

Consolidation, Collaboration or Contrarian? The Future of the US Credit Union System



Mark C. Meyer | Chief Executive Officer | Filene Research Institute

www.filencu.org

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- Where were you on Monday, September 15, 2008? Do you recall the significance of the date?



- Who said? *“There never was a normal year which could effectively be used as a pattern for other years, hence every effort to get back to normalcy must necessarily fail.”*



The New....

- Normal
- Consumer/or members
- Competition
- Regulation
- CU Business Model
- Competencies
- Opportunities



“A new world has come into existence. We did not plan it, but we must plan how to live in it.” Edward A. Filene - 1932



The New Normal

“It is increasingly clear that the current economic downturn is fundamentally different from the recessions of previous decades. We are experiencing not merely a turn of the business cycle, but a restructuring of the economic order” Ian Davis

Or stated another way....

“The storm is a time to fish. In a period of uncertainty, asking questions and posing scenarios makes us feel more confident. It’ll be the people that do this now that will create the companies or products that we’ll be talking about in five years’ time.” <http://www.guardian.co.uk/inspire-innovate/roundtable>



The New Normal

- Economic reset across the globe
- LUV or W?
- Recession over in the US?
- Impacting recovery?
- Highest probable outcome = ?
- Be prepared for ?
- The good news is that during an economic reset new _____ are born.

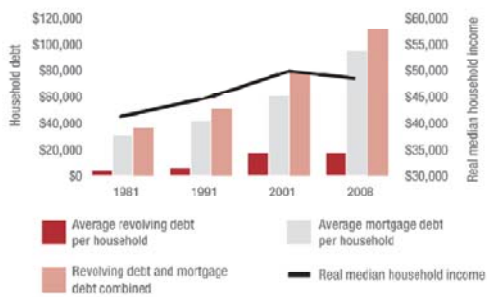


The New Consumer (our Members)

- Walk away versus pay
- Save more, less debt
- Financial planning focus: De-leverage
- Inertia
- Consider...
 - What is on the minds of those in Michigan?
 - Litmus test: What's the conversation on Saturday night at while watching the University of Michigan (or the Michigan State) game?



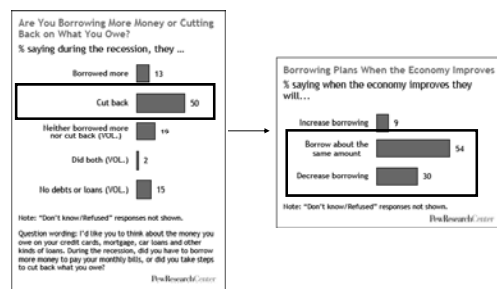
The Need to De-Leverage



Source: Fiske Research Institute



De-Leveraging



Switch Financial Institutions?



| | |
|------------------------------|-----|
| Won't switch for any amount | 41% |
| A gift valued at \$250+ | 33% |
| 1% point higher deposit rate | 20% |
| ipod | 5% |
| Toaster | 1% |

Source: IBT/MCA Market Pulse.



The New US Regulatory Environment



- Overdraft
- CARD Act
- CFPB
- Interchange
- MBL Cap
- NCUA Assessments
- Alternative Capital
- Taxation (?)



The New Competition?

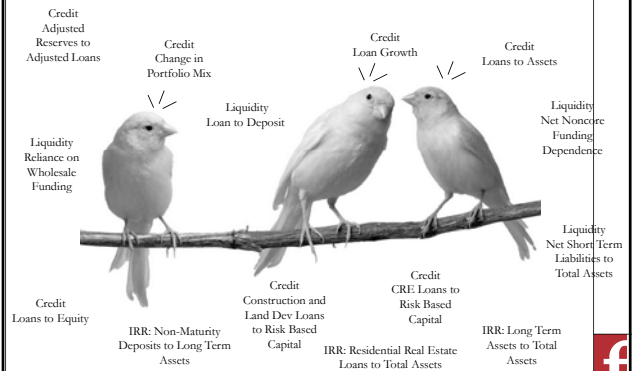
Google™



Walmart*
Save money. Live better.



Canary in a Coalmine



The New CU Business Model

- Consider your income levers:
 - Net interest Margin
 - Interest Income
 - Fee Income
- Consider your expense levers:
 - What does 50.3% represent?
 - Operational expenses
 - Allowance for loan losses
- What can you control?



Response in the US

- Operational Efficiency
 - Cost cutting staff and facilities
 - Consolidation
 - Large strategic mergers
 - Reg'ed out
 - Financially required
 - Collaboration Models
 - Transformational versus Incremental
 - Competencies required
 - Most successful when?
 - Contrarian
 - Clarity of focus
 - Bad at something
- New consumer friendly sources of fee income that align with their needs...Example: The Wealth Coach



Bonus: Operational Efficiency!

- Banks must bring down operational costs — not just by capturing traditional back-office savings but also by distribution costs.
- Mass-market customers prefer banking at branches = 70 percent of traffic and resource consumption. (However, mass-market customers are only half as profitable as mass-affluent customers.)
- Gen Y will put further pressure on the traditional bank branch network, which banks may soon be unable to afford.
- Rationalization of branch networks will emphasize electronic channels and alternative formats.
- In the future, branches may cater to specific customer segments, becoming “wealth” branches or “small business” branches, with fewer expensive, resource-hogging generic branches open to all.

— Booz & Co



Operational Efficiency + Increase Service





FRBSF ECONOMIC LETTER

Number 2005-29, November 4, 2005

Economies of Scale and Continuing Consolidation of Credit Unions

The evidence for credit unions is different. This *Economic Letter* shows that, in contrast to banks, larger credit unions, on average, have decidedly lower average costs and higher net incomes, as we might expect in the presence of important economies of scale. It further notes that these economies of scale put pressure on the credit union industry to continue consolidating into fewer, larger credit unions.

James A. Wilcox
Visiting Scholar, FRBSE, and
Professor, Haas School of Business, UC Berkeley

| Consolidation = Who benefits? |
|---|
| <ul style="list-style-type: none"> • The Members! <ul style="list-style-type: none"> – 80% of mergers members of acquired CUs benefit significantly (etc. pricing, locations, products) – Acquiring CU members service does not decline |

| How Many CUs Have Merged? |
|---|
| <ul style="list-style-type: none"> • 12,485 CUs merged in 1971-2008 <ul style="list-style-type: none"> – 2.3% of CUs per year • Mergers account for most of the reduction in the number of CUs from its peak of 23,866 in 1969 to 8,147 in 2008 • More than one third of the CUs in operation in 2008 had participated in at least one merger during 1979-2008 <ul style="list-style-type: none"> – Few CUs are “serial acquirers” |

Comparing Acquirers and Targets during 1984-2008

- Mergers transferred members and assets from institutions that, on average, performed less well (the targets) to other institutions that, on average, performed far better (the acquirers)
- Targets held few assets
 - Totaling \$37 billion
 - \$46 billion inflation-adjusted
 - 0.39% of CU assets per year

| | Targets | Acquirers |
|--|---------|-----------|
| Noninterest expense per assets (%) | 4.36 | 3.12 |
| Interest income per assets (%) | 8.23 | 7.60 |
| Interest expense per assets (%) | 3.66 | 3.98 |
| Loan loss provisions per assets (%) | 0.86 | 0.36 |
| Net income per assets (ROA, %) | 0.08 | 1.00 |
| Annual asset growth (merger-adjusted, %) | 0.17 | 10.11 |



Comparing Mergers across Sizes during 1984-2008

- Most targets were very small
 - 7,867 targets (90%) held under \$10 million in assets
- 21% of targets' assets were concentrated in 47 “medium-sized” targets (i.e., with \$100 million to \$1 billion in assets)
- Medium-sized CUs (not larger ones) acquired most targets' assets (56%)
- Acquirers have higher noninterest expenses than non-merging CUs of similar size



Mergers of Equals (and of Unequals) during 1984-2008

- Most targets were much smaller than their acquirers
 - 6,405 targets (73%) were less than one tenth as large
- 21% of targets' assets were concentrated in 437 mergers of equals
 - i.e., where the target was at least half as large as the acquirer
- While mergers of equals among larger CUs are becoming more common, they remain relatively rare
 - Since 1984, there have been only 16 mergers of equals where both credit unions held over \$100 million (inflation adjusted) in assets




Unassisted Mergers vs. Other Exits during 1984-2008

- Unassisted mergers (i.e., not receiving formal assistance from the NCUA) are the main mechanism for “exits”
- Failures (assisted mergers, P&As, and involuntary liquidations) performed, unsurprisingly, far worse financially than other exits
- Regulators rely extensively on P&As for larger CUs during troubled times

| | # of exits (total) | % of CU assets (annually) |
|---------------------------------|--------------------|---------------------------|
| Unassisted mergers | 8,209 | 0.37 |
| Assisted mergers | 560 | 0.03 |
| Purchase and Assumptions (P&As) | 275 | 0.05 |
| Involuntary liquidations | 463 | 0.03 |
| Voluntary liquidations | 309 | 0.01 |
| Conversions | 34 | 0.06 |
| Total | 9,850 | 0.55 |



| How does this happen? |
|---|
| <ul style="list-style-type: none"> • Concerns over long-term viability <ul style="list-style-type: none"> – Stagnate membership – Weak financial condition – Inability to expand services • CEO/leadership succession issues • Merging entity is most likely to initiate |

| Planned or Unplanned |
|---|
| <ul style="list-style-type: none"> • 50/50 from the merging entities <ul style="list-style-type: none"> – “We’ve been talking about it” – CEO announced he/she was leaving • 35% of the acquiring entities “planned” on acquiring another CU • 40% of those in the study had a plan  |

| Board Engagement |
|--|
| <ul style="list-style-type: none"> • Overall about 75% of the boards were reported to be highly influential • Limited Board Involved <ul style="list-style-type: none"> – About 30% of the acquiring institutions – About 20% of the merging institutions |

| Board Involvement - Merging |
|---|
| <ul style="list-style-type: none"> • An engaged board <ul style="list-style-type: none"> – Determined their needs and expectations – Sought multiple potential partners – Gathered information from multiple sources – Processed and evaluated their options – Selected the potential partner – Allowed executives to implement |

Board Involvement - Merging

- Unengaged boards
 - Abdicated decision-making
 - Trusted professionals to make appropriate decisions
 - Selecting partners
 - Negotiating details
 - Manage the process



Implications

- Build mergers into your strategic plan
 - When might you consider that option?
- Develop a clear succession plan for the CEO & the board
- What is the best role for your board?



Collaboration

- The models...many to choose from
- What does it take?
- Will it happen?



Contrarian

- Scale matters...but it's not the only thing that matters...
- Many CUs have dynamic entrepreneurial managers
- Control costs
- High service



Implications:

“Most financial institutions don’t have a clear strategy. The banking industry is basically riddled with ‘me-too competition’. That works fine when tides are rising but not forever. Financial institutions have been protected a lot by inertia and stickiness on the customer side. But the pressure will grow as the era of consolidation and restructuring abates. We’re entering a period of strategic repositioning. Increasingly financial institutions will have to be able to deliver something distinctive to their customers. Very few financial institutions have the courage to have a distinctive value proposition from their competitors. You must have clarity of purpose.” - Michael Porter, Harvard Business School



Funny, Memorable AND Effective



© BANK OF THE WICHITAS



The New Competencies

- Not just operational efficiency
- Leadership
 - Act early
 - CEO
 - Vision required
 - Entrepreneurial
 - Clear strategic focus
 - Board
 - New expectations by regulator
 - New level of competencies
 - New talent



The New Competencies

- Advocacy
 - Clarity of purpose
 - Competency
 - Courage



The New Opportunities

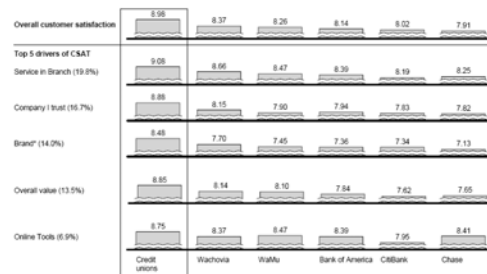
In a structural break: “Old sources of competitive advantage weaken and **new sources appear.** Afterward, upstarts can leap ahead of seemingly entrenched players” (NOTE: Thinking differently required)

- Consumer trust
- Cooperative/local model
- Awareness
- Young Adult



Service....

... credit unions outperform banks with particular strength in service and emotionally driven categories but less so in value or functionality
Customer satisfaction (1-10 scale)



* "Feel good about telling people you are with them"

SOURCE: 2008 McKinsey Cross-Industry Customer Experience Survey



The Opportunities // Marketing innovations

- Social media is so credit union
- Telling the story – the cooperative structure
- Patronage as differentiator



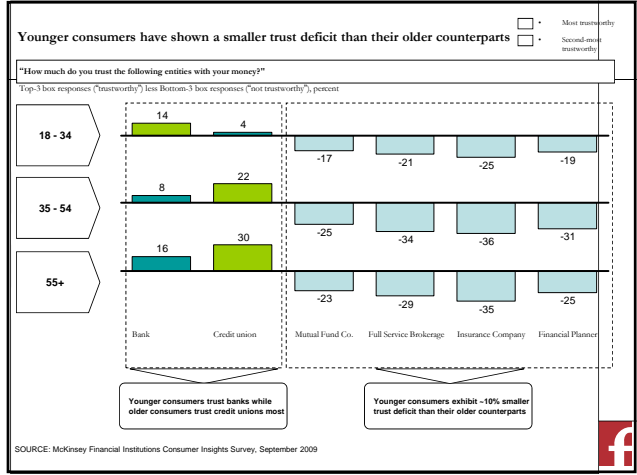
Social Media

- Ashton Kutcher and Ellen Degeneres have more Twitter followers than the entire populations of Ireland, Norway and Panama combined (Source: Twitter & World Population Data)
- Generation Y and Z consider e-mail passé...In 2009 Boston College stopped distributing e-mail addresses to incoming freshmen (Metro Newspaper)
- 78% of consumers trust peer recommendations (July 2009 Nielsen Global Online Consumer Survey)
- Only 14% trust advertisements (“Marketing to the Social Web,” Larry Weber, Wiley Publishing 2007)
- Only 18% of traditional TV campaigns generate a positive ROI (“Marketing to the Social Web,” Larry Weber, Wiley Publishing 2007)

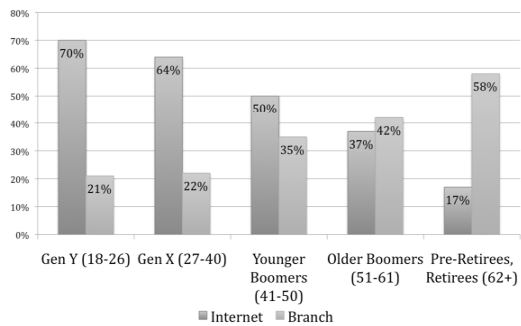


The Opportunities // New market opportunities

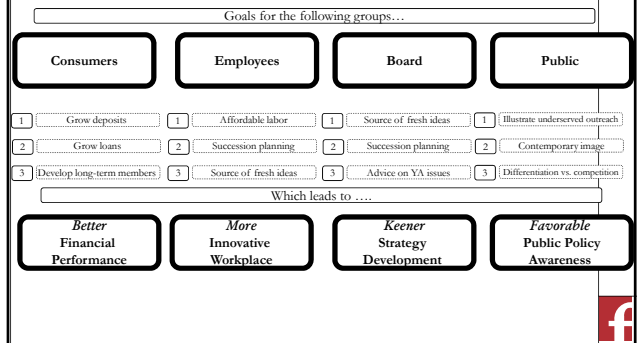
- Young Adults
 - Not de-leveraging
 - Not engaged w/ financial providers
 - Lower opinion of CUs (don't understand)



Channels Used to Research New Banking Products



An Economic Rationalists' View of the Young Adult Opportunity for Credit Unions



The Opportunities // Service or Product development

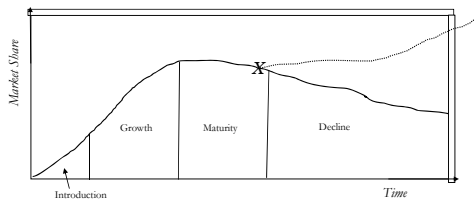
- 3 Lessons from 3M
- Rapid prototyping (beta) and testing (pilot)
- Ethnographic Research
 - Examples:
 - Debt in Focus: *anonymous for consumer, lead generation for CU*
 - Save to Win: *making savings fun*
 - Savings Challenge: *reality TV for your wallet*



Remember: Cast out the three deadly sins -
fear, myopia and inertia



So Where Do We Find Ourselves: Lifecycle Decline or Renewal



Inspiring Thoughts



“Progress is the constant
replacing of the best
there is with something
better still.”

Edward A. Filene

PS: Keep in touch!
Markm@filene.org
608.231.8554
www.filene.org

