

Before You Take Your Chevy To The Levy Or Last Train To The Coast, What To Know

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By Peter Duffy

"I can't remember if I cried / When I read about his widowed bride, / But something touched me deep inside / The day the music died."

-Don McLean's "American Pie."

History remarkably will show Yankee Stadium and Wall Street (as we know it) both closed in the same week, officially marking the beginning of the end of the way financial services has been played. Led first by the forced marriage of Bear Stearns with JP Morgan Chase, followed by Bank of America's acquisitions of Countrywide and Merrill Lynch, the government takeover of AIG and the bankruptcy filing of Lehman Brothers, the market has begun to deal with the massive leverage put on by households and companies in the past 10 years (consumer credit increased 250% since 2000, according to Bloomberg L.P.).

Massive regulatory change is on the way and the once-thought "DOA" Treasury Blueprint for a Modernized Financial Regulatory Structure seems very much alive. Among other things, the Blueprint calls for a unified federal depository charter for banks, thrifts and credit unions, and a single federal prudential regulator. More on this later.

The very best and worst of America has been on display, as we witness the credit meltdown unfold. Wall Street innovation (securitization/repackaging of loans) allowed for massive amounts of liquidity to be returned to lenders, enabling the economy to steam ahead while leading to a lack of accountability for credit risk. Mortgage lending became so efficient that, among other reasons we will also discuss later, margins for lenders eroded dramatically. Bank net interest margin declined 12% since 2002, and CUs' NIM declined 15%, according to NCUA/FDIC statistics for banks/CUs \$100 million to \$34 billion in assets).

How Did We Get Here? Who's To Blame?

The backdrop to all this is that America has too many lenders. For years, consumers became more aware of their ability to drive product prices and loan rates lower (their shopping efforts made simpler by the power of the Internet). Specifically, as any lender will say, "we have eight lenders competing for one piece of 'A' paper." This, combined with the improved efficiencies, led to drastic margin erosion and sent good lenders and companies scurrying for alternative business in many creative, innovative (and now we know) damaging ways - from sub-prime lending to indirect loans to 125% financing on autos to credit default swaps to massive leveraging. In CUs, for example, indirect loans grew to 14% of all loans, and home equity lines tripled since 2000, while subprime lending became the vogue in many institutions. It's the amount originated that is worrisome. Compounding the problem is that the same nefarious battle

occurred for deposits, creating consumer squeeze on margins that occurs from both directions in a manner that only a thinning of the supply side will correct. And all this while the Federal Reserve kept fed funds accommodative for the better part of four years. We were throwing money at people.

That brings us to TARP (Troubled Asset Relief Program) which is being designed on the run in hopes of avoiding calamity. While no one knows how regulatory reform will shake out, some concepts are taking shape. For example, it's obvious that Camel 4/5 FIs are not eligible to participate in TARP. CAMEL 1-2 FIs are and they'll be encouraged (as JPM, BofA, Wells Fargo were) to acquire the Camel 4/5s. This indicates the oversupply of FIs is headed for government intervention, and it probably makes sense.

Bye, Bye American Pie?

How your CU uses resources in the next three years will define the long-term future of the franchise. That's because once the wounded large competitors are healthy again, it's a good bet they will be even more aggressive in retail banking.

Thankfully for many of you, your destiny is still in your hands, but you need to get moving! Management's ability to focus the organization on leadership results through effective marketing, financial competitiveness and improved capital utilization - while protecting franchise culture - will be the deciding factors.

The CU "State of Readiness" to compete while generating competitive earnings has been the central focus of our discussions. Recently, several prominent credit union leaders have written about the effect the tax exemption has upon the ability to raise secondary capital. Moreover, in the event regulatory reform includes the Treasury Blueprint, many CUs have also asked me to model the impact of taxation on CU earnings. By making some conservative assumptions in leveraging bank regulations, we learned that the effect is more good than bad.

The Treasury Blueprint could be the much-needed regulatory relief CUs \$100 million to \$34 billion in assets have sought. As mentioned above, our analysis indicates taxation is more than offset by the "earnings and growth friendly" regulations banks currently enjoy (and how they're able to achieve the 101 BP income advantage). No matter what happens however, the two most important CU tools for success are also the ones you exercise the most control over: your culture and your "will to win."

What To Do Now

So what do all these changes mean for credit unions? It means you must take quick action on the following:

1. Consider a change in how (and with whom) the CU conducts strategic planning and marketing. CUs have trailed banks in growth over the last five years by 50% to 70%, and that's a red flag. Your greatest attribute-culture-and therefore growth has been held back unnecessarily by various "sacred cows." These sacred cows require a full vetting, and some (not all) are considered in the related story on this page.

2. Understand the impact of the Treasury Blueprint on your CU. As offered earlier, no one knows where and how far new regulations will reach, but to hope the Blueprint does not happen is to shrink from fiduciary responsibility. What's more, consider that the Blueprint was introduced in the Spring of this year, meaning that the meltdown since then has supercharged momentum for its implementation.
3. Determine the appropriate steps needed to boost what I have been calling Financial Competitiveness. In the asset class above, CUs trail banks by 101 basis points in income; before fees are added in (CUs lose 51 BP before fees, according to FDIC/NCUA call reports). This trend has been worsening for the last 10 years and has all but eliminated the future capability of most CUs to maintain value, while straining marketing budgets.
4. Increase understanding of the role capital plays in member/customer acquisition and earnings. Competitively effective use of capital is a critical ingredient for success in a commoditized business. The average CU has trailed the average bank by 250 to 440 bps in ROE over the last five years (despite the tax advantage, according to call reports).
5. Where appropriate, fix impaired assets immediately and analyze the true value of the credit card portfolio.
6. Determine the role regulation plays in holding back your CU's growth and earnings. The shortfall compared to banks is directly related to the difference in regulations. What's more, the CUs with performance comparable to banks are, with few exceptions, still single-sponsor CUs, yet they too could be doing better with regulatory parity.

Pete Duffy is with Sandler O'Neil & Partners, New York.