

Executive intelligence on credit union exams, enforcement and risk management

Think Twice before Snatching Potentially Unprofitable New Members, Experts Say

In credit unions' rush to scoop up new customers fleeing banks because of sharply higher debit-card fees, some experts are beginning to wonder: Is this a gift – or a Trojan horse?

The consumer backlash has translated into double-digit increases in deposit growth and new accounts at some CUs. A kind of gold rush mentality has taken hold, with CUs aggressively mining customers of the banks with offers of extra debit-card rewards, no-fee guarantees, and even cash.

But it's not clear if all those new accounts will be profitable for very long.

The concern is that the banks may know something that you don't – that the mass checking account business is dying a slow death. CUs may be able

to make some money for now with their competitive advantage on costs. But the same regulatory pressures that have put the banks in a pinch could eventually erode that advantage. The real test will be whether CUs can do what the banks did not: turn these customers into consumers of new and more profitable products.

"The challenge for community banks and credit unions is this: If consumers do begin to migrate their accounts to local financial institutions, community banks and credit unions must be willing to take the bad with the good," writes Bill Handel, vice president-research/development, Rad-don Financial Group, Chicago.

"The bad is the single-service, low balance checking accounts, which

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NCUA Inches towards ERM

Is the NCUA becoming a disciple of ERM? The October *NCUA Report* suggests, at a minimum, that the regulator thinks it may be worth considering. The newsletter has a brief article where it describes ERM as an "effective" way for a CU to evaluate risk and analyze the potential impact of new strategies.

"ERM is effective because it establishes a documented process to measure risk across the entire credit union and relates these risks to a consistent measurement such as risk to capital and earnings," the

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Established Ability, Innovation within Existing Lines Fueled Recession-Era Lending Stars

How do they do it? How do some credit unions continue to grow, again and again, even under the worst possible conditions?

Taking some calculated risks helps. So can indirect lending, well-managed. Geography matters. But size, it turns out, does not; at least it is not as important as you might think.

So found the Filene Institute, in a

new report that studies an elite group of CU performers. The common denominator: They all showed sustained consumer loan growth in each of the last three recession-marked years.

As part of the report, "Superior Consumer Lenders During the Great Recession," the research firm pulled call reports to identify credit unions with at least \$50 million in assets that grew their consumer lending portfolios by more than 5% annually between

2008 and 2010.

Two dozen CUs made the cut based on the volume of their new and used auto loan portfolio growth. Some 11 of the 24 also were able to achieve annual 5% growth in their credit card portfolios. Filene interviewed CEOs and loan managers at many of the CUs to obtain a behind-the-scenes look at the success. Three of the 24 CUs had "volatile" asset returns were

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(Unprofitable, continued from p. 1)

will need to be subsidized by the institution's other business. The good is the accounts where relationships are built," he says. "If too many bad checking accounts are attracted and the institution is not successful in cross-selling, then at some point I believe they will need to move away from free and move towards a relationship-based pricing structure."

To be sure, it is all one of the greatest marketing opportunities that has come the way of CUs in a long time. Rarely, have CUs had such a chance to differentiate themselves on a national stage. (After all, how many times does a NAFCU executive get to appear on Diane Sawyer?) In a way, credit unions are the cavalry, rushing to the aid of the beleaguered bank customer.

There is a market education going on that credit unions had been hoping they could achieve for years – to let people know that credit unions are materially different than banks in their motivation, in their financials, in their goals," says Tim Kolk, principal and consultant at TRK Advisors LLC. "That has always been a hard message for credit unions to get out broadly."

"There is a real financial arbitrage that they have a chance to use that they never had before. They make more money on debit transactions than an over-\$10 billion institution – and that money can be spent to their advantage. They can take it straight to the bottom line. They can use it for advertising, marketing and brand awareness. They can use it to deliver better value. Those are very substantial reasons to be really excited."

CUNA and NAFCU are stoking the fires with resources aimed at helping credit unions market the advantages they offer, including convenience, safety, service, and lower fees.

The NCUA, anticipating a large in-

flux of deposits is giving examiners special advice in how to handle what may be temporary gyrations in CU capital ratios brought on by a surge in deposits.

Rep. Brad Miller (D-NC) has introduced a bill that would make it easier for consumers to dump their banks by prohibiting them from assessing fees for closing accounts. Sen. Richard J. Durbin (D-Ill.) has sent a letter to community banks and credit unions in his home state urging them to "seize

"If you draw lots of new members by marketing against what banks are doing, there is a danger you will draw members that the banks are most trying to purge."

this competitive opportunity" to woo consumers away from the big boys.

A national "Bank Transfer Day" on Nov. 5 is becoming a national happening with CUs gearing up with special hours to feel the love of deposit inflows. A recent poll found that 78% of debit card holders would switch institutions to avoid monthly debit card fees.

But some basics still apply: money-losing products do not suddenly become profitable when sold in volume.

While acknowledging the unusual opportunity, Kolk has concerns that some CUs may be going overboard.

"If you draw lots of new members by marketing against what banks are doing, there is a danger you will draw those members that the banks are most trying to purge with these fees – which are the low-balance, not-many-product relationships," he says. "If you bring in 1,000 \$200 checking accounts, you probably brought in 1,000 unprofitable checking accounts."

Product and relationship profitability tools are widely available, he says, although less widely used, especially among small to medium sized CUs.

"You don't need those tools to take advantage of this market and gain share," he says. "But you do need them to know if you are gaining business that will be profitable." Right now, the promotions that many CUs are using to lure bank customers, including cash bounties, look hard to justify in the near-term.

"It is hard for a credit union to say, 'If someone wants to come to us, we may not want them,'" Volk says. "But if you are pricing something wrong, and on a checking account, it may be no fees, that may lose money, and you are doing existing members a disservice."

Banks with public shareholders have an easier time making those judgments because they are focused on the bottom line. Credit unions, he says, have a harder time balancing how generous they need to be because of their mission to serve the underserved – including those who the banks are now dumping at the curb.

The hoopla, of course, stems from a mandate in Dodd Frank that limits the amount large financial institutions can collect from merchants each time a shopper swipes a debit card. A regulation that went into effect Sept. 30 cuts the fee by about half to 24 cents for an average \$38 transaction. Banks say the move will cost them billions in lost

revenue. Institutions with fewer than \$10 billion in assets – meaning all but three credit unions – are exempted.

Bank of America's decision to begin charging a \$5 monthly fee next year to customers with its most basic checking accounts is credited with igniting the run. Wells Fargo and Chase are also testing new fee strategies; many regional banks have already instituted rate hikes.

For now, the two-tiered interchange fee system established by the Federal Reserve has given credit unions and community banks a tangible structural advantage. But it remains to be seen how long it will last, and many believe it will be eroded over time.

Handel says credit unions would do better to accentuate the positive -- promote the benefits of membership rather than the disadvantages of doing business with big banks. There are too many ways, he says, in which actions now could come back to haunt the industry in two to five years.

He sees the new Consumer Financial Protection Bureau trying to rein in what are now checking-account profitability drivers such as NSF/OD charges -- just as the Federal Reserve has limited interchange fees. That will limit the ability of checking accounts to carry their own weight.

"Because of these factors, I think banks and credit unions need to be cautious right now," Handel says. "Promote the value of relationship and community, and avoid bashing the banks too hard on the fees because I anticipate more than a few will move away from free in the next several years."

While low-cost, high-volume operators are likely to benefit the most from pulling in the new deposits, that has never been the profile of the vast majority of CUs and commu-

nity banks, says Serge Milman, chief executive of OptiRate Inc., a San Francisco firm that promotes a CD service for CUs and banks catering to high-net-worth individuals.

The move to capitalize on the backlash is generally "terrible" for most credit unions, he says.

That's because the consumers most likely to switch as a result of the new fees are those who have purchased limited numbers of products and services and have smaller balances in their accounts. These consumer relationships are unprofitable to the larger banks and, he says, will be even more unprofitable for credit unions. He estimates each of the new relationships acquired by credit unions will result in operating losses exceeding \$200 a year.

"Credit unions seem to have lost sight that it isn't sufficient to grow membership. "Membership growth must be profitable – or at the very least break-even," Milman says. "Lack of data, lack of focus on fundamentals, lack of understanding of relationship profitability metrics is 'the silent killer' of credit unions. We hope that credit union executives take the medicine before it is too late."

"So, let's see what is going on. Large banks are pushing unprofitable customers out the door with the goal of improving overall customer profitability. Credit unions are welcoming this cohort, and that will serve to further deteriorate CUs' operating performance," he says. "Seems like a pretty astute strategy by the large banks to improve their own financials while weakening that of the credit unions and community banks." ▲

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The Safety & Soundness Report, the independent eyes and ears of the credit-union movement, provides executive intelligence on CU exams, enforcement and risk management.

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not studied in detail.

Surprisingly, there were no clear cut silver bullets. None had hit upon a wholly new product or program. By and large, the credit unions succeeded by innovating and persevering within their existing lines of products and services. The closest thing to a silver bullet the report found was attracting the right leaders.

“Most credit unions that could point to a turning point referred to a personnel change, either at the lending management level or at the CEO level, as a critical moment of improvement, the study found.”

“Several took special advantage of the recession to lure in lending talent from struggling competitors,” the report adds.

The majority captured their growth primarily from indirect lending. Each cultivated strong dealer relationships, invested in technology and set its own underwriting standards.

They made in-roads by maintaining consistent standards even as banks and captive lenders bailed as times got tough.

Targeted refinancing programs, aided by data mining and aggressive sales efforts, paid off as interest rates fell.

And a handful was able to leverage market power by strong positions in a local economy.

“A golden ban runs through the middle of the country,” the report, authored by Filene research director Ben Rogers, observed.

Most of the CUs studied were in the Midwest; Texas had four high-performers. Not surprisingly, the sand states didn’t have any CUs that made the cut.

The super performers ranged in size from Daniels-Sheridan FCU (\$54 million), Scobey, Mont., and Acadia FCU (\$95 million), Fort Kent, Me.,

to the Security Service FCU (\$6.5 billion), San Antonio, Tex.

Most of the CUs had this in common: they stared into the teeth of the recession as it was gathering steam, and they kept on lending, aggressively so in some cases, as bank financing for cars and consumer loans dried up.

One of the firms highlighted, Scott Credit Union (\$773.9 million), Collinsville, Ill., had an indirect lending program since the 1990s, but did not gear it up until about five years ago. When the recession hit, the program went into overdrive. Loan volume jumped about 50% in 2008 and membership nearly doubled. It has continued to grow ever since.

“There was about a two-year window where there was not a lot of competition in the auto arena,” says Frank Padak, president and CEO. “We were really able to pick up a big market share.”

“We knew we were going into an economy that was questionable,” he adds. “Unemployment was high and getting higher.”

The CU made a conscience decision to support its members and keep lending, even as banks and other institutions were closing their windows. “We thought about it, talked about it,” Padak says. The prevailing thinking was, “You know, these are our members. We are going to continue to lend money,” he says. “And we have.”

It aggressively expanded its network of dealers, doubling the number since 2008, and invested in technology to expedite the underwriting process. “At the end of the day, the one that gets back quickest wins,” he says, adding that decisions on many loans are made within eight seconds. Funding and commission payment is also done electronically.

It is not a business for the faint of heart. The growth has been accompa-

nied by a discipline in choosing and maintaining members of its dealer network. “We manage dealers very tightly,” Padak says. “If they send us a fishy deal or anything inappropriate, they have one chance to fix it, otherwise they are out of the program.”

The car loans, mostly on used vehicles, turn over every 27 months. The short-term investment gives it a chance to re-price with minimum downside if rates spike.

Founded by employees at the Scott Air Force Base, it has expanded its membership over the years as a kind of hedge against the possibility that military cutbacks would lead the base to closed or down-sized.

The CU now serves 17 counties, and its growth comes from outside the military. Happily, the base has seen its mission expand, benefitting from others’ closing.

While he is not personally a fan, Padak says indirect lending has become a focus because members desire the convenience of one-stop shopping.

“Be cautious. It is a very tough business,” he says. You need to choose your dealers carefully, he advises. Some see their mission as selling a vehicle whatever the cost.

“There are many reputable dealers. You just want to do your due diligence,” he says. “You want to be very, very careful.”

Larry Lemoine, the loan manager for the Baton Rouge Telco FCU (\$202.7 million), Baton Rouge, La., recalls how in the summer of 2008 the NCUA was not thrilled with the way his CU was reacting as the economy started sliding.

Not that the CU was not doing well. It was long one of the more venerable and profitable CUs in the state. The troubling part to the regulators

was that it had decided to scrap its business plan – and more than triple auto loans even as banks and other institutions were pulling in their horns.

“We decided to do something a little contrarian,” Lemoine, who joined the CU that summer from Wells Fargo Bank, recalls in an interview. “The NCUA was a little nervous.”

“My view was: We had all these deposits flowing in. We had a need out there. Our business partners in the auto world needed funds. We hooked up and we made some great connections,” he says.

Auto loans grew more than 20% that first year – compared with a target of 6% in the business plan it scrapped. “It was a great vehicle,” he says. “When the captives quit lending and the large banks got nervous, it was a great opportunity for us to step in.” It went fishing for market share, hoping to catch a few from the big banks.

Lemoine hung a net along one wall of his operations center. Every time one of his loan officers snagged a loan from the competition a plastic crawfish with his or her name on it was dropped into the net. “We ended up doing almost 60 captured loans from other institutions,” he says. “We had 60 plastic crawfish on the wall.”

The CU has a large 40% of its direct loans in credit card loans. It offers a 6.9% no rewards VISA card. It is pitched as a complement rather than a substitute to the rewards cards offered by competitors Chase and Capital One. “Swipe that sucker if you want and then transfer the balance free of charge to Telco each month,” he says. “We hold much higher balances on our cards. It is low delinquency and good interest.”

It helps having the unemployment rate below 7%, and being headquartered in the state capital, along with

two large universities.

Growth is slowing this year, he acknowledges. The glut of cash continues to drive rates down, he says, although the CU does not plan to “chase rates to zero.”

He feels comfortable dipping a little deeper into the loan pool. He is also doing more used car financing, and branching out, developing relation-

“There are many reputable dealers. You just want to do your due diligence,” he says. “You want to be very, very careful.”

ships with boat and power sport dealers. That business has tripled over last year. The CU is marking its 75th anniversary this year, and even though growth will lag compared with a year ago, it still has a lot to celebrate.

“You have to be nimble and flexible,” Lemoine says. “You need to understand the market and position yourself to take advantage. People want that point of sale financing. Some credit unions have been slow to change. If an opportunity presents itself, go ahead and take the chance.”

The Filene study found all interviewees painfully aware that lending growth is hard to maintain, and some admitted that 2011 was not going to be as successful as 2010 or prior years.

But they were all looking to im-

prove: hiring new business development staff, streamlining online lending applications, and tweaking risk-based underwriting.


To be sure, the big banks have come back with a vengeance. Small and midsized credit unions, Filene advised, would be wise to consider expanding their marketing budgets to make sure they are not drowned out by larger competition.

The cash and rock-bottom rates – and the fact that auto lending accounts for just 10% of CU loans today compared with 18% in 2006 – seemingly paint a bleak picture of the future.

But Filene sees the overall market turning up. New auto loans from all sources were up 21% in the first quarter. Credit unions just need to work harder to get a piece of it. To wit: stronger direct originations, a better indirect pipeline or aggressive measures to refinance loans from other institutions.

“Auto lending will become increasingly competitive during the hoped-for recovery,” the report said. “Credit unions should focus on recapturing as many competitors’ loans as possible and strategically deepening relationships with dealers, which drive much of the auto loan volumes.”

Filene also sees an emerging opportunity in credit cards, amid evidence that consumers may finally be dusting off their plastic. With interest averaging around 14%, there is room for credit unions to undercut the competition, the report said.

“Credit unions can win on no-fee balance transfer and by making rewards programs more attractive,” Filene said. “Promoting credit cards as a third or fourth product for indirect members is also promising.” 

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article said. “An ERM framework can be adopted by all credit unions to varying degrees.”

“Ultimately, an ERM process will provide management and officials with a singular process to assess all risks to the credit union and their related controls on a regular basis,” the article continues. “Regardless of whether a robust ERM framework is in place, credit unions should work to gain a more comprehensive understanding of their overall risk profile.”

NCUA spokesman David Small says, while risk-management is an essential function for CUs, the agency is not suggesting that ERM is the only or best way to achieve that.

“There is no standard expectation or requirement for CUs to utilize an ERM framework specifically to address risk areas, either manu-

ally or with an automated software program,” he says in an email.

“An ERM mechanism would more likely be appropriate to a CU with a strong financial condition and management team looking to fine tune operations and their strategic planning process,” Small said.


“There is no standard expectation or requirement for CUs to utilize an ERM framework.”

He said that NCUA does not require ERM in problem CUs or those under a Net Worth Restoration Plan.

NCUA examiners do not receive

specific training on ERM, but Small said NCUA training courses cover ERM topics individually.

Here, according to the NCUA Report, are the core concepts behind any ERM program:

- Establishing an initial baseline level of risk across the entire credit union through a documented risk-assessment process;
- Establishing a method to measure, monitor, and report changes to the baseline risk profile using a consistent measure of risk (i.e., risk to net worth); and
- Adopting an ongoing process of risk assessment to measure risk, including evaluation of new strategies, relative to a credit union’s defined risk tolerances. 

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