

CU Culture Is Too Big – and Too Important – to Fail

By Peter Duffy

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The credit union culture is not only too big to fail—it's too important to fail.

Despite this, the culture of natural person credit unions is at risk of failing because of the one-two punch of capital regulations that have restrained growth and now both tottering corporate credit unions and natural person credit unions that are likely to drain more capital from healthy CUs.

This shouldn't have surprised us. Over a decade ago, the 1997 U.S. Treasury study of credit unions warned of the interdependence risk among corporate credit unions and U.S. Central: "The three-tier cooperative structure of the credit union system creates an interdependence risk and [natural person] credit unions could face losses on their deposits and a reduction in net worth" (emphasis added).

The study also warned that corporate credit unions needed to address "weak management [and] poor internal controls, [which should be] monitored by the NCUA."

Too often, we have heard that when credit union industry leaders are told that healthy CUs may be driven to the mutual savings bank charter to avoid the risk to their capital, the standard reply is "That would be like jumping from the frying pan into the fire; if you think it's bad here, take a closer look at the banks."

Let's do that.

The risk to the insurance fund from troubled assets in credit unions is 79% greater than that of banks. Assets at troubled banks are 2.70% of total bank industry assets, while troubled CU assets are 4.83% of the total, not including corporate credit union problem assets, according to FDIC and NCUA statistics.

Due to the interconnected risk of the credit union system, healthy credit unions face a potentially large and unlimited contingent liability on their capital. For example, the unrealized losses in the corporate credit union bond portfolios, reported at \$16 billion, is nearly triple the NCUSIF. Healthy credit unions face more special assessments and will probably pay more than their fair share because the growing number of unhealthy credit unions will be capital constrained.

Banks don't have a corporate credit union problem to bail out.

Banks are building capital through higher earnings than credit unions. NCUA data show that credit union ROA is down 75% in the past 10 years. In fact, 47% of credit unions are unprofitable.

Large banks with asset problems have tapped outside investors, TARP and private equity that stand before and serve as a cushion to the FDIC in the event of losses. Neither large corporate credit unions nor natural person credit union have this option.

Riskier banks also pay higher deposit insurance assessments than less risky banks. Healthy credit unions have no such advantage and are penalized in the form of higher potential assessments while paying the same insurance as risky credit unions.

Healthy banks are also accessing capital and using these funds to acquire competitors and branches at bottom-of-the-market-pricing, putting healthy credit unions at an extreme competitive disadvantage.

The FDIC is actively resolving troubled banks and thrifts—140 in 2009. By contrast, the 1997 Treasury study anticipated today's credit union industry dilemma, including a lack of interested, suitable merger partners for troubled credit unions, eventually leading to higher losses to the share insurance fund from liquidations.

Some fear that all of this will lead to more special assessments in the next two years for credit unions than banks will pay in four years, while credit unions must keep 1% of assets on deposit at the NCUSIF. Special assessments in 2009 were 5 basis points for banks (so, low risk banks paid 17 basis points total) and 15 basis points for CUs. In 2010, the announced range for CUs is 15-40 basis points, while banks are prepaying three years of insurance equal to 45 basis points. The final (seven-year?) tally is unknown and, when asked at Town Halls what the total assessment appears to be, the NCUA has responded that "we haven't released a loss projection as it is likely your auditors would make you begin accruing (for the total)."

CURIA was the effort by the movement to level the field with banks on regulations regarding field of membership, asset risk weighting, the minimum capital requirement and member business loans, but this effort now appears dead. What is more, CURIA never contemplated secondary capital.

Now, the growing tsunami of bad assets threatens healthy credit unions because of the interconnected risk of the system. Lacking a taxpayer bailout, many large CUs are prudently conducting due diligence on the credit union charter. These managers and directors aren't worried about being able to sustain their culture because it was shaped by people over years of service and would survive and thrive after a charter change.

Among other things, such due diligence exposes the fallacy of the long-held belief that tax exemption is more valuable than CURIA and access to secondary capital.

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