, the biggest difference is the improvement by banks.

### 20-20 Vision

CUs need better clarity in how to deal with the needs of the business. We mentioned last month that traditional sources of advice and traditional forms of "peer" analysis are keeping you in the dark in both understanding what is missing and what can be done. Our belief is that, *on a level regulatory playing field*, many CUs will compete more effectively and grow earnings.

We promised to continue the slaughter of sacred cows and this month's steak on the grill is the role that borrowing and capital utilization *should be playing* in helping you fight the battle for more market share.

First, however, combine the customer satisfaction trend with the following trends related to CU culture (fees) and financial competitiveness.

Take a look at these graphs ([net interest margin](#) between banks and CUs, [ROE](#) between banks and CUs and [fee income](#) between banks and CUs).

Think about what these long-term trends are telling you. The trends related to CU culture (fees and customer satisfaction) are going the wrong way, while the trends related to income are also moving *the wrong way*.

CUs are at risk of losing their brand advantage, even as their financial disadvantage grows.

CUs should consider this unacceptable. The culture of your institution is more important than *any other aspect of the CU and you're letting it slip away*.

Imagine a world where Ivory sinks, Tide lets dirt stay, Kleenex scratches, Pampers irritate and the formula for Coca-Cola is released to the Internet. That's a world where your CU's culture is reduced to meaningless in the value equation.

Why is this happening?

See last month's column for the role bad advice, regulation and peer analysis all play in keeping you in the dark. This month we focus on a new angle: *Regulation has not adapted to the realities of the marketplace, and despite the best effort/intention of the movement to get regulatory relief, it's not getting done*.

The result is that CUs are fighting the battle with less ordnance. The benefits of being tax free are becoming outweighed by the regulatory disadvantage of making drastically less income.

The result is that CUs are shooting the wrong sacred cow ... and adding fees.

Take a look at this [competitive group analysis](#) table as I recently did. You'll have to take my word for it, but, this is a very typical outcome. In all markets we have analyzed, the banks (at the top of the page) have higher ROE/ROA than the CUs. The differences are huge on both a ratio and dollar basis.

What's the reason for the difference?

It's not ability.

It's regulation.

Regulation for safety and soundness in banks is based on credit risk ("don't write bad loans"). CUs are regulated by the belief that earnings are at risk when rates go up. Therefore banks are free to generate 75-180 basis points more income in the investment portfolio (depending on the year), and leverage capital to increase earnings.

Some ALM advice has exacerbated this problem by discouraging appropriate balance sheet management in an effort to "keep the regulator off your back."

The result?

The regulator is off your back (on ALM) while you make less money than your competitor and put the culture at risk with the customer/member.

With many categories of loans becoming commodity-like, banks are increasing their earnings advantage through balance sheet management tactics.

One such tactic is capital utilization.

Look at the capital ratios of the banks and CUs in this [competitive analysis table](#).

Bank capital ratios (seen here as tangible equity to tangible assets) are less than half those at the CUs. The CUs are routinely maintaining capital (undivided earnings) at levels the market considers unhealthy.

Free to borrow and utilize capital in a financially rewarding manner, banks are using capital (undivided earnings) to fund growth initiatives and increase earnings (with leverage strategies). Most CUs (above \$100 million in assets) are fully capable of doing this too, were it not for regulation.

If capital truly belongs to members, why aren't we dividing the funds back into the value equation for the customer? From this perspective, banks are using capital to drive up earnings and make up for the lack of earnings in the loan business.

This fact makes *laughable* the rhetoric that banks "steal" the member's capital.

How much longer will the tightly wound spring of CU potential be held back by the unrealistic regulatory environment?

Press On

CUs are doing the right thing. You've got what it takes to compete because you put the customer first, with conviction. The result of this is the member who knows you, loves you. Now, you need to convert more of your potential members into depositing/borrowing customers.

The risk for many CUs isn't taxation; you can handle it (just like the banks). The risk for CUs is losing the luster on your brand as you wait for *regulatory relief*.

This is what has dominated the senior management and board meetings I've been involved in over the last year and why yesterday isn't soon enough to address the trends that are eating away at your advantage.

This reminds me of the famous quote from Sun Tzu in *The Art of War*:

"Whoever is first in the field and awaits the coming of the enemy will be fresh for the fight. Whoever is second in the field and has to hasten to battle will arrive exhausted."

Next Steps

CUs are at a point in development where the future is better left in the hands of the individual CU. After all, banks don't rely on the FDIC or the ABA for leadership; they *utilize* the trade association as a resource and then operate in a safe and sound manner under more market-friendly regulation.

Procter & Gamble and Frito Lay don't rely on a "mother ship" of consumer goods nor does Google rely on a regulator of the Internet for leadership.

Leadership brands innovate to the market's needs and then price the goods so the consumer will buy. They balance this against the need to competitively pay staff and shareholders. Leadership comes from using (not hoarding) capital in a manner that increases awareness of the brand.

That's how America works. That is how it should work for CUs.

Leadership, however, needs to come from within.

Therefore, I would like to suggest you think of these 10, two-letter words when you consider the source for leadership.

"If it is to be, it is up to me."

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