

## Stress Testing the CU Business Model: Is the 'Cost of Carry' Too Heavy?

By Peter Duffy

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There has never been a more appropriate time for all financial institutions, particularly CUs, to perform stress tests on their individual models and remove the obstacles that restrict growth and earnings. Many CUs are doing just that.

Before the corporate stabilization, community and SEG CUs were already coming to grips with the regulatory constraints to growth and earnings of the CU charter. Year-end call report data reflects this reality.

For the 10th year in a row, CUs trailed community banks by an unacceptable measure. Specifically, banks turned in a 73-basis-point ROA advantage over CUs—before fees. As a result, CUs are now more reliant on fee income as a percentage of gross income, 13.9% at credit unions versus 12.1% at banks (banks and CUs in the \$100 million to \$36.4 billion asset category, according to NCUA-FDIC data). The regulatory difference is a hidden tax that, for many, outweighs the federal tax advantage.

Virtually no CU with assets above \$300 million is insulated from the regulatory disadvantage; the degree of severity depends on how the CU's business model has evolved since leaving the single sponsor.

The sizable income advantage over such a prolonged period of time has allowed banks to branch and market in a manner that has produced 50% to 70% higher growth compared to CUs for the past five years. Unfortunately, CURIA never got off the ground.

The culture, of course, has never been in question. Does it make sense that healthy CUs (with few exceptions) are trailing in growth given a culture that puts the member first with such conviction? Does it make sense to allow the disadvantage to continue given consumers' heightened desire to transact with an institution they can trust? Shouldn't CUs, where appropriate, be free from such regulatory burden in order to contribute to economic recovery?

As if the regulatory imbalance isn't enough, CUs are now reeling from the 99-basis-point impact to earnings, while considering this to be the second in a series of assessments needed to offset the credit problems in both the corporate central and natural person CUs; the bank "special assessment" is currently 20 bps, with the FDIC determined to lower it to 10 bps.

Meanwhile, and coincident with the death of CURIA, American Express, Morgan Stanley, Goldman Sachs, Lincoln National and Genworth Financial, among others, have transitioned to a bank charter, further increasing the competition for CUs as they each market for retail deposits, among other things.

Many community/SEG CUs now wonder if the CU "cost of carry" is too much to bear. The cost of carry refers to the lack of regulatory parity on asset risk weighting; lack of access to secondary capital; a 40% higher capital requirement than banks; deficient brand awareness (California CU League research indicates that four out of five consumers don't know what a CU is, before considering the complication of membership requirements); higher bailout cost; field of membership restrictions, which also inhibit merger; and a lower business loan cap.

Is the mutual savings bank charter an idea whose time has come? Many CUs have been asking me this question over the past 18 months. This depends on numerous factors, but a charter switch is most likely not right for many CUs.

We have always advised that a CU not approach the decision due solely to one problem where a workaround can be found.

For some, the mutual savings bank was already the right idea.

Determining the appropriateness of a charter change, as with any strategic decision, requires a specific set of steps and considerations that allow the board and senior management to make a choice with knowledge and confidence. The questions that guide due diligence are: What are the strengths of our CU and what factors are inhibiting us from fully leveraging our culture on a long-term basis? and What is the best outcome for the member?

A noteworthy benefit of the due diligence is often the discovery of ideas that enable better growth and earnings within the charter for those that decide not to change. For those that decide to switch, the process leads to effective leveraging of the new regulations sooner than otherwise possible, while providing for increased leverage of the culture.

With all the discussion about regulatory change, including Treasury's Blueprint, which calls for one prudential regulator for banks, thrifts and CUs as recently researched and reported by Filene, conducting due diligence is prudent.

Given the banks' advantages, combined with increased access to capital through TARP and lower assessment costs, CUs cannot afford to wait to stress test their models or for a lifeline from above. With the competitive roster increasing and their rules of engagement better, action is needed.

This is why CUs tell me they continue to advocate and hope for the best, while putting all options on the table for serious consideration.

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