Justification for a credit union to charter a bank

Diane Patricia Eazell

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JUSTIFICATION FOR A CREDIT UNION TO CHARTER A BANK

A Project
Presented to the
Faculty of
California State University,
San Bernardino

In Partial Fulfillment
of the Requirements for the Degree
Master of Business Administration

by
Diane Patricia Eazell
June 2000
JUSTIFICATION FOR A CREDIT UNION TO CHARTER A BANK

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Approved by:

Professor Linvol Henry, Chair, Finance

Professor Tapie Rohm, First Reader

D. Brian Reider, Second Reader

6-14-00
ABSTRACT

The purpose of this project is to establish the need to create a bank wholly owned and operated by members of the credit union industry. The activities of the bank would support the needs of credit unions and their members in the changing financial services industry. The impetus for the project is based on a survey of 352 credit unions across the United States. The survey was mailed to credit unions with assets in excess of $250 million dollars; more than 30% or 104 credit unions responded. The findings determined that the bank could be used as a source of credit union alternative capital such as long term debt, if authorized by the National Credit Union Administration. The bank could also be a source of expertise for business lending, a centralized source for credit union loan participation agreements and a secondary market for the sale of real estate and member business loans. The project recommends that additional research be conducted to ascertain the best charter option for such a bank, the gathering of a focus group from among survey respondents to establish capitalization levels. Lastly, a recommendation is made to create a working group to develop the necessary business plan for the venture.
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<table>
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<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABA</td>
<td>American Bankers Association</td>
</tr>
<tr>
<td>BIF</td>
<td>Bank Insurance Fund</td>
</tr>
<tr>
<td>CUMAA</td>
<td>Credit Union Membership Access Act</td>
</tr>
<tr>
<td>ESOP</td>
<td>Employee Stock Option Pension</td>
</tr>
<tr>
<td>FCU</td>
<td>Federal Credit Union</td>
</tr>
<tr>
<td>FDIC</td>
<td>Federal Deposit Insurance Corporation</td>
</tr>
<tr>
<td>MBL</td>
<td>Member Business Loan</td>
</tr>
<tr>
<td>NCUA</td>
<td>National Credit Union Administration</td>
</tr>
<tr>
<td>NCUSIF</td>
<td>National Credit Union Share Insurance Fund</td>
</tr>
<tr>
<td>PCA</td>
<td>Prompt Corrective Action</td>
</tr>
<tr>
<td>ROI</td>
<td>Return on Investment</td>
</tr>
<tr>
<td>SAIF</td>
<td>Savings Association Insurance Fund</td>
</tr>
<tr>
<td>SBA</td>
<td>Small Business Administration</td>
</tr>
<tr>
<td>SCU</td>
<td>State Credit Union</td>
</tr>
<tr>
<td>SEG</td>
<td>Small Employer Group</td>
</tr>
<tr>
<td>SEP</td>
<td>Simplified Employee Pension</td>
</tr>
<tr>
<td>SIMPLE</td>
<td>Savings Incentive Match Plan</td>
</tr>
</tbody>
</table>
CHAPTER 1

INTRODUCTION

The homogenization of the financial services industry continues to be one of the greatest challenges facing the American consumer and small business owner today. Bank mergers, acquisitions and consolidations over the last 20 years have dramatically reduced the number of financial institution options available for consumers and businesses alike. Since 1979 over 3500 mergers occurred consolidating two or more banks under a single charter; during the same period there were more than 5800 banks acquired by a different holding company. Just looking at the early 1990's, bank mergers involved 20 percent of the industry's assets in each year. This resulted in 60% of industry assets in banks with assets greater than $10 billion today compared to just 40% in that asset category in 1985.

All this consolidation translated into fewer larger multi-state banks and correspondingly fewer and smaller community-based banks. Today, the average asset size of U.S. banks is $550 million, a figure double what it was in 1985. While asset size grew, the number of banks in the United States declined during the same period from 14,000 in 1985 to just 9,000 currently. (Mester)
One of the most significant impacts of this 20-year-trend, is that banks have moved in and out of small business lending based on shareholder demands for return on investment. The needs of the consumer became secondary to the demands of the bank investor.

In our review of the Office of Advocacy Studies on Small Business from 1994 to 1999, repeated concern is voiced about the disappearance of the small banks. The Small Business Administration data indicates the percentage of assets represented by small business loans and the ratio of small business loans to total business loans declines as the bank asset size increases.

Traditionally, small business relies on the banking industry for its borrowing needs, however statistics indicate a decline in small-business lending from the banking sector even in the midst of a small business explosion\(^1\). Some experts believe this reduction is due to the acquisition and merger of smaller banks, which are widely considered to have a greater propensity to lend to small business. To illustrate the point, consider the effect on a small to medium-size bank with assets of less than $10 Billion that is acquired by a large bank. Pre-

---

\(^1\) U.S. Small Business Administration data indicate firms employing fewer than 500 workers in the U.S. grew 2.8% from 1989-1991 and 5.2%
acquisition, the bank held total business loans of $222 million, of which $125 million were to small businesses (56% of total business loans). Post acquisition, the percentage of small business loans drops to 15.2% of total business loans (same percentage allocated by large banks) or $34 million. In this example, a reduction in small business loans of $91 million dollars occurs. (Mester)

In a recent article in Crain's New York Business, Tami Luhby noted that mega-bank Citibank approved only six SBA loans during the first four months of fiscal year 1999 worth $473,000 in the southern area of New York state compared to the over $2.2 million loaned last year during that period by all SBA lenders in the same area. Luhby quoted SBA officials reporting similar declines at other banks involved in large mergers like Citibank.

The Small Business Administration conducts an annual study on small business lending in the United States. The study tracks bank performance in lending to small businesses and attempts to stimulate competition in business lending that will benefit small firm owners. The discussion that follows describes a few of the findings of these studies from 1994 to 1998.

The number of small businesses (firms with less than 500 employees) in the U.S. increased from 5,081,234 in 1992 to 5,353,624 in 1995, a 5.4 percent increase. In California, 99.2 percent of the over 800,000 companies operating in 1997 were small businesses employing fewer than 500 workers. During 1995, commercial banks provided 59% of the funds borrowed by small business in the United States. If you also consider the size of small business loans made to these firms from 1994 to 1998, a dramatic trend appears. Table 1 represents the percentage of loans extended to small businesses in California in three different dollar-size categories from 1994 to 1998.

Table 1

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; $100,000</td>
<td>8.6%</td>
<td>8.8%</td>
<td>26.6%</td>
<td>19.3%</td>
</tr>
<tr>
<td>$100,000 - $250,000</td>
<td>10.7%</td>
<td>6.0%</td>
<td>8.6%</td>
<td>1.8%</td>
</tr>
<tr>
<td>$250,000 - $1,000,000</td>
<td>11.6%</td>
<td>7.5%</td>
<td>8.0%</td>
<td>1.4%</td>
</tr>
</tbody>
</table>

Source: U.S. Small Business Administration, Office of Advocacy

The chart shows an increase in smaller loans and a significant decline in the larger loans exceeding $100,000 during the period reviewed. While the smaller loans help businesses meet short term cash flow needs, the larger loans...
usually serve as a means to expand the businesses by purchasing equipment and production space. One reason for the decline in small business lending could be attributed to a reduction in loan demand by small business. Is this logical considering the significant increase in the number of small businesses in the U.S. as previously noted? We doubt it, rather, we believe the data demonstrates the banking industry "hot and cold" mentality in serving the needs of small business -- sometimes being a resource and at other times a roadblock.

The SBA expressed concern about this issue in several of its annual studies. Their 1998 Annual Study noted their position:

"Commercial banks help maintain the health of small firms, but the declining small firm share of business loans raises concerns about the adequacy of small business commercial bank credit, especially for firms looking to grow."

Other facts revealed in the SBA 1998 report include:

- Dollars in small business lending increased at a slower rate than lending to large firms (6.3 percent compared to 13.0 percent)
- The number of banks offering small business loans is declining

Only 22 California banks of the over 300 in the state were identified by the SBA as "small business friendly" in 1998. This finding is generally supported by a survey of
over 800 small business owners and executives conducted by The NETWORK of City Business Journals and American City Business Journals in 1998. This study was designed to update and expand on studies conducted by the SBA and Federal Reserve. The survey reported that larger national and regional banks fall behind literally every other type of financial institution in responsiveness to small business.

Bank consolidations and mergers have affected the relative importance of small business lending nationwide. The merging and acquisition of small banks and the consolidation of the larger banks are two factors which appear to be causing a decline in total small business loans to total assets. As they seek alternate sources of loans, small business owners are turning to credit unions as a source of funds because for years their credit union, as an employee benefit, has provided excellent financial services for their employees and their families.

The Current Credit Union Regulatory Environment

In 1990, the American Bankers Association (ABA) and four North Carolina banks challenged the National Credit Union Administration's (NCUA) approval for AT & T Family Credit Union to accept small employee groups (SEG) not related to the telephone industry into their field of membership. The banks sued on the basis that NCUA's actions
violated the Federal Credit Union Act. During the course of the case, a Washington D.C. (District of Columbia) District Court judge in September 1994 concluded that the NCUA acted properly. The bankers appealed the decision and in July 1996 the D.C. Circuit Court of Appeals handed down a decision that NCUA's long standing regulation permitting multiple groups in one credit union was unlawful. The case was sent to the Supreme Court for review. Credit Unions viewed this case as the latest effort on the part of the banks to continuously control and restrict competition in the financial services arena.

In February 1998, the Supreme Court issued a ruling stating that the NCUA interpretation of the Federal Credit Union Act that allowed multiple groups was not permissible. As a result of the decision in the AT & T Family Credit Union case, many Federally chartered credit unions nationwide could no longer accept members. A legislative solution was sought.

President Clinton signed the Credit Union Membership Access Act of 1998 (CUMAA) into law on August 7, 1998. CUMAA authorized multiple group chartering for federally chartered credit unions (in effect overturning the AT & T Family Credit Union law suit decision) but also imposed significant new regulatory requirements for federally
insured credit unions. While some U.S. credit unions are federally chartered and others state licensed, virtually all credit unions in the U.S. are federally insured by NCUA. Therefore, CUMAA imposed sweeping regulatory reforms on all credit unions, not just the federally chartered ones who sought relief from the banking lobby's latest effort to curtail credit union membership expansion.

Key Provisions of the Credit Union Membership Access Act

There are four areas addressed under this new law, 1) credit union membership, 2) regulation of credit unions, 3) capitalization and net worth of credit unions and, 4) miscellaneous provisions.

The credit union membership section of CUMAA specifically enables the NCUA to approve community-type charters for federally chartered credit unions. This rule deals directly with the issue of the ABA lawsuit previously discussed.

The next section of CUMAA addresses certain financial statement and audit issues and provides for the optional conversion of a credit union to a mutual savings bank or savings association charter. The most critical issue in this section relates to the limits placed on member business loans. The law places an aggregate limit on a credit union's outstanding member business loans of the lesser of
1.75 times the credit union's net worth or 12.25% of the credit union's total assets. This new law applies to both federally chartered credit unions and federally insured state credit unions.

The third section of CUMAA establishes a new system of tiered capital requirements for all insured credit unions (other than corporate credit unions). It sets a new net worth standard of 7% of assets for insured credit unions and a yet-to-be-defined, risk-based standard for "complex" credit unions. The law leaves the definition of a "complex" credit union up to NCUA to decide. Also included here is a stringent "Prompt Corrective Action" provision that applies to credit unions who do not meet the risk-based capital standards.

While the last section of CUMAA has no immediate effect on credit unions, it requires the Treasury Department to conduct various studies on the differences in regulation, taxation and credit union member business lending.

**Significance of the New Law**

The regulatory interpretation and implementation of CUMAA is still being determined at this writing, but the potential effects on the credit union industry can be analyzed. The implications of certain provisions of the new law present the industry with many challenges. For the
purposes of this project, we demonstrate how the new law, in reality, acts as a governor on the future growth of credit unions. This argument sets the stage for our premise that a bank, wholly owned by credit unions, is needed to ensure credit unions continue to grow and prosper in this new and potentially stifling regulatory environment.

We will examine the three challenges to credit unions created by CUMAA. The first challenge is the restriction of credit union member business loans. The second is the "Prompt Corrective Action" regulation's inherent limitations on a credit union's ability to grow. The third, and potentially most difficult challenge, is how credit unions are going to deal with the high growth rates they will likely experience, not as a result of mergers as banks are seeing, but due to more open fields of membership as a result of new law. This last area is especially problematic considering the restrictive impact of the first two challenges.
CHAPTER 2

CHALLENGES FACING CREDIT UNIONS
IN THE 21ST CENTURY

The First Challenge -- Member Business Loan Restrictions

The Credit Union Membership Access Act prescribes a new computation for the maximum allowable member business loans outstanding for federally insured credit unions. In essence, the rule imposes a cap of 12.25% of assets as a maximum of member business loans outstanding. These loans are categorized as a "loan, line of credit or letter of credit where proceeds are used for commercial, corporate or other business investment property, venture or agriculture purpose." The law provides for a 3-year transition period because many credit unions already have a higher percentage of outstanding member business loans than this new regulation allows. To comply, they must "apply the brakes or gas" to their business lending activities as they grow -- not a very attractive or practical business strategy.

Credit unions, as an industry, have not pursued member business loans -- rather, their members have sought the assistance of credit unions for their business needs because of the role their credit union played as their trusted personal financial partner. Credit unions provide financial services to employees of small businesses in the community,
and so the business often looks to the credit union as a potential source of funds to grow the business. In still other instances, the credit union serving as sole sponsor in a close knit relationship, such as a group of churches, may see the institution as a source of financial assistance for the church as well as the parishioners and church members and their families.

**Demand for Member Business Loans from Credit Unions**

Member business lending statistics gathered from the NCUA Annual Reports from December 1996 through June 1999 show strong growth and demand for business loans from credit union members. In fact, as of June 1999, U. S. credit unions held over $3.5 billion in member business loans with average balances exceeding $65,000. This mid-year figure is on a track to grow about 15% for the year -- 5 times the growth the industry experienced in member business loans in 1997. The outstanding total dollars in member business loans for credit unions across the nation grew over 24% for the period December 1996 to 1998. When we compare member business loans granted during the period December 1996 - 98, we see the number increased 11% over the period, but the dollar amount of these loans increased 45% from $1.0 billion in 1996 to $1.5 billion in 1998 - a significant gain.
Additionally, average balances of loans granted increased from $40,035 in 1996 to over $57,000 in June 1999. This information reflects the increased demand for business loans from credit union memberships across the nation. Graph A displays the outstanding balances in credit union member business loans and loans granted from December 1996 through 1998.

Graph A

Credit Union Member Business Loans 1996-99

Source: National Credit Union Administration

Another area of business lending growth for credit unions over the last few years is in construction and development loans. This area of lending increased from $87 million in December 1996 to over $129 million in June 1999. While the total dollars are smaller, the industry
experienced strong 30% growth in this product over the period.

Credit unions will continue to play an important role in fulfilling the financial demands of the growing small business owner across the United States. The restrictions imposed on credit union member business lending by the Credit Union Membership Access Act can be overcome by formation of a credit union owned bank. This proposal will be explored further in the next chapter.

The Second Challenge: Prompt Corrective Action (PCA)

The Credit Union Membership Access Act of 1998 includes provisions that require federally insured credit unions to comply with a version of the Prompt Corrective Action rule originally created for banks in 1991. There appears to be a huge inequity based on what we currently know of the PCA requirement for credit unions compared to banks. First of all, credit union risk-based capital differs from that of a bank. Secondly, banks have the ability to generate capital from external sources (by issuing stock or long-term debt). The only way a credit union can improve its reserve position under PCA is to earn more income -- a very slow process. In this way, the PCA regulation acts as a governor on credit union growth. It forces credit unions to slow their growth,
to serve fewer member needs or accept fewer new member deposits in order to keep reserve ratios in line with PCA requirements. At this writing, the National Credit Union Administration is developing credit union PCA rules including what they will conclude is a "complex credit union." Presumably "complex" credit unions will have to meet even higher PCA requirements that is currently published.

What is Prompt Corrective Action?

Prompt Corrective Action for banks grew out of the bank failures of the 1980's. The bank deposit insurance fund was seriously depleted as a result of the poor financial condition of the banking industry after the bailout of the savings and loans. When the American tax payer (through the federal government) stepped in to bolster the industry, Congress passed the Federal Deposit Insurance Corporation Improvement Act of 1991 mandating that regulators take corrective action when bank capital declines below certain acceptable thresholds as a result of unsafe or unsound conditions or practices. PCA dictates acceptable capital levels for all U.S. banks and thrifts. To remain free of regulatory intervention, an institution must maintain capital in the well-capitalized or adequately capitalized
categories as documented in the regulation. If capital
declines, causing the institution to rate as under-
capitalized, significantly undercapitalized or critically
undercapitalized, regulators may exercise authority to cease
payment of dividends, prohibit opening of new branch offices
or prevent the bank from making acquisitions; other
provisions are provided for in the law giving the regulator
increasingly more control over the institution. At the
minimum, the institution must file a capital restoration
plan with the regulatory authority outlining how capital
levels will be restored. Table 2 outlines the PCA capital
requirements for commercial banks.

Table 2

<table>
<thead>
<tr>
<th>Capital Category</th>
<th>Bank Total Risked-based Capital Ratio</th>
<th>Bank (Tier 1) Risked-based Capital Ratio</th>
<th>Bank Leverage Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well capitalized</td>
<td>≥ 10%</td>
<td>≥ 6%</td>
<td>≥ 5%</td>
</tr>
<tr>
<td>Adequately capitalized</td>
<td>≥ 8%</td>
<td>≥ 4%</td>
<td>≥ 4%*</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>&lt; 8%</td>
<td>&lt; 4%</td>
<td>&lt; 4%*</td>
</tr>
<tr>
<td>Significantly undercapitalized</td>
<td>&lt; 6%</td>
<td>&lt; 3%</td>
<td>&lt; 3%</td>
</tr>
<tr>
<td>Critically undercapitalized</td>
<td>&lt; 6%</td>
<td>&lt; 3%</td>
<td>&lt; 2%</td>
</tr>
</tbody>
</table>

*May be 1% lower for CAMEL high-rated institutions
Source: Federal Reserve Board
Essentially, banks are permitted to generate capital externally or internally. Externally generated capital is created through the issuance of common or preferred stock and by long term debt. Banks create capital internally through accumulating net income over many years -- a very slow process. By contrast, this slow, internal process of net income accumulation is currently the only method available for credit unions to generate capital.

**PCA Regulation: Credit Unions vs. Banks**

The credit union industry must now comply with a version of PCA as a result of passage of the Credit Union Membership Access Act of 1998. The inclusion of this provision in the legislation caught the industry somewhat unaware. There is no crisis in the credit union industry similar to that which preceded the regulation for the banking industry -- only a political battle with banks who want to control future credit union growth in the financial services marketplace. There are a myriad of differences between banks and credit unions both regulatorily and philosophically; however, one important difference for the American taxpayer is often overlooked. The National Credit Union Share Insurance Fund (NCUSIF) that insures credit union member deposits is, and always has been, completely
underwritten by insured credit unions. They initially provided the seed money to start the fund and continue to pay part of their annual earnings into it each year to support it. No federal government funds have ever been used to insure credit union deposits.

In the credit union PCA regulation, adequate capital levels are determined by the Net Worth Ratio. The net worth of a credit union is the sum of regular reserves, undivided profits and year-to-date net income (not including the Allowance for Loan Losses) as a percentage of total assets. Credit unions not meeting at least adequately capitalized levels are required to develop a Net Worth Restoration Plan to be submitted to NCUA. The proposed regulation contains regulatory controls on credit union operations similar to those of the banking regulation if adequate capital levels are not met. Table 3 outlines capital levels under PCA.

<table>
<thead>
<tr>
<th>Capital Category</th>
<th>Net Worth Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well Capitalized</td>
<td>7%</td>
</tr>
<tr>
<td>Adequately Capitalized</td>
<td>6% to 6.99%</td>
</tr>
<tr>
<td>Undercapitalized</td>
<td>4% to 5.99%</td>
</tr>
<tr>
<td>Significantly</td>
<td>2% to 3.99%</td>
</tr>
<tr>
<td>Critically Undercapitalized</td>
<td>Less than 2%</td>
</tr>
</tbody>
</table>

Source: National Credit Union Administration
PCA may have an extremely destructive effect on credit unions of all sizes; and it virtually ensures that few new credit unions will be established in the future. PCA became a provision of the Credit Union Membership Access Act of 1998 through a suggestion and powerful support by the Treasury Department in an effort to create stronger capital positions for the nation's credit unions. Unlike banks, the only way credit unions generate capital is through the very slow internal process of increasing net income over many years. Historically, credit unions have not used external methods to generate capital; it was not permitted regulatorily. For this reason, the proposed rule will act as a governor on future credit union growth. If credit union growth outstrips the pace of net income growth, their capital position will decline placing them in lower regulatory capital thresholds. This is a likely scenario because deposits affect an increase on assets immediately while the income generated on deposits occur later through the return on investments or member loans. This clearly leaves the banking industry with a significant advantage of being able to generate capital from external sources quickly to respond to rapid growth.

The credit union proposed PCA rule provides for a time frame for newly formed credit unions to meet the net worth
schedule. Unfortunately, the required reserve levels and corresponding time requirements proposed will likely not allow them to grow fast enough to become economically viable; with no external means to generate capital, their future success is seriously in doubt.

The Impact of PCA on Credit Unions

As mentioned above, credit unions have two sources of capital -- regular reserve and undivided (undistributed) earnings. Banks also have these two sources plus several more including common stock, paid-in surplus and some even have minority interests in subsidiary corporations as part of their Primary Capital. They also have several other sources, called "Secondary Capital", such as preferred stock, subordinated debt and allowance for loan and lease losses. This issue becomes another hurdle for credit unions as they deal with the implementation of PCA and the definition of "complex" credit unions.

Another, yet undefined, aspect to PCA is the provision for the definition of a "complex" credit union. The NCUA is charged with the task of defining a "complex" credit union that may have more stringent net worth levels than those currently outlined in PCA. It is assumed that these "complex" credit unions may require higher net worth ratios because their asset mix poses greater risk to the NCUSIF.
While we cannot speculate on NCUA's final definition of a complex credit union, we suspect that larger, more diverse credit unions will fall into this category.

The illustration that follows is a comparison of capital allocation for a same-size bank and credit union. Using the risk-based capital computation for FDIC-insured banks, and using the balance sheet information from a credit union, we show how differently PCA applies to credit unions compared to banks. Using information from a credit union balance sheet, we gathered the following selective data required for our comparison:

Table 4

Selected Credit Union Balance Sheet Data

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$373,458,503</td>
</tr>
<tr>
<td>Total Loans</td>
<td>297,049,037</td>
</tr>
<tr>
<td>Less: Allowance Loans/Leases</td>
<td>4,023,578</td>
</tr>
<tr>
<td>Treasury Securities</td>
<td>17,445,349</td>
</tr>
<tr>
<td>U.S. Gov't Securities</td>
<td>5,236,698</td>
</tr>
<tr>
<td>Regular Reserve</td>
<td>3,669,982</td>
</tr>
<tr>
<td>Undivided Profits</td>
<td>21,040,534</td>
</tr>
<tr>
<td>Risk Weighted Assets(^2)</td>
<td>343,783,244</td>
</tr>
</tbody>
</table>

We can compute the risk based capital requirements and corresponding Risk-based Capital Ratio and Leverage Ratio.

\(^2\) Risk Weighted Assets were computed based on FDIC guidelines.
for this credit union using the FDIC criteria that would be used if it were an FDIC insured bank.

Table 5

**RISK-BASED CAPITAL COMPUTATION**

**FOR FDIC-INSURED BANKS**

<table>
<thead>
<tr>
<th>Adjusted Total Assets:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$373,458,503</td>
</tr>
<tr>
<td>+ M to M Adjustment</td>
<td>-0-</td>
</tr>
<tr>
<td>+ Allowance loans/leases</td>
<td>4,023,578</td>
</tr>
<tr>
<td>+ Unused Credit Commitments</td>
<td>3,564,087</td>
</tr>
<tr>
<td>+ Letters of Credit</td>
<td>-0-</td>
</tr>
<tr>
<td>- Cash</td>
<td>(17,445,349)</td>
</tr>
<tr>
<td>- Treasury Securities</td>
<td>-0-</td>
</tr>
<tr>
<td>- Gov't Agency Securities</td>
<td>(5,236,688)</td>
</tr>
<tr>
<td><strong>Adjusted Total Assets</strong></td>
<td>$358,364,131</td>
</tr>
</tbody>
</table>

**Tier 1 Capital**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>-0-</td>
</tr>
<tr>
<td>Paid-in-Surplus</td>
<td>-0-</td>
</tr>
<tr>
<td>Minority Interest-Subsidiaries</td>
<td>-0-</td>
</tr>
<tr>
<td>Regular Reserve</td>
<td>3,669,982</td>
</tr>
<tr>
<td>Undivided Earnings</td>
<td>21,040,534</td>
</tr>
<tr>
<td><strong>Total Tier 1 Capital</strong></td>
<td>$24,710,516</td>
</tr>
</tbody>
</table>

**Tier 2 Capital**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred Stock</td>
<td>-0-</td>
</tr>
<tr>
<td>Subordinated Debt</td>
<td>-0-</td>
</tr>
<tr>
<td>Allowance for Loan Loss</td>
<td>3,994,578</td>
</tr>
<tr>
<td>Allowance for Lease Loss</td>
<td>29,000</td>
</tr>
<tr>
<td>Less: Disallowed Portion</td>
<td>-0-</td>
</tr>
<tr>
<td><strong>Total Tier 2 Capital</strong></td>
<td>$4,023,578</td>
</tr>
</tbody>
</table>

**TOTAL CAPITAL BASE** | $28,734,094

We can use these computations to determine the Leverage Ratio and Risk-based Capital Ratio for this institution. The Leverage ratio is Total Tier 1 Capital divided by
Adjusted Total Assets or 6.90%. The Risk-based Capital Ratio is determined by dividing the Total Capital Base by the Total Risk Weighted Assets from Table 5 above and computes to 8.36%. If this credit union were a bank, these ratios would meet the FDIC capital requirements even without additional sources of capital beyond its retained earnings and reserves.

Under the credit union PCA regulation, this credit union's net worth ratio is 6.62% (Tier 1 Capital divided by Total Assets), clearly in the adequately-capitalized category from Table 2. However, if NCUA poses higher net worth requirements for "complex" credit unions, this institution may be considered undercapitalized. Such categorization brings with it regulatory intervention and competitive restrictions on the institution.

From this illustration, one can see that a credit union of comparable size and complexity to a bank could be placed at a significant competitive disadvantage through PCA enforcement by their regulator. For this reason, credit unions must be allowed to seek other sources of capital to meet potential higher net worth ratio requirements. If they are not allowed this flexibility, reserve requirements will prevent them from meeting the demands of their membership and place controls on their ability to grow.
PCA, Secondary Capital and Subordinated Debt - A Legal Opinion

As a result of the PCA regulation, credit unions are beginning to take a closer look at their ability within the current regulations to raise secondary capital or subordinated debt. In a recent legal opinion on the subject to a Southern California credit union, a law firm found that in 1996, the National Credit Union Administration (NCUA) approved a form of secondary capital (non-member shares) as a means for low-income credit unions\(^3\) to raise capital. They further stated that NCUA's authority to create this form of secondary capital is derived from the Federal Credit Union Act which allows federal credit unions, "to borrow in accordance with such rules and regulations as may be prescribed by the Board of any source." While the specific references to secondary capital or subordinated debt did not come about until later when PCA was enacted, the NCUA actions were consistent with the definitions of the two terms.

The firm points out that by the above action, NCUA created a form of subordinated debt that stipulates restrictions that mitigate risk to the National Credit Union

\(^3\) Low-income credit unions are chartered by NCUA specifically to serve low-income members. This type of charter is the only one allowed to raise secondary capital.
Share Insurance Fund (NCUSIF) and provides for due diligence requirements for credit unions utilizing this resource. The restrictions are:

1. A written plan must be submitted to NCUA and receive approval from the Regional Director
2. The account must be established as an uninsured capital account or other non-share account (uninsured)
3. The account must have a minimum of five years maturity (subject to special regulatory accounting treatment)
4. The funds are not redeemable prior to maturity
5. Not insured by NCUSIF or a private insurer
6. The funds are subordinate to all other claims including NCUSIF
7. Their available to cover operating losses and not subject to restoration or replenishment by the credit union
8. The funds are not available to pledge as security
9. Funds will be paid out upon merger or dissolution of the credit union
10. A written contract between the credit union and the account holder is required
11. A disclosure and acknowledgment must be provided as prescribed by NCUA Rules and Regulations stating the funds may not be redeemed for a period of stated years, are not insured and subordinate to other claims.

Many of the above restrictions were derived directly from the Federal Deposit Insurance Corporation (FDIC) subordinated debt policy. The law firm concludes from these facts that the NCUA recognized secondary capital as a form of subordinated debt. Most mainstream credit unions in the United States have not opted to pursue secondary capital; their growth rates have not yet dictated a need.

How does the enactment of PCA affect the ability of federal credit unions to raise secondary capital? According to the legal opinion, PCA recognizes that low-income credit
unions will include secondary capital in their "net worth" computation; and that secondary capital is "uninsured" and "subordinate to all other claims against the credit union, including the claims of creditors, shareholders and the Fund."

The purpose of PCA is to resolve the problems of insured credit unions at the least possible long-term loss to the Fund. NCUA's stated purpose in providing low-income credit unions with the ability to raise secondary capital is because low-income designated credit unions "find it difficult, in view of the limited resources of their members, to accumulate capital." This clearly indicates that NCUA's purpose in allowing creation of secondary capital or subordinated debt is not to prevent failure but to build capital. This objective is consistent with the purpose of PCA, to build capital in order to prevent possible long-term loss to the NCUSIF.

In their final point, the law firm concludes when Congress enacted the PCA provisions in CUMAA, they did not interfere with either NCUA or FDIC's ability to modify their interpretation of secondary capital or subordinated debt. Additionally, there was no evidence that PCA was created over concerns about secondary capital. In fact, secondary capital and subordinated debt did not even appear in either
agency's Acts until PCA. However, the NCUA current
definition of "capital" does not include secondary capital
which poses a problem for federal credit unions wishing to
include it in their "net worth" computation. The NCUA
needs to revise its regulation to revise the net worth
definition to include secondary capital to be within the
scope of PCA. Certainly Congress did not intend the FDIC
to have the ability to count secondary capital or
subordinated debt as part of the "net worth" computation and
not allow credit unions the same provision.

The Third Challenge: High Growth Rates

Credit unions today are poised for significant growth.
Between 1992 and 1998, membership in federally insured
credit unions grew almost 20% from 61.4 million members to
73.5 million. This growth occurred at a time when
significant consolidation occurred during the financial
services industry and the number of credit unions declined
from 12,596 in 1992 to 10,995 in 1998 -- a 12.7% decline.
Graph B reflects credit union membership growth from 1992 to
1998.
Credit union asset growth in recent years increased at rates never experienced in the industry. From 1992 to 1998, federally insured credit union assets grew from $258.4 billion to over $388.7 billion, an increase of 50% (Graph C).

Source: National Credit Union Administration
By comparison, during the same period, the assets of FDIC insured banks increased from $4,541.1 billion to over $6,528.6 billion, an increase of about 44% -- this despite the enormous increase in bank mergers and acquisitions during the period.


Graph D reflects a leveling off of growth for the banking sector. During the same period, credit union growth began to move upward after a flat growth period from 1992 to 1996. More recent credit union growth on the graph appears stronger than banks; the credit union sector showed a five-year growth rate of 26.5% from 1992 to 1996, 26.7% from 1993 to 1997 and 34.3% in the 1994 to 1998 period.
Credit union member surveys continually indicate that the most important aspect to keeping an account relationship is providing excellent customer service. Credit unions historically pride themselves in keeping their finger on the pulse of their members -- providing quality products and services to meet member needs at a reasonable cost. Credit unions may have experienced the growth they have in recent years due to their closeness to their membership and their emphasis on excellent customer service.

If credit unions continue this strong growth, the ability to keep their net worth ratio in line with PCA requirements may be difficult. Credit unions may be forced to slow down their growth if they can't meet PCA guide-
lines. This could have an adverse impact on meeting member needs and the needs of their community. A credit union chartered bank is one method to deal with rapid credit union growth challenges.
CHAPTER 3

HOW FORMATION OF A CREDIT UNION-OWNED BANK RESOLVES THE IDENTIFIED CHALLENGES

Credit Union-owned Bank as a Secondary Market for Member Business Loans

One of the challenges revealed by this study is the problematic regulatory cap of 12.25% of assets on member business loans. If credit unions are forced into an environment of "hitting the gas" when they are below the regulatory cap and "slamming on the brakes" when they hit their 12.25 percent limit, how are members to rely on their credit union as a consistent and dependable source of funds for their business?

One way a credit union-owned bank would alleviate this concern is as a secondary market for credit union member business loans. As long as the credit union follows consistent and prudent procedures for making business loans, the bank would agree to purchase these loans from them as they approach their 12.25% cap level, thereby ensuring their ability to continually offer member business loans to their membership. When requests for business loans, construction or development loans exceed the credit union's ability to fund, the bank can coordinate participation agreements with member credit unions or just make the loan directly upon
referral from the member credit union. This allows the credit union to retain the all important member business relationship.

The bank could act as a business-lending advisor or resource for credit union commercial lending managers as needed. The bank could also be a source for hands-on training for credit union business lending staff. In summary, the bank would be a tremendous resource to credit unions in their member business lending activities at whatever level they wish to participate.

**As a Source of Trust Services for Individual and Business Members**

Small businesses have many needs, especially when it comes to providing cost effective benefits to their employees or highly compensated company executives. A credit union-owned bank could provide a myriad of trust services for small business members, business owners and executives. The design of employee benefit plans such as deferred compensation plans, profit sharing plans, money purchase plans, employee stock ownership plans (ESOP), Savings Incentive Match Plans (SIMPLEs) and Simplified Employee Pension plans (SEP) would be available for credit unions using the bank.
Small business owners are always looking for ways to reduce tax obligations. There are several options a business owner can consider while providing retirement benefits for employees. This is another area where trust services through the bank can provide expertise and add value to the relationship between the credit union and their business member. Personal trust services could meet the need of an individual or business member through their credit union’s relationship with the bank.

**As a Means to Support Credit Union Growth**

The PCA provisions soon to be applied to credit unions may act to inhibit the ability of credit unions to grow. One component of the credit union PCA regulation net worth ratio is total assets. As credit unions experience significant growth, the increase in their asset base causes a decrease in their net worth ratio if their net income and contribution to reserves is not growing at the same rate. This is virtually impossible because it takes longer for internally generated capital (income) to grow.

Credit unions could use the bank as a place to move certain deposits as needed to keep their net worth ratio in line in response to PCA compliance requirements. The bank would be helpful in cases where the credit union cannot
place the deposits into income generating loans immediately, thereby negatively affecting their net worth ratio.

For example, if a regionally based credit union is realizing a tremendous influx of new savings and checking accounts due to a recent bank merger in their area, should they turn away the opportunity to increase market share just to keep their regulatory ratios in line? No. Through the bank, they can move some of the incoming deposits to a special investment program at the bank offering a competitive rate in an insured account until credit union loan demand increases. Remember, this is a credit union-owned bank and the products and ROI are based on the needs of its shareholders -- credit unions using bank services to build member relationships not provide high returns to a select group of investors.
CHAPTER 4

A HISTORY OF BANK CHARTERS IN THE CREDIT UNION INDUSTRY

The Need for a Credit Union-controlled Bank - a Historical Perspective

In the early 1970's, credit unions were not able to offer checking accounts because legally, they were prohibited from gaining access to the Federal Reserve Bank that clears checks for financial institutions. At the time, member demands were creating a need for credit unions to offer checking-type accounts, but the only solution that seemed viable was to find a bank willing to process their items and act as a payable through bank for them. Credit unions in California used Security Pacific National Bank as their payable through bank for many years to process their checking account items for many years until WesCorp, the corporate credit union in California purchased most of the SPNB credit union check processing business. Other states experienced similar challenges.

Dick Ensweiler, Chief Executive Officer of the Texas Credit Union League, the state credit union trade association, revealed in a recent interview that the only way state chartered credit unions in Texas could get into the checking account arena was to purchase a bank jointly
with the state trade association. So, over 20 years ago, Town North Bank was purchased by a group of credit unions and the Texas Credit Union League so credit unions members could have checking accounts. Today, TCUL is no longer an owner of the bank but forty-two Texas credit unions still do. These and several more Texas credit unions use Town North for their debit and credit card processing needs.

In Cleveland, Wisconsin, a small group of credit unions purchased a bank in 1977 for similar reasons noted above and named it WISCUB (Wisconsin Credit Union Bank). According to Tom Knabel, Vice President of the Wisconsin Credit Union League, the right of the credit union group to collectively form a bank holding company was challenged by the Wisconsin banking industry, but the credit union group prevailed. Today, 150 Wisconsin credit unions own stock in WISCUB. According to Mr. Knabel, local credit union officials indicate that the relationship between them and WISCUB still thrives.

Credit unions in Kansas enrolled the help of their state credit union trade association, the Kansas Credit Union League to purchase an equity position in a small bank to enable them to clear their credit unions checks during the same period. During the 1970's, there were many states where credit unions purchased banks and have since sold
them. Credit unions today have full access to the Federal Reserve system to process their own checking accounts, order cash, purchase Treasury securities as well as originate and receive items through the automated clearing house.

**Canadian Credit Unions and Bank Charters**

During 1999, Surrey Metro Savings Credit Union in Surrey, British Columbia, Canada's second largest credit union became embroiled in a controversial takeover bid by Canadian Trust Bank. A group of Surrey Metro Savings CU executives tried unsuccessfully to sell the $2.2 billion credit union to the country's fourth largest bank. A dissident group of members from the credit union voiced a call to action for the 115,000 membership who strongly defeated the acquisition plan by Canada Trust. This was the first bank takeover of a credit union in North America. What situation made it possible for a bank to takeover a credit union?

In 1992, Surrey Metro Savings Credit Union sold the majority of the credit union's equity to the public becoming the first and only publicly traded credit union on the continent. This decision on the part of the credit union's board of directors created a rather unique structure: member-controlled, but not member-owned. The members still
maintained voting control with less than 5% of the equity; the other 95% of equity was owned by non-voting stockholders who purchased their shares over the Toronto Stock Exchange.

When the takeover vote came before the membership in March 1999, they rejected the offer by a 76 percent margin. They demanded ouster of the current board of directors and management. Obviously a hybrid version of a bank-credit union did not succeed in Canada.

**Credit Union Conversions to Bank charters**

One of the provisions of CUMAA allows credit unions to convert to a mutual savings banks or mutual savings association without prior approval of NCUA. All that is needed is approval by a majority of the credit union board of directors and membership approval by a simple majority of the members voting. Of course, no director or member of senior management is allowed to gain economic benefit from the conversion.

Subsequent to the passage of CUMAA, two California credit unions elected to convert to a mutual savings bank charter. One of the primary reasons for the move for one credit union was the level of commercial lending conducted by the institution. Their participation in commercial and business lending was so extensive; the member business loan
regulations in the new law would have crippled them financially. Others may follow because there are several church fields of membership credit unions who play a critical role in assisting the membership in making church-related loans. Another area where traditional financial institutions such as commercial banks have not met the need of the community.

**Bank Conversion to Subchapter S Corporations**

One of the key complaints about credit unions heard from banks is the tax-exempt status of credit unions. However, some banks are taking advantage of an option available to them to convert to Subchapter S corporations to reduce their tax liability. "Sub S" status exempts the bank from paying corporate income tax, however makes the bank's net income taxable as personal income to the owners. This, in effect, eliminates the double taxation on stockholder dividends and may result in a reduction.
CHAPTER 5
CREDIT UNION SURVEY

Purpose of the Survey

The critical role a credit union-owned bank could play in meeting the future needs of credit union members and ensuring that consumers will continue to have the credit union alternative was established in Chapter 3, but what do other credit unions professionals think? Do other credit unions across the United States believe a credit union-owned bank could be a viable solution to some of the challenges facing the industry? If a group of credit unions cooperatively gathered the capital to form such an entity, would other credit unions use it? How many credit unions nationally would be willing to underwrite the effort? These are just a few of the questions that need to be answered to determine the next step in this bold venture.

In order to determine support for the idea that credit unions could use a bank as a means to continue offering member business loans or move deposits off balance sheet as needed to meet PCA required reserve levels, a survey was developed. Additionally, we needed to determine if any credit unions would use bank services and if they would consider commitment of funds necessary to capitalize such a venture.
Survey Results

The survey was mailed to 352 credit union CEOs across the United States. We selected credit unions with assets in excess of $250 million dollars because the affects of the new regulations have almost immediate impact on these credit unions. The actual survey and cover letter are included in Appendix A.

The response rate to the survey was over 30 percent; 104 credit unions returned the survey. This reflects a significant level of reliability on the results.

Graph E, below, shows the breakdown by asset size of those responding to the survey.

Graph E
Over seventy-seven percent (77.7 percent) of the respondents stated they currently make member business loans in their credit union (Table 6).

Table 6
Question 1: Do You Currently Make Member Business Loans?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent</td>
<td>22.3%</td>
<td>77.7%</td>
</tr>
</tbody>
</table>

Of those who do not currently make member business loans, fifty percent (50.0 percent) intend to do so in the future (Table 7).

Table 7
Question 2: If No, Do You Intend To Do So In The Future?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percent</td>
<td>50.0%</td>
<td>36.6%</td>
</tr>
</tbody>
</table>

An overwhelming majority of respondents (83.3 percent) indicated they believe credit union ownership of a bank has potential to help meet the challenges facing the industry today (Table 8).
Table 8
Question 3: Do You Believe Credit Union Ownership
Of A Bank Has Potential to Meet The Challenges
Facing Us Today?

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>83.3%</td>
<td>16.7%</td>
</tr>
</tbody>
</table>

When asked how their credit union would use a bank, if chartered, Table 9 that follows indicates the services respondents believe would help them serve members. While respondents found value in all the options listed, the first two, as a secondary market for business loans and trust services were selected most often.

Some of the responses submitted in the "Other" category were: as a source of credit underwriting, as a cooperative loan participation facilitator, outsourced loan approval, leverage growth for e-commerce, for large loans, services to members such as cash management, or as an originator for commercial loans.
Table 9

Question 4: How Would Your Credit Union Use This Bank, if Chartered?

<table>
<thead>
<tr>
<th>Use Selected</th>
<th>Percent Stating They Would Use</th>
</tr>
</thead>
<tbody>
<tr>
<td>As a secondary market for member business loans</td>
<td>54.8%</td>
</tr>
<tr>
<td>To purchase Trust services</td>
<td>51.9%</td>
</tr>
<tr>
<td>As a method to move assets off balance sheet</td>
<td>41.3%</td>
</tr>
<tr>
<td>To maintain legal limits of commercial loan portfolio</td>
<td>35.6%</td>
</tr>
<tr>
<td>As a method to leverage growth</td>
<td>34.6%</td>
</tr>
<tr>
<td>As a market for real estate loans</td>
<td>26.9%</td>
</tr>
<tr>
<td>Other uses</td>
<td>13.5%</td>
</tr>
</tbody>
</table>

Lastly, the survey asked the respondents if their credit union would be interested in participating as a stockholder in such a bank venture to which almost forty-four (43.9 percent) said yes (Table 10).

Table 10

Question 5: Would Your Credit Union Be Interested In Participating As A Stockholder?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td>43.9%</td>
<td>56.1%</td>
</tr>
</tbody>
</table>

The strong positive response to this question is sufficient to allow further investigation and the initial groundwork on bank formation to proceed.

Not only did the survey support the idea of a credit union-owned bank; it also re-confirmed the credit union commitment to members. Credit unions are willing to take
necessary steps to ensure that members have access to needed financial services -- but even more importantly that consumers have the credit union choice for their financial service needs.
If chartering a bank is a viable option for credit unions, consideration of the various charter options must be reviewed. In this chapter, we endeavor to explore bank-chartering options as well as the type of holding companies that might be considered.

The National Bank Charter Option

National banks are chartered under the authority of the Office of the Comptroller of the Currency (OCC) who is also responsible for examination of their operations. They are not restricted as to the number of branches, but must comply with the laws of the states within which they operate. Similar to state banks, they are permitted to branch across state lines in accordance with state law. National banks may move their charters within a state in compliance with the laws of that state.

National Banks are FDIC (Federal Deposit Insurance Corporation) insured through assessments paid to the Bank Insurance Fund (BIF). Ownership of a national bank is limited to individuals and qualified corporations; corporations owning 25% or more of a national or state bank are considered to have control and are classified as bank
holding companies (BHC's). Institutions chartered as a national bank have the ability to own subsidiaries if the OCC grants approval.

National bank chartered institutions may have a mix of consumer, real estate and commercial loans of various types. They are required to maintain membership with the Federal Reserve and as an option may also hold membership with the Federal Home Loan Bank.

The State Bank Charter Option

Individual state regulators license state-chartered banks; branch authority is determined by state law. Branching across state lines is only permitted if enabled through state law, but are usually limited to the state where the charter was granted.

Just like national banks, state banks are FDIC (Federal Deposit Insurance Corporation) insured through the Bank Insurance Fund (BIF). Ownership of a state bank is limited to individuals and qualified corporations; corporations owning 25% or more of a national or state bank are considered to have control and are classified as bank holding companies (BHC's). State banks may own subsidiary corporations provided they receive approval from their state and/or the FDIC. These institutions may offer a wide
variety of loans to their customers similar to those permitted for national banks.

State chartered banks are not required to be members of either the Federal Reserve or the Federal Home Loan Bank, however, they may need to do so for access to cash liquidity resources. Both the state regulator and the FDIC as insurer examine state bank operations.

The Federal Savings Bank Charter Option

An institution chartered as a federal savings bank (FSB) is operated under the authority of the Office of Thrift Supervision (OTS) which is also responsible for examination of their operations regardless of their deposit insurance selection. Federal savings banks have unlimited branching authority and can move branches anywhere provided the OTS grants their approval—no state law applies.

Federal savings banks have a choice for deposit insured either through FDIC Bank Insurance Fund (BIF) or the Savings Association Insurance Fund (SAIF). Ownership of an FSB is not restricted to individuals and qualified corporations, as is the case for state and national banks. FSB's also have the ability to own their service corporations with the approval of the OTS.
The loan mix of a federal savings bank is somewhat dictated by type of loans in their portfolio. For example, at least 60% of their loans must be in real estate mortgage, consumer or student loans. They may hold up to 20% of their assets in commercial loans provided that at least 10% are made to small businesses.

Membership in both the Federal Reserve and the Federal Home Loan Bank is mandatory for FSB's.

**Bank Holding Companies**

For the purposes of this study, we comment here on two types of holding companies -- one-bank holding companies and unitary thrift holding companies. In general, corporations that own 25% or more of a national or state bank are presumed to have control and are considered to be bank holding companies (BHC's). Corporations that own more than 5% but less than 25% may be BHC's depending on the facts and circumstances. BHC's may engage only in specified banking-related activities. Unitary thrift holding companies are corporations that own only one financial institution (e.g. a single savings bank). The activities in which they engage and their ownership is not restricted on the basis of line of business. (ABA Library)
The activities of a one-bank holding company is limited to those closely tied to banking. They must meet certain minimum capital requirements with their ability to hold debt is based on their capital position and asset size.

By contrast, unitary thrift holding companies have no regulations that limit their business activities. No capital requirements are stipulated and no debt limitations.

From this brief review of bank charter options, it is our opinion that a federal savings bank charter is the best fit for a credit union owned bank for several reasons. 1) Our survey indicates that credit unions from several states are interested in participating in a bank-chartering project, 2) credit unions require the flexibility of loan mix permitted by this charter type. An FSB must have at least 60% of loans in real estate mortgage, consumer and student loans making that charter selection a good option for credit unions desiring to move real estate loans off their books. It is also a good option for credit unions desiring to provide student loan options to the membership. FSB's are permitted to hold up to 20% of their assets in commercial loans which meets the need of credit unions to move commercial loans off balance sheet as they grow. The small business provision will not be a problem because
almost all of credit union commercial loans will fall into this category.
CHAPTER 7

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS

1. The CUMAA law and the new regulations it spawned present significant limitations to future credit union growth. This will have a negative impact on consumers and businesses across the nation as credit unions struggle to compete as they grow. If alternative sources of capital are not permitted for credit unions, use of a bank as a tool to operate effectively is essential for future credit union viability and their ability to meet regulatory capital requirements.

2. The number of small businesses continues to grow signaling an opportunity for financial institutions to play a significant role in underwriting that growth. Small businesses are using credit unions as a new funding source to build and expand. A credit union owned bank would be a natural source for member business lending expertise as well as an effective partner to buy credit union business loans as needed to meet ceilings dictated by CUMAA and keep the flow of credit union member business loans moving.

3. Many credit unions today are involved in loan participation agreements. A credit union owned bank could
act as a central focus for such activities providing specialized expertise as required.

4. As PCA is implemented, some credit unions may have a need for another secondary market for real estate loans held on their books. While there are other such markets available today, a credit union owned bank could be another source.

5. If credit unions experience significant growth rates in the future, they must have external sources of capital to meet their net worth ratio requirements under PCA. Long-term debt, if authorized by the NCUA, could be an option to leverage capital for credit unions in the future. A credit union owned bank could be an excellent source for long-term debt if that option becomes a reality.

6. Credit unions across the nation use their corporate central credit unions as their primary liquidity source. A credit union owned bank could serve as another source of liquidity if needed.

The credit union survey indicates a strong interest in forming a credit union owned bank by some of the largest U.S. credit unions. Some of the credit unions surveyed indicated a willingness to assist in capitalizing a credit union owned bank. Based on the findings and conclusions in
this report plus the responses received in the survey results, we make the following recommendations.

RECOMMENDATIONS

The scope of this study was to determine if an environment exists that justifies chartering a credit union owned bank. We believe the conclusions outlined above resulting from our research support the idea that a credit union owned bank is a viable option to meet the challenges facing credit unions today and in the future.

Recommendation 1:

Additional research should be undertaken to determine specifically which charter option is most viable, how much capital is needed and how many shareholders are needed to establish the bank.

Recommendation 2:

A focus group made up of credit union survey respondents should be established to ascertain the level of capitalization they would be willing to commit to the project.

Recommendation 3:

A working group should be established to develop a business plan for the new bank and work with regulators to get the project off the ground. This group would also be responsible for promoting the bank and attracting new
shareholders. This group needs to determine what type of services will be offered at inception and added as the entity grows.
Appendix A
The Credit Union Survey

1. Do you currently make member business loans?
   
   Yes □  No □

2. If no, do you intend to do so in the future?
   
   Yes □  No □

3. Do you believe credit union ownership of a bank has potential to help us meet the challenges facing us today?
   
   Yes □  No □

   Comments:
   __________________________________________________________
   __________________________________________________________
   __________________________________________________________

4. How would your credit union use this bank if chartered?

   Check all that apply:
   □ As a secondary market for member business loans
   □ To maintain legal limits of commercial loan portfolio
   □ As a market for real estate loans
   □ To purchase trust services for members
   □ As a method to move assets/liabilities off balance sheet as needed
   □ As a method to leverage growth
   □ Other: ___________________________________________________

5. Would your credit union be interested in participating as a stockholder
   (State Chartered Credit Unions only -- prohibited for Federals)?

   Yes □  No □

6. What is your credit union asset size?
   □ $250 - $500 Million
   □ $500 - $750 Million
   □ $750 Million - $1 Billion
   □ Over $1 Billion

Please return survey to: Arrowhead Credit Union, P.O. Box 735, San Bernardino, CA 92402
Appendix B

Individual Comments by Survey Respondents

Individual Responses in Question 3, Comment Section:

1. Gives you the ability to raise capital
2. No. We are a credit union and plan to remain one—if you want to be a bank then do it. However, you are asking for taxation of credit unions if you go down this path. Are you going to be a bank or a credit union? You have to answer that question.
3. Potential
4. We currently have a relationship with the National Co-Op Bank who underwrites business loans for us.
5. Not sure
6. Yes, if done right!
7. Uncertain how a bank charter would help. Our state prohibits us from owning a bank.
8. Could open up potential markets and access to customers not otherwise possible.
9. Possibly
10. The bank would have potential as a knowledgeable (in commercial loan underwriting and structuring) over line partner for participating credit unions.
11. Sufficient funding sources already exist and are growing. Liquidity is available through participation with other CU's. Care CU's and other intermediaries. Don't have enough info about this proposal to support what appears to be reinventing the wheel.
12. As an FCU we could only invest in the bank to aid with objectives.
13. We are currently exploring business lending and loan participations. Credit union ownership of a bank may defer or eliminate the future consideration of a mutual savings bank charter.
15. Texas credit unions have owned a bank for more than 25 years. It has assisted credit union in handling share drafts and credit card applications.
16. I would love to be able to access the experience of a commercial loan lender.
17. Yes, but we're Federal. Off balance sheet is best way to retain capital ratio and achieve desired bottom line.
18. Great care will need to be taken.
19. Yes, to do collective commercial loans -- could also happen by other means.
20. Possibly
21. Yes, Anything that will assist us in gaining economies of scale and to optimize on behalf of our members.
22. Possibly. Need more details on how this would be structured.
23. No. A very quick way to bring taxation to CU's. Bad idea.
24. Our interest is trust services.
25. Not sure. Management interlock is an issue.
26. Yes. It has in Texas
27. Yes. ACU owned CUSO also has potential.
28. Maybe
29. This idea has been kicked around for years (20 years). Perhaps there is a time -- now -- that it makes sense!
30. Yes. Properly structured with tight controls it could provide an adequate outlet to serve our business members.
31. Certainly an interesting concept, much like CUSO's.
32. As we cannot deal with corporations, it makes no sense for us to waste time developing a commercial program, however, many members would like to do so.
33. We already own one in Texas.
34. In Utah, we need a CU owned national bank because of state laws restricting commercial lending.
35. We have some MBL's on the books but are not active in that market. Do not intend to offer in future but you never know.
36. Maybe. I would have to know more about the process. Even if we start making business loans, we probably don't have the demand to take us over the legal limit.
37. No. Feel we could -- some with loan participation program or through securitization of loan portfolio!
38. Wisconsin credit unions already own a bank.
39. No. If you want to be a bank, change your charter to a bank.
40. Don't know
41. Yes. I applaud your efforts. Let me know if I can help in some way.
42. Yes. I just introduced this idea to our board this month.
43. WI credit unions own a bank now -- this could be avenue for those CU's that are limited.
44. Need to know more.
45. No. We need to serve our members in a more efficient manner in order to meet future challenges.
46. Yes. We don't make member business loans, but there is a need.
47. Expanding the corporate credit union including banking power would probably take care of the need -- changing membership is forcing us to seek other types of loan - business loans is one -- however, my understanding is FCU's cannot own a bank even as part of a co-op effort.
48. We are a single sponsor CU -- interesting concept -- anything that could help our members generally is positive.

49. No. I served as chairman of the CUNA Banking Study Committee in 1972. Five leagues purchased banks. Wisconsin still has one; partnership and alliances may work better. A bank is a different animal.

50. Yes. Referring commercial loans/accounts including dealer lending.

51. No. Previous experience produced, I believe, negative results.

52. Yes. Could enable CU to participate in activities not allowed in a credit union or serve as a vehicle to other competitive products/services which may be thwarted by unrealistic, unreasonable, outdated and/or non-business friendly regulators. I'm not sure how the politics of a CU-owned bank would play out. Also, profits would be taxable income; may also trigger UBIT at the CU level?

53. If the goal is to provide an off-balance sheet home to commercial lending, a CUSO is another avenue to explore.

54. Interesting idea. I have insufficient knowledge about the concept to comment intelligently.

55. We will look into this ourselves.

56. I don't have enough to answer convincingly.

57. We already own 5% of a CUSO which owns Cleveland State Bank, Cleveland, WI.

58. Interesting concept.

59. SDCCU is exploring this option with a target date of 12-1-99.

60. Need to a federal charter. Could be a federal S & L charter.
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