

CREDIT UNION COLLABORATION: THE FUTURE OF INVESTING CAPITAL

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The credit union industry is in crisis, even if many of us don't admit it.

Consumer behavior and attitudes are changing everyday and many credit unions are serving the "same old members." The Corporate credit union structure has largely collapsed; it is clear in its absence we do not have the structure necessary for the large-scale funding that is necessary to create the innovation that our industry needs to grow. In the past, we have played around the edges, working on incremental innovations with no real commitment to replicate it across the industry and change the game. Before the economic crisis, this might have been acceptable, but it can be no longer. We talk about collaboration, but we need to take it up a notch – to where collaboration doesn't just happen in the back office but is part of the "front office" and on our balance sheet.

We need to move beyond our six percent market share and focus on what we do best. We are different in how we treat our members. We don't just say it, we live it every day – through our structure, our pricing, our attitude. But we need a new model that can leverage the scale necessary to compete in a global marketplace with the local service that matters to the member.

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So what if we outsourced our balance sheet and focused on how to provide the best product or service for our members?

What if we created a network of vendors – CUSOs and other businesses – that allowed us to continue to provide fair, competitive products to our members that were truly innovative, collaborate solutions, rather than simply being creatures of our back office capabilities?

What would happen if we became entrepreneurial in our thinking and business practices?

There is an immediate need for transformational change. It begins with us looking for ways to collaborate, and yes, that means with capital. There are credit unions with liquidity. There are credit unions that need it. There are credit unions and CUSOs that have specific expertise in a product or service, and there are those that could use it. Yet, there is no efficient way for one to help the other – to leverage the power of our network. How we build that model will determine the industry's ability to step up and serve even more members.

WHY THE STATUS QUO WON'T WORK

During the past 20 years, credit unions have consistently maintained about six percent of the consumer financial services market. There's nothing wrong with that number if holding steady is your objective, but with the member-first focus and quality products and services credit unions provide, it is somewhat surprising we haven't moved the needle. We have had a consistent message of the credit union advantage, but it's been difficult to be heard above the over-promises of the country's largest financial services providers.

The credit union industry has been faced since mid-2009 with the opportunity to gain significant market share. Consumers – potential members – are looking for financial institutions that have their best interests in mind – someone that is connected to a local community and understands that doing business for the right reasons is the best strategy. They are truly open to looking at fair, competitive products and are leery of offers that have conditions attached in teeny-tiny print. Yet, while there are individual credit unions making strides across the country, not all are seizing the opportunity. First, you have to be an optimist to see beyond some of the economic turmoil and risk, and many credit unions aren't willing to be that optimistic. After all, we are conservative by nature, which is why we have survived, but it doesn't set us up well to take advantage of opportunities like the one currently before us. Second, the sources of funding that credit unions have traditionally used to leverage liquidity to pay for the innovations and programs are simply not what they used to be.

While some growth can be achieved easily by investments from individual credit unions, it is the long-term sustained growth that will take a concentrated effort by the industry as a whole. This means collaboration like we've never done before – a collaboration of capital. To put in place the foundation we need to grow as an industry, we will need to leverage the collective balance sheets of credit unions to make meaningful change.

Are we ready to do this? Yes, because we have been willing to do it on a smaller scale throughout the past 100 years. It is clearly demonstrated in the numerous CUSOs that have been created to serve an operational, technology, investment or product-specific need. However, this time it is likely we will have to do it without a single point of investment, like a Corporate credit union, and that is a significant obstacle. There are also additional restrictions being put in place by regulators and legislators that will force us to think differently about how we invest and ultimately leverage our capital for the good of our collective membership.

THINKING DIFFERENTLY

This concept isn't just something we think of from time-to-time, instead it is something we've lived as my own company has faced these kind of challenges first-hand. Now, as other credit unions and CUSOs begin to ponder this very issue, our phone rings on a regular basis with the question: "How did you do it?" It's obvious that broadening this discussion industry-wide is more than important, it is imperative.

The "it" is the Collateralized Advanced Program (CAP) – an innovative financing structure that credit unions utilize to collaborate with our business so we may purchase credit union credit card assets. It is not a business loan participation program, but a true collaboration of capital among credit unions of all sizes from across the country.

Interestingly, what we don't get asked about this program is the "why did you do it" question. The program came about out of need – we launched our credit card portfolio partnership business in 2007, the exact time that the Corporate network began to experience stress. If we were to be successful in purchasing these portfolios, we had to find another avenue of financing. By mid-2008, it was clear that it was time to think differently and be innovative (even though this is a word that most don't like to asso-

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ciate with financial endeavors) about how we would access the financing necessary to purchase credit card portfolios. The CAP offering has raised more than \$115 million to date and continues to grow. But this is not just about our program – I'm not sure we are unique, we were just first.

The collapse of the Corporate credit union structure has created a profound void in funding availability for the simple reason that the Corporate credit unions have been the ultimate financial resource for credit unions and CUSOs. They have provided settlement services for payment systems; broker/dealer services; short-term liquidity, and institutional funding for CUSOs.

While it has been convenient and beneficial to have settlement, liquidity and investment services in one place, there are comparable solutions available through other reputable sources. Institutional funding for CUSOs will prove harder to replicate. Credit unions and their CUSOs will be facing long-term issues as they seek to replace that funding mechanism. Individual credit unions certainly have problems stepping up and filling the gap. Federally-chartered credit unions are bound by the restrictions set forth in Rule 712.2 that states credit unions can only invest or loan 1 percent of assets each to a CUSO – that's limiting when you think of all the different CUSO interests credit unions have. State chartered credit unions usually fare a little better with a slightly higher limitation, sometimes as much as 5 percent of assets.

It's difficult to think of many places that CUSOs can turn to get a significant line of credit. For example, a CUSO that provides mortgage services often needs to carry individual mortgages on their balance sheets for a period of time before sale into the secondary market. They have looked to a Corporate credit union to provide a warehouse line of credit (LOC) that they could draw against for that purpose. With this approach however, it is pretty easy for a CUSO to quickly grow beyond what a single credit union could support and fund. Certainly there are a handful of large credit unions that could band together and offer individual lines at each credit union

so the CUSO could draw on the various lines as needed. This hasn't traditionally been done because Corporate credit unions have been highly supportive in providing the resources – both both financially and through staff – needed to make this a simple process.

But those days are gone. As the regulators and Corporate credit unions clean up from the past 18 months, it has become increasingly evident that Corporate credit unions will no longer be in the position to fund CUSOs. Regulation 704 has two primary provisions that will make it very difficult for Corporates to play an active role as they have in the past, specifically:

704.11 (b) limits the amount of investments/loans based on capital. Most corporate capital has been reduced significantly due to losses. The 15 percent of capital restriction will limit the amount of funding available.

704.11 (e) restricts permissible activities to those expressly permitted by NCUA: Brokerage services, Investment Advisory; and Other approved by NCUA. This is much more restrictive than the long list of CUSO activities permitted for natural person credit unions (712.5) b.

While Regulation 704 is not final as of August 2010, it appears that the provisions are likely to stay in the final version. The writing is on the wall – Corporate credit unions will no longer be able to provide the type of funding that supports innovation and new programs.

Individual credit unions will also have their liquidity impacted as well. Credit unions have used their Corporate memberships to leverage excess liquidity through a variety of deposit programs. In cycles where liquidity was needed, the Corporates provided multiple loan programs that allowed credit unions to bridge their needs. While it is unlikely that function will go away in the new Corporate structure, it is more likely that it will be difficult to access and not as competitive as it has been in the past.

SO NOW WHAT?

The past 18 months has shown that there are “haves” and “have nots” in terms of liquidity. These have typically been defined by geographic placement. For example, in the Midwest where the recession was not as severe, credit unions have access to unprecedented levels of liquidity as consumers looked for safety and soundness over rate.

For credit unions on the coasts where the recession was significant, liquidity is dramatically less as credit unions try to pull back and build up capital. There are examples of credit unions writing only “A” paper auto loans when the standard has been to write “B” and “C” level loans. Other credit unions are turning away deposits as they try to manage their capital ratio.

It doesn't have to be this way, but there is no mechanism in place to make the liquidity available on a broad scale to those who need it. There are likely informal collaborative efforts happening at a personal relationship level – a kind of “hey, we're looking at launching this product but we don't have the scale or expertise to do it. If we work together, we can get it off the ground and maybe package it for others.” The problem with this is it typically doesn't produce enough scale to replicate nationally and ends up being a best practice left to be implemented on an ad hoc basis.

To be innovative and collaborate as never before, we need to change our mindset. We need to move away from the credit union way of thinking and become more entrepreneurial.

We cannot discount the formal collaboration that has happened over the years in the form of multi-owned CUSOs where a legal entity was created as a solution to a problem. CUSOs were formed to pool resources, create economies of scale, specialization and non-interest income. Most CUSOs are a solution to a specific concern, and while effective, they often create back-office efficiencies and don't truly embody innovative collaboration.

To be innovative and collaborate as never before, we need to change our mindset. We need to move away from the credit union way of thinking and become more entrepreneurial. What does that mean? In our business, we are rewarded for mitigating risk. The first thing that top managers ask is “what if” when evaluating a new opportunity. And, that “what if” is typically something negative such as “what happens if your program goes bankrupt.” Of course that is a critical and valid question, but as an executive shouldn't you be asking the positive

side, too? “What happens if you blow out this business plan and grow to a billion in assets?” As an investor, it’s likely you’d want to be a part of that scenario. The problem is that few opportunities present themselves so obviously. Instead, you have to work at weighing the opportunity versus the risk.

CASE STUDIES

While “what if” is an interesting question to ponder, few businesses, including credit unions, devote much time committed to looking outside of reality. True innovation and collaboration is often mandated by a need for an immediate solution. The future is already here — it’s just unevenly distributed.

Local Government Federal Credit Union (LGFCU) had long been a partner with local governments, but two years ago, they realized they could provide an even better product for their members if they could provide commercial loans. So they created a CUSO – LGFCU Financial Partners – dedicated to providing commercial financing directly to cities and counties throughout North Carolina. In the first six months, they had underwritten more than \$9 million in loans, when the business plan had expected to loan around \$1 million the first year, and \$2 million by year five. During the past 24 months, they have provided more than \$24 million in loans used to purchase everything from fire trucks to facilities to real estate to equipment – necessary loans for municipalities.

What is compelling about this example is that while they have worked with municipalities across the state, they have a high percentage of loans in counties deemed “economically depressed.” This isn’t by mistake. As they were establishing the CUSO, they realized that community banks – their largest competitor for commercial loans – focused on obtaining Tier 1 and Tier 2 loans. LGFCU understood

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that focusing on Tier 3 loans didn’t necessarily translate to high-risk. Part of their business plan was to sit down with the different municipalities, work to really understand their financial situation, and then find the best financial solution. The reward has been a thriving business with customers who look to them as a lender of first-choice.

While LGFCU represents a single credit union creating a CUSO, our second example focuses on an existing CUSO identifying a need and working with its credit union owners to form another CUSO to fill it. The next example is our own. Twenty years ago, Iowa credit unions created a CUSO to provide credit card processing for credit unions. Over the past two decades The Members Group (TMG) has grown to serve credit unions across North America with credit, debit, ATM and prepaid processing solutions. More than five years ago, TMG was seeing an increasing number of credit unions looking to sell their portfolios to access liquidity. Because there were limited, if any, credit union-centric solutions available, those valuable credit union assets were being sold to large agent-issuers – primarily large banks. After the sale, few credit unions were pleased with the partnership, so TMG Financial Services (TMGFS) was conceived.

We faced two significant obstacles. One, in a space dominated by two or three large bank agent-issuers, how quickly could we make an impact? Two, how would we secure the financing to purchase the assets on a grand scale?

Our model is based on collaboration on two planes. Even though the assets are under management with TMGFS, we work closely with our partner credit unions to grow the program organically at each individual credit union. This means there has to be buy-in from the front-line staff. This can only happen if we are listening to what they are saying and understanding what they are hearing from their members. This approach has been successful.

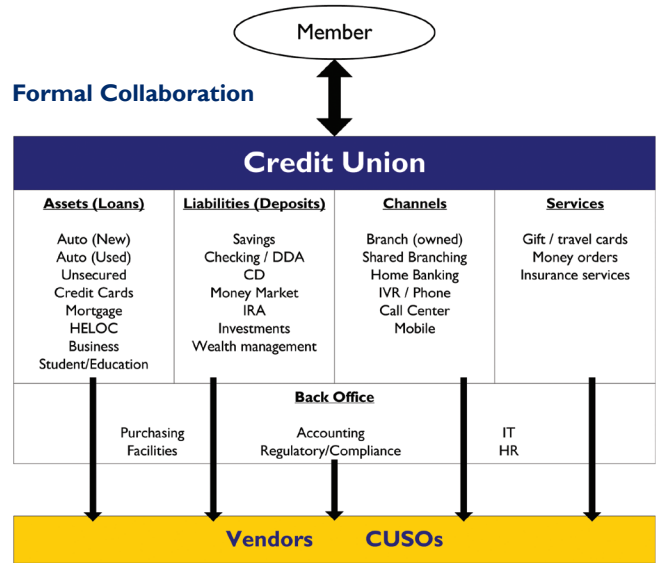
Collaboration has also been critical with the funding mechanism. Before TMGFS began, there were attempts to create a credit union-centric entity to purchase credit card portfolios. In each case, funding was difficult to obtain and limited the number of portfolios that could be purchased, which dramatically impacted the ability to create scale and created a long-term, negative impact. As we explored our different options – partnerships with a

Corporate, warehouse lines of credit, securitization, etc. – it was clear the traditional methods of funding a CUSO weren't going to work. So we began to investigate different ways to partner. The Collateralized Advance Program was created to leverage excess liquidity at credit unions from across the country. In many cases, these are credit unions we have not worked with in the past, but they had the capacity to make a loan to a CUSO, particularly if it is a good return on investment. We market the program as one would promote any product. We hold informational webinars. We make on-site presentations. We have clearly demonstrated the need for capital, and we have delivered results in the form of business growth and a healthy return on investment.

Why does this work? The answer is pretty straight forward – there is money available. A quick overview of the financial picture of credit unions demonstrates this. There is less than a 70 percent loan-to-share ratio in 52 percent of credit unions. While there are pockets of the country with higher loan-to-share ratios, there are 25 states collectively below a 70 percent loan-to-share ratio. Overall, loan participations make up less than 1.5 percent of assets. There is room for significant growth in CUSO investments and loans to CUSOs — in fact, some sources indicate \$7.5 billion of investment capacity and \$8 billion in lending capital to CUSOs exists. So we determined there was money available within the industry, but we'd have to work to get access it.

We have created a network of credit union partners who understand the how and the why of our business model, plus we offer a good rate of return on the loan. As we watched certificate of deposit and other options drop to historic lows, credit unions were looking for solid investments with a strong rate of return. CAP provides this opportunity. In 2009, we paid out more than \$2 million in interest payments. In 2010, we expect the number will exceed \$5 million.

This hasn't been an easy process. While the concept is rather straightforward, there really wasn't an example for us to point to and say "see, it worked well here." The difficult economy provide us both with opportunity – we could provide an obviously good rate of return – but boards of directors could be skeptical because they'd point to examples of where CUSO problems had negatively impacted their credit union investors. Yet, since 2007, we have raised more than \$115 million through CAP to fund

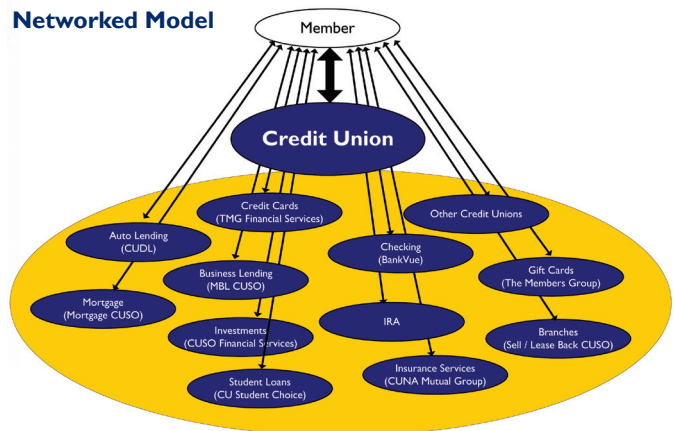


40 credit card portfolios representing 50,000 accounts. To do this we have had more than 50 credit unions who have participated in the program, and we're still seeing strong interest throughout the country.

THE NETWORKED MODEL

So what's the best solution to an industry in need of capital collaboration? We've already looked at two examples of how credit unions and CUSOs have solved specific business issues. But these solutions have been one-off and aren't easily replicated.

Traditionally, credit unions have sought solutions in a formal, linear manner. The credit unions act as a hub, still performing many back office functions, as well as actively managing many of the programs even if they have partnered with another entity to provide the services – a model that doesn't create economies of scale that would cut the cost of doing business.



What if credit unions instead outsourced their balance sheet and focused on providing world-class member service, as in the network model.

For this to be effective, credit unions must identify their core competencies, which would be defined as those services that it can be world-class in delivering. The credit union looks to others — CUSOs, credit unions, outside companies — to perform the other service for its members that it can't be world class in delivering. These entities interface directly or indirectly with the members in delivering the service, always managing the contact and quality as the credit union would if delivering the service itself.

This could work in a number of ways.

The Franchise Model. Under this concept, a series of credit unions would share a common brand, systems and products while maintain individual governance and management.

The “Outsourced Balance Sheet” Model. The financial accounts are on another institution's balance sheet and the credit union can solely focus on providing the delivery of services.

The Shared Services Model. Here, the credit union “hires” the expertise to provide specialized skills—a SVP, Credit Card Lending is a part of the credit union's management team but works for another entity.

The common thread through each of these models is that each will take collaboration to be successful. Each also has the potential to create scale and efficiencies that will create stronger credit unions while remaining focused on providing top level member service.

CONCLUSION

Look around the credit union industry today, and you'll see an opportunity to grow. Yet, are the conditions truly right for growth with the absence of funding partners that can help credit unions create an infrastructure necessary to create a sustainable competitive advantage?

Maybe we aren't in a crisis – yet. We are most certainly at a crossroads. Corporate credit unions are already cutting lines of credit to CUSOs. We should treat this as a certainty. The fallout will not only be to the CUSOs themselves, but to the individual credit unions they serve and, ultimately, members. But there is still time to act. Certainly, we can choose to maintain the status quo and work in our individual silos, content that we are serving our members as best we can. Or we can choose innovation and entrepreneurial spirit. There is risk inherent in the second choice, but it can be mitigated. We have the opportunity to serve members in a way that no other financial institution can or will. Are you ready to collaborate? Are you ready to truly embody the credit union mission of world-class service and re-invent it for a new century?

Many of the concepts discussed in this paper are adapted from conversations and brainstorming sessions with leaders in our industry. They are at their core a collaboration of ideas meant to spur conversations about how we set aside a century of inertia and change the game ... and in the end better serve our members and our industry. We must move beyond spirited, thoughtful conversations at industry conferences to actually integrating innovation into the system. This means an investment – a monetary investment. That's a hard action to take when almost everything crossing your desk is less than positive. But know this, the economy continues to show signs of improvement. To wait until it completely stabilizes will be too late. Others, likely those outside the credit union industry, will have already capitalized on this opportunity.

So, are you ready to collaborate? Really collaborate? Let's talk. Jeff can be reached via email at jeffr@tmgfinancialservices.com.

Jeff Russell is President and CEO of TMG Financial Services, a credit card agent issuing company dedicated to providing a credit union-centric solution that is collaborative and focuses on providing value for both credit unions and cardholders. Jeff also holds the position of Executive Vice President at The Members Group, a leading provider of credit, debit, ATM and prepaid processing solutions and a sister company of TMG Financial Services.