Converting from a Credit Union Update

Also consultants on matters pertaining to Business Lending * Regulatory Enforcement * Mergers * CUSO Organizations

News for those interested in bank charter conversions by credit unions

Strategic Planning and Implementation Services for Progressive Credit Unions

CU Financial Services, Portland, ME – Tel: 800-649-2741 – www.cufinancial.com – February 23, 2012

Pipeline Update

$1.9 Billion HarborOne Collects Member Comments

The second largest Massachusetts credit union, HarborOne CU, announced on February 15 that it is considering converting to a FDIC insured cooperative bank to shed geographical restrictions, increase lending authority, and gain strategic access to capital.

The notice follows $1.6 billion, California based, Tech CU's announcement last quarter that it was considering a conversion to an OCC supervised FDIC insured bank for similar reasons. Tech's *"request for comments"* period has ended, but a conversion application with the FDIC has not yet been filed.

Last October $188 million Har-Co Maryland FCU received member approval to convert to a bank. Its applications with the OCC and FDIC are still pending.

Also, the Credit Union Journal recently reported a tip that a $500 million Florida credit union was preparing a conversion application. Conversion advisors say multiple credit unions are in various stages of considering conversion.

CA, VA, WI – Now Open

States Open Doors to Conversion Option

Legislative and regulatory paths to convert to a bank charter are now opening up for state chartered credit unions. Virginia, Wisconsin, and California are new examples of policymakers acknowledging the critical need for charter choice given the current economic conditions.

Many states allow conversion under parity provisions with federal credit unions. Some states have reasonable laws and rules in place that make conversions possible. A few states, like Michigan and Minnesota, have a "cosmetic" path for conversion, but a minefield of rules, including a super-majority vote of members, designed to dramatically increase the risk of a failed bid, and thus keeping members trapped in a state charter.

OCC & FDIC

Preparing for an Increase in Conversion Applications

In June 2011, the Office of Thrift Supervision (OTS) as ordered by the Dodd-Frank Act merged with the Office of the Comptroller of the Currency (OCC). The OTS was the regulator of choice by credit unions moving to the bank charter.

Merging the two agencies has been a topic of discussion among policymakers for many years. Troubles in the real estate sector triggered Congressional action to make the merger a reality.

Provision was made for continuing OTS policies related to credit union conversions. However, in order to best handle the increasing level of conversion interest and to mitigate a multi-year

> ***"Mutual thrifts are federally insured depository institutions most similar in structure to credit unions, because like credit unions, mutual thrifts generally do not have corporate stock, are not for profit entities, and are owned by their depositors, or members, rather than shareholders".***
>
> January 2001, US Department of the Treasury study comparing credit unions with other depository institutions.

About CU Financial Services

Over 35 credit unions switched to the bank charter. Our firm has advised the majority of them – including multiple billion dollar institutions and most of those which later raised regulatory capital.

Although the switch is not for everybody, why not explore the positives and negatives with an experienced advisor? Or, if you are ready to move forward, make us part of your team.

With first-hand experience no one can replicate, we have a comprehensive and cost effective program to address the feasibility of the switch and document the due diligence.

Since our work on the first conversions dating back to 1993, we have developed a suite of tools for credit union executives to utilize throughout the process.

We help with the feasibility plan, FDIC "Gap Analysis", the regulatory business plan, the CRA plan, the public relations plan, and guide management and staff with solid briefings during the process saving tens of thousands of dollars and helping reduce the risk of failure.

backlog of applications, staff recently developed criteria for screening potential applicants. Thus, credit unions are now free to come forward again.

The last thing the credit union industry needs is a two or three year backlog of applications as was experienced by California credit unions flooding into a state credit union charter during the last decade.

Clearly, OCC and FDIC are reluctant to accept NCUSIF's problem credit unions. As always, good capital, earnings, good loan quality, and experienced management are important.

Unfair Assessments Paying the Cost

NCUA is Picking Winners and Losers at the expense of Healthy Credit Unions

NCUA is secretly investing NCUSIF money in failing credit unions to avoid recognizing huge losses to the fund and thus attracting Congressional and marketplace scrutiny. Last quarter's call reports show $80 million was invested in insolvent credit unions in Texas and Arizona.

Allowing insolvent credit unions to continue to operate as fully functioning depository institutions is viewed by policymakers as unfair to their "in-market" competitors and counter-productive to the overall health of the banking system. Such forbearance during the S&L crises was thought to dramatically increase resolution costs.

FDIC's policy is to seek buyers for the assets of insolvent banks, retire the charter, and fully disclose the cost of the resolution. Resolution costs total about 30% of assets.

By hefty NCUSIF assessments, NCUA requires healthy credit unions to absorb the losses of the weaker. For years, all credit unions will be paying yet another "hidden tax" in the form of large NCUSIF assessments. For many, this inter-dependence is both conflicted and unfair.

Soon policymakers will force NCUA to deal with the inevitable loses. With only $100 billion in capital and stagnant earnings, recognizing these losses will dramatically limit the ability of the industry to serve its members and the community.

Thus, CU Board members and management are concluding a bank conversion is the best strategic option. Conversion sidesteps future NCUSIF assessments, which could be as large as 5% of deposits, and preserves member capital and independence.

Members will gain other benefits which remain off limits to credit unions including expanded business lending authority and access to capital. The expanded powers allow institutions to better serve their members and the community as the economy recovers.

Would Powers Be Meaningful?

Supplemental Capital Bill is Announced

Two pro-credit union Congressmen introduced a bill in February which would allow credit unions to access "supplemental (debt) capital" and apply it toward meeting regulatory capital requirements.

After a decade of resistance to the idea, both CUNA and NAFCU claim they are behind the bill. But bragging rights must be shared with Boeing CU which has been leading a group of credit unions and paying a D.C. lobbyist $210,000 in 2010 and $380,000 in 2011 for work on the bill. Another New York credit union is thought to have spent $120,000 on the effort.

Unfortunately the current mood of Congress is to take away banking powers rather than grant them. Furthermore, in light of the failure of the Corporate Credit Union System and the many low-income credit unions, both of which had access to “supplemental capital”, policymakers will question whether NCUA is equipped to handle supervision of this expansive power. The bank trade associations are also opposed.

If, by chance, these elusive new powers are acquired, many years will pass before regulators, investors, and the marketplace embrace them. The delay would be costly to members and career threatening for employees. Justifiably, many credit union managers concerned about long-term viability and maintaining independence are exploring better options while a few exist.

Today, retained earnings alone won't sustain even the most conservative business plans or support the current level of assets and the declared missions of many credit unions.

The unfiltered, mathematical reality is that there is not and will not be sufficient self-generated capital to solve the problems caused by the breadth of corporate and natural person credit union failures without reducing all credit unions to the lowest common denominator.

Key Benefits of Conversion

- Capital advantage
  - Risk-based capital
  - Capital efficiency
- Access to third party capital
- Improved consumer awareness
- Product and market flexibility
  - More business lending
  - More investment options
- Unlimited membership
  - Municipalities
  - Non-profits
  - Business entities
- Lower cost deposit insurance
  - Risk based premiums
  - 5 – 9 bp (pre-tax) cost
- Corporate governance flexibility
  - Holding company
  - Proxies
  - Director compensation
- Reduced public relations risk
- Reduced political risk

Strategic Topic

Conversion Slowdown is Only Temporary

CUNA’s economists are on record making claims about conversions, FDIC, and bank stocks. No doubt their employer fears that a groundswell of concern about the problems in the credit union industry will lead to a flood of charter conversions. Thus, they offer only data to support conclusions designed to scare off those credit unions which might consider conversion; and reiterate the false hope that Congress will provide a solution on supplementary capital and business lending, thus inducing many credit unions to delay acting on a conversion plan.

Let’s set the record straight on what’s really going on with charter conversions, the FDIC fund, and the banking industry:

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CUNA's View	Banking Industry Reality
The slowdown in conversions in the past few years implies that conversion to a bank is no longer a strategic option being considered.	The reasons to convert to a bank charter are still valid. What's more, they are amplified by current economic conditions and the problems plaguing the credit union industry. The economic meltdown of 2007-10 slowed all financial transactions such as mergers, IPOs, private equity capital issuance, and new bank organizations. During 2010 deals started to happen again. Today, more credit unions than ever are looking seriously at becoming a bank. CUNA should know, as their economists are occasionally asked to defend the CU charter at BOD meetings.
NCUSIF deposit insurance will be less costly than FDIC insurance. NCUA will not have to increase its reserve ratio to the 2 to 2.5% range announced by FDIC.	NCUA has told credit unions to budget annually more for deposit insurance than FDIC. FDIC says to budget 5-9 basis points (pre-tax), which includes the provision for building the fund to a 2.5% reserve ratio. NCUA will be forced by marketplace and political pressure to follow FDIC's lead, leading to higher NCUSIF assessments than projected. FDIC says the big bank failures are behind us. In contrast, NCUA continues to practice forbearance, investing NCUSIF money to prop up big insolvent credit unions. More retail credit unions losses are inevitable while the size of the corporate credit union losses remains a mystery.
The merger of the Office of Thrift Supervision (OTS) into the Office of the Controller of the Currency (OCC) makes conversion more difficult and less desirable.	On the contrary, the OTS charter required a focus on real estate investments. This presented a strategic challenge for credit unions invested primarily in consumer loans and auto loans. The OCC charter does not require specific concentrations and its examiners are experienced in reviewing all types of lending activity. Thus, as part of the conversion process, transitioning to the broader OCC charter can be planned with more certainty. Conversion has never been a way out for a weak credit union. OTS and FDIC eligibility exams have always been a part of the conversion process. Some CUs were required to correct problems before conversion.
Investor demand for bank stocks is weak. Thus, this is a bad time to be raising capital after conversion to a bank.	Banks have raised almost $400 billion in capital in the last few years. Bank stocks continue to be in high demand. In fact, since 2010 former credit unions have raised over $400 million in capital. Currently depressed bank valuations make this a perfect time for a mutual-to-stock conversion since members can buy the stock in the range of 50% of book value, thus reducing investment risk.
"Bank" is a four letter word; banks alone were the cause of the recent crisis; and asking members to convert to a bank will generate opposition which could get the CEO fired.	Banks control over 90% of the market. The consumer has spoken. Although the giant banks are struggling with a public relations problem, community banks remain respected, healthy businesses. Members still describe their activity as, "I'm going to the bank." Surveys show members do not care about the "ownership" characteristics of the credit union charter. CUNA has also overlooked the fact that credit unions were a part of the sub-prime mortgage problem; corporate credit unions funded tens of billions of the loans. Lastly, it was not rank-and-file members of credit unions who generated the opposition to some past conversions. The opposition was led and funded by credit union trade associations, and their bedfellows, with the help of a complicit NCUA. No CEO has been fired because of a conversion.
Recent state laws and NCUA regulations have made conversion rules "clearer."	NCUA's illegal and deliberately obstructionist anti-conversion rulemaking has increased the cost and time to complete a conversion. The rules do not prevent conversions; with proper guidance conversions will still be accomplished. However, because of the costs, smaller credit unions will not be able to afford a conversion. In the past, certain states did not have enabling conversion legislation. Changes to state law or regulatory perspective are now providing a path. For example, in Virginia, Wisconsin, and California direct conversion is now possible.
Congress will solve the credit union industry's problems by reducing net worth requirements, providing access to supplementary capital, and by eliminating business lending restrictions.	The Treasury Department, banking committees, and banking regulators have been pushing for *more* capital, not less. Debt-based capital instruments have been a disaster for the banking industry. Neither the Democrats nor Republicans will support lowering capital requirements or counting debt as capital in order to solve the credit union problem. In the current environment, it is no doubt shocking to members of Congress to hear NCUA appealing for capital relief and authority to accept weaker forms of capital. This ill-advised request may lead to unintended consequences for the industry. Any relief will only happen in conjunction with taxation.

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CU Financial Services, Portland, ME – Tel: 800-649-2741 – www.cufinancial.com – June 15, 2010

Unfair Assessments and Need for Capital

Large Credit Unions Are Looking to a Charter Conversion for Relief

Through mergers and assessments, NCUA continues to require healthy credit unions to absorb the losses of the weaker. For many, this interdependence is both conflicted and unfair.

Also, it will soon be evident the industry is critically undercapitalized at current asset levels. NCUA and independent analysts estimate credit unions are facing losses in the $15 billion to $50 billion range. But, how long can NCUA delay loss recognition?

With only $90 billion in capital and stagnant earnings, recognizing these losses will dramatically limit the ability of the industry to serve its members and the community.

To maintain today’s asset levels, projected aggregate capital ratios are likely to tumble as much as 30%. Many CUs will face the loss of independence and local control, even failure. For years, all credit unions will be paying yet another “hidden tax” in the form of large NCUSIF assessments.

Thus, CU Board members and management are concluding a bank conversion is the best strategic option.

Conversion sidesteps future NCUSIF assessments, which could be as large as 5% of deposits, and preserves member capital and independence.

Members will gain other benefits, which remain off limits to credit unions, from the larger, albeit also strained, but better reserved, FDIC insurance fund. The expanded powers attendant to the banking charter will also allow institutions to better serve their members and the community as the economy recovers.

Access Unlikely for Years

Alternative Capital Options Are Being Considered

The unfiltered, mathematical reality is that there is not and will not be sufficient self-generated capital to solve the problems caused by the breadth of corporate and natural person credit unions failures without reducing all credit unions to the lowest common denominator.

Today, retained earnings alone won't sustain even the most conservative business plans or support the current level of assets and the declared missions of many credit unions.

For over a decade, accessing outside capital markets has been carefully studied by CU researchers. To currently gain access to capital, one universal conclusion is that Congress must act to give credit unions newer capital powers, or credit unions must convert to a bank charter.

Unfortunately the current mood of Congress is to take away banking powers rather than grant them. Furthermore, in light of the failure of the Corporate Credit Union System and the many low-income credit unions, both of which had access to alternative capital, policy makers will question whether NCUA is equipped to supervise institutions needing alternative capital.

Lastly, even if these elusive new powers are acquired, many years will pass before regulators, investors, and the marketplace embrace them. The delay would be costly to members and career threatening for employees. Justifiably, many credit union managers concerned about long-term viability and maintaining independence are exploring better options while a few exist.

As Losses are Realized
Aggregate CU Market Share Will Decline
Lower Net Worth Ratios Will Lead to CU Failures, Loss of Local Control, Loss of Independence, and Introduce New Risk into the CU System

Timing of Losses	Unrealized Losses Billions	Declining Capital Billions	Assets – NW: 10% Billions	Assets – NW: 7% Billions
Before	0	90	900	1,287
During	15	75	750	1,071
After	30	60	600	857
Yikes	50	40	400	571

Preserving Member Net Worth

New Strategy: Management-led Capital Redemption

Nowhere in the cooperative world (mutual savings banks included) can the member owned capital of one cooperative be siphoned off for use by another cooperative without an affirmative membership vote; agriculture cooperatives, housing cooperatives, consumer cooperatives, wholesale buying cooperatives, and utility cooperatives included.

But, the NCUA imposed industry interdependence redefines a credit union; inconsistent with the constitution of a cooperative. Member net worth is being re-allocated through assessments in order to resolve industry-wide losses, and to preserve the NCUA's and the trade association's business models.

Therefore, some reason that if the net worth cannot be preserved as a credit union and management believes the organization is truly member/owned, another option, supported by cooperative principles, is simply to return the net worth to members and stop further erosion.

A management-led buy-out or an outright sale of the assets and liabilities to a bank or another credit union are strategies worthy of study in this regard. The member's windfall capital distribution resulting from some of these strategies is sure to be more popular than watching the net worth disappear.

"Mutual thrifts are federally insured depository institutions most similar in structure to credit unions, because like credit unions, mutual thrifts generally do not have corporate stock, are not for profit entities, and are owned by their depositors, or members, rather than shareholders".

January 2001, US Department of the Treasury study comparing credit unions with other depository institutions.

2010 Conference Schedule

The Capital and Charter Options Conference:

A one day, economically priced ($125) seminar designed to provide up to date information about the mutual bank charter, FDIC insurance, conversion pros and cons, the impact of NCUA rules, director due diligence, and capital alternatives. Attendance is limited to credit union executives and credit union board members.

Learn from those who have made the switch:

- Escaping NCUA assessments
- Handling the critics and getting the vote
- Charter differences and business opportunities
- Expanding your boundaries
- Why many are making the move
- Why the opportunity justifies the tax outlay
- Keeping the philosophy alive while serving the community & your members

Call 800-649-2741 for details

10:00 a.m. to 2:30 p.m.

New York	**Minneapolis**
Wed., Sept. 22	Wed., November 3

The S&L Crisis Revisited

The NCUSIF is in Much Worse Shape than FDIC

During a June 2, 2010 webinar on Alternative Capital for Credit Unions, Bert Ely, a well known banking industry consultant and an expert in deposit insurance, offered an analysis of the NCUSIF and the FDIC fund, observing that the NCUSIF reserve for potential losses is currently less than 2% of the assets of CAMEL 4 and 5 credit unions, whereas the FDIC reserve represents 11% of the assets of troubled banks.

Ely concluded, "The NCUA will have to continue to levy premiums at a relatively high level for the next few years." Instead of paying high premiums, he recommended that strong credit unions – ones with high capital and not burdened by problem loans – "switch their charters to preserve the capital they have and avoid future premium increases." He noted FDIC premiums are higher as well, but rule changes which move the premium calculation away from deposits "will shift the assessment burden away from community institutions to larger banks."

During the webinar, several speakers compared credit unions to troubled thrifts during the Savings and Loan Crisis, "except today it's much worse" said one speaker. If weak institutions are allowed to continue to operate, greater risk is introduced into the system as poor performers stretch for yield to make up for lost ground.

Also, the credit union business model is fundamentally changing from serving closely knit groups to broad communities as NCUA approves mergers among credit unions located hundreds and even thousands of miles apart. The wisdom of this strategy is still being tested and the risks are yet to be measured.

For many, the challenge of growth and relevance to the community and the desire to remain independent outweigh the benefits of a tax subsidy. Despite the credit union income tax advantage, it is an indisputable mathematical fact that a depository institution can do more for its members and its community, can offer more financial products and services, and can open more branches if it is has a bank charter. Access to the capital markets further expand the opportunity to serve.

Critical: Experienced Conversion Team

The Conversion Learning Curve Covers Disciplines from Public Relations to S.E.C. Rules

The idea of converting to the mutual bank charter often comes from hearing about it at a conference, from a colleague, or during a strategic planning meeting. Conversion is a strategic decision, and although it may not be appropriate for all credit unions, it is worthy of thorough study by many. The first step to embracing the idea involves education.

The following are among the areas to be examined as a credit union considers and moves through the conversion process:

- Charter powers and limitations
  - What are the limitations and benefits of the mutual charter?
  - How are we being constrained by the credit union charter? Is our future in jeopardy?

- What is the future of credit union legislation? Will conversions be constrained?
- Evaluate other non-conversion options (e.g. merger - liquidation - CU community charter)
- Feasibility for our credit union
  - What is in it for the members?
    - How will members react?
    - Can we get the vote?
  - Do we have the senior staff expertise to implement a conversion?
- Financial modeling
  - Are we in a growth market/mode?
  - Can we deploy capital from an IPO profitably?
  - What is the impact of income taxes versus the net revenue from seizing new opportunities?
  - What are the one-time costs of conversion and will our revenues cover them without sacrificing service quality and member benefits?
  - What are the "hidden" and/or opportunity costs of remaining a credit union?

The cost of conversion for larger institutions amounts to a few weeks' earnings. Smaller credit unions, because of the fixed expenses involved, may take months to recover the costs.

The basic information which needs to be processed for a conversion includes:

- Feasibility Plan (including financial models)
- Public Relations Plan
  - Media training for management and the board
  - Member communications
  - Dealing with opposition
- Pre-filing package for regulatory agencies
- Process member comments
- Time and Responsibilities schedule
- Application forms and management biographical information
- Assessment of current and proposed activities
- Business Plan (with 3 years of financial projections in OTS/FDIC format)
- Community Reinvestment Plan (CRA)
- Eligibility exam briefings for staff
- Community Foundation Plan
- Board training in public company issues
- Policies and procedures transition plan

Under the direction of CU Financial Services as conversion advisor and coordinator, the following participants work as a team on the conversion process:

- Washington D.C. (regulatory) law firm
- Local legal counsel (state law issues and litigation)
- Federal and state lobbyists
- Financial trade associations (training, etc.)
- Financial printer
- Public relations consultants
- Vote solicitor
- Inspector of Elections
- Investment banker
- Accounting firm with S.E.C. experience

As an advisor to credit unions since 1984, CU Financial Services has been dedicated to gathering the tools and material to help credit union management and directors get up to speed quickly on important new ideas.

As the coordinator of the feasibility and conversion process, CU Financial has developed numerous tools to help reduce the stress and learning curve for management, employees and directors. The firm has advised the majority of credit unions which have embraced this pioneering change.

"Like other new ideas in the credit union industry, the mutual bank charter option has its critics as did share drafts, investing in government securities, mortgage lending, offering investment services, making commercial loans, and secondary capital", said Alan D. Theriault, President, CU Financial Services.

"The critics have always claimed these new innovations will lead to taxation and the demise of the credit union philosophy, but where would credit unions be today without share drafts or mortgage loans", he said. "Embracing change is critical to survival."

In conclusion, a bright future is ahead for those with the courage to act on the knowledge that this recession will change some things forever, as all major recessions do. Gaining the knowledge will involve acquiring a deeper understanding of the capital markets and the bank charter. Acting will involve renouncing the status quo.

Jack Welch on Change

"Change is an absolutely critical part of business. You need to change, preferably <u>before</u> you have to."

Welch's experience about resisters of change is also timely because he advises, "resisters only get more diehard and their followings more entrenched as time goes on. They are change killers; cut them off early."

Jack Welch is the former CEO of GE and one of the most well known change agents in modern times.

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