Community Lenders Can Aid in Our Revival

By Peter Duffy

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Lost in the finger pointing of today's financial calamity is the fact that feeding the beast of consumption is at the foundation of our system's failure. Keeping Americans engaged in consumption was so important that we increased the supply of lenders beyond the point of saturation. America, the land of opportunity and entrepreneurs, allowed anyone to make credit available to everyone. Automakers, investment banks, manufacturers (over half of GE and GM revenue comes from making loans) and many others became competition for traditional community lenders.

Good community lenders found themselves in nefarious competition with eight other lenders for one piece of A paper. As a result, the margin couldn't support the oversupply, leading many to experiment with how to make money through subprime loans, overreliance on indirect lending and other ways.

For a time, the oversupply of lenders was good for consumers and lawmakers because a voter who is employed and consuming holds no one accountable. In the end, everyone lost.

America's community lenders now share the same draconian challenges and therefore should consider combining forces to become the next trade association.

We were throwing money at people.

The consumption binge led to record loan demand, yet CU earnings declined dramatically. Household debt more than tripled from 1990 to 2007 to $13 trillion (U.S. Department of Commerce). Meanwhile CU net interest margin eroded 21% and ROA declined 56% (1994-2008 NCUA statistics).

Community bank NIM and ROA were also down 1998-2008, but less than for CUs. Banks more nimbly respond to consumer evolution because regulations related to risk weighting of assets, and capital, plus FOM restrictions and business lending caps lead to a 101 basis point income advantage for banks before fees and a 46% better growth performance over the last five years.

Interestingly, some CUs are marketing a loan promotion to support the purchase of American-made autos while GMAC (whose 0% financing helped erode CU margins) has applied for and received a bank charter. Yes, in a matter of days, GMAC got a bank charter that enables access to capital, TARP, as well as cheap deposits.

Since 1998, we've cautioned CUs that the imbalance of supply and demand, combined with the transition to community and SEG charters, mandates CUs change the way they individually market and operate. Among other things, we've discussed the need to boost financial competitiveness, analyze the impact CU regulation and the role capital plays on growth and earnings.

Recently, CU thought leaders called access to secondary capital the industry's most important regulatory need. But the need for secondary capital depends on the individual CU. Some CUs that need secondary capital might have difficulty raising it. Investors won't invest in an institution that needs capital. The investors want the seed money to lead to growth and earnings, not to plug a hole.

A depositor would also expect a higher rate of return for the added risk as these investments would lack deposit insurance. In today's market of bank subordinated debt, the investor's yield exceeds 10%. Financial institutions with a high "state of readiness" will be able to access plenty of capital. High state of readiness lenders maintain sound financials and possess a history of successful capital utilization. They will be attractive to both private and public investments. Note that TARP funds with some exceptions aren't going to needy FIs but to strong FIs that can absorb wounded competitors, a better bet for the American taxpayer.

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CUs no longer compete with one arm tied behind their backs. CUs are now hog tied. This meltdown is exposing the regulatory imbalance. Despite the tax advantage, the regulatory tax is overwhelming many CUs. Some CUs know this and are pushing the FOM envelope to leverage the tax advantage for as long as possible. Lawmakers recently have said that secondary capital and MBL cap relief is not in the cards for CUs.

Meanwhile, the massive change promised by the Obama administration and the Treasury Blueprint will likely include CUs. As I've been discussing with CUs, if the change means that CUs and banks come under the same regulator, it will mark the beginning of an exciting new era for many CUs. Why? Because the math of the business model is better with the tax, assuming the bank regulations come with it.

In short, "CURIA with tax" frees up CUs to compete more effectively and leverage the CU culture into more households.

The following are just a few of the considerations we believe will increase leverage of your culture into more households.

Focus. Many CUs have begun to focus more attention on the needs of the member versus the needs of the movement.

Anticipation/Adaptation. Lately, I find myself advising CUs to avoid the burden of building the perfect plan. Better to implement the well-considered plan and adjust it. We need to be prepared for likely significant change; for example, has senior management and the board discussed and modeled the impact of the Blueprint?

Vetting inventory. CUs are evaluating the value received from various traditional expenses like branches and consultants, and many other items that keep the marketing budget smaller than it should be. The best culture in the business has not grown market share in 15 years, and marketing quantity and quality is appropriately under fire and so should the advisers be.

When in doubt, do without. The discipline here is simple. High state of readiness FIs are well positioned to expand, so if there is any doubt about a traditional expense, do without because a better choice may be right around the corner and you need more funds for marketing, not less.

Get after sales. Are MSRs empowered, developed, motivated and monitored to deliver more business? Do they understand how important their role is?

In short, logic supports the idea that the well-run, community lender can still have a major say in the quality of our economic revival, one household at a time, but not if it's business as usual.

Peter Duffy is associate director with Sandler O'Neill. He can be reached at 212-466-7871 or pduffy@sandleroneill.com

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