STRATMOR GROUP

In-Focus

RISE OF THE CREDIT UNIONS

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RISE OF THE CREDIT UNIONS

Are you one of the banks or independent lenders who doesn't pay much attention to credit unions because you think they are only competition for community banks? Are you a credit union thinking the mortgage market doesn't offer growth opportunities?

You might take a second look.

There's a growing group fishing along the shore of the mortgage banking pond: credit unions. According to the *2018 Mid-year Credit Union Report* by the Credit Union National Association (CUNA), credit unions in the U.S. serve more than 115 million members. CU membership growth has averaged more than four percent annually since 2016, five times the rate of the population growth in the U.S., and loan balances have increased more than 10 percent annually since 2014.

It's not hard to see why community banks keep a watchful eye on their local CUs. Credit unions provide low-cost banking solutions and high-touch service that appeals to many of their depositors. In the current intensely competitive banking market, CUs are fishing for customers looking for loans — Including mortgage loans — and CUs are taking home a reasonable catch.

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The CU Competitive Advantage

Credit unions have many "etched-in-stone" competitive advantages. CUs don't pay Federal or State taxes; they're not subject to Community Reinvestment Act (CRA) low-to-moderate income lending rules nor Basel III capital requirements; and unlike for-profit banks and independent lenders, CUs only need to make a relatively small profit, or surplus[1] to remain in existence. CUs' ability to accomplish this, even in tight margin markets like 2018, is a noteworthy competitive advantage — as good stewards of their members' assets, they always have a keen eye on costs and efficiencies.

"Credit unions appreciate value," says STRATMOR Principal Andrew Weiss. "Their members are their top priority, and they look for ways to make their members happy and be good stewards of the CU's budget. The CU philosophy isn't about making the most profit possible, it's about doing what's best for their members."

Members First

Providing superior customer service is hallmark of credit unions. "The CU's mantra of 'Members First' is a focus all mortgage bankers should adopt," says Weiss. "CUs know how to do it, and the case for choosing a CU is compelling. They charge less for their loan products, pay more on deposit accounts and they are willing to take more risk on their customers. Plus, they treat their employees well. Credit unions don't pay as well as other lenders, but layoffs are rare. As a CU employee, you may trade job security for less pay, but you gain a place in the community where you have a degree of respect, seniority and authority."

Lower Sales and Marketing Costs

Credit unions gain another advantage through mortgage acquisition costs. "The CU business model keeps them low cost," says Weiss. "Their fulfillment operations are a hybrid of Consumer Direct — minus the buying of leads but with a branch network like traditional Retail. CUs don't have to buy leads because they have a captive marketplace — their members — and they drive to give their members competitive products at a low cost."

According to Weiss, all areas of compensation at a CU are typically lower cost. "At one CU we worked with, until recently, their LOs were salaried. They've just added some level of variable compensation, too, and they worried about doing this, fearing that it would impact member services.

"In most CUs, the licensed mortgage people originate other loan products," says Weiss. "These LOs function more like financial advisors in that they talk to their members about all of their financial needs — members first, right? CUs don't want a member to get the wrong product. They do rigorous surveying of their members and then, centered on meeting or exceeding established performance metrics — overall, not mortgage only — compensate their employees accordingly based on achievement of high member services scores."

Because CUs have a built-in mortgage prospect base, the cost of acquisition is lower than community banks and traditional mortgage lenders. "CUs will, however, invest in their ability to get the right mortgage products to their members, usually by investing in

[1]A surplus is generated when CU revenues from loans and investments exceed operating expenses and interest paid on deposits.

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fulfillment efficiencies, particularly building LOS, and then in CRM and marketing activities," says Weiss. "To improve their ability to gain mortgage market share, CUs need to figure out how to know when to get in front of members when they want a mortgage — before a real estate agent sends the borrower in the direction of another lender."

Better Interest Rates

One of the greatest advantages CUs have: the ability to simultaneously pay higher interest on deposit products and charge lower interest on loan products. In comparison to banking institutions, the interest rate differences between the two are noteworthy, as shown in Table 1.

Table 1

Credit Union and Banking Institution
March 2018 Average Interest Rates and Fees

Loan Products	Average Rate at Credit Unions (%)	Average Rate at Banks (%)	Rate Difference vs. Banks (%)
60-month new car (A paper)	3.05	4.35	-1.30
48-month used car (A paper)	3.17	4.72	-1.55
Unsecured loan (A paper)	9.23	9.93	-0.70
5-year adustable rate 1st mortgage, 0 pts	3.81	4.01	-0.20
15-year fixed rate 1st mortgage, 0 pts	4.14	4.15	-0.01
30-year fixed rate 1st mortgage, 0 pts	4.60	4.58	0.02
Home equity / 2nd mtg, 80% LTV 0 pts	4.66	5.64	-0.98
Credit card - rewards	10.72	13.67	-2.95
Credit card - platinum	9.53	12.48	-2.95
Savings Products			
Regular savings, $1,000 balance	0.16	0.08	0.08
Share draft checking, $5,000 balance	0.12	0.07	0.05
Money market accounts	0.25	0.10	0.15
1 year certificate $10,000 balance	0.87	0.45	0.42
Retirement (IRA) accounts	0.56	0.27	0.29
Fee Income			
Share draft checking, NSF fee	$28.36	$31.24	-$2.88
Credit cards, late fee	$24.56	$34.18	-$9.62
Mortgages, closing costs	$1,151.00	$1,361.00	-$210.00

Source: CUNA U.S. Membership Benefits Report, First Quarter 2018.

At a CU, a 60-month car loan costs, on average, 30 percent less than at a bank, and across all the major deposit products — savings, checking, money market, CDs and IRAs — CUs currently pay about twice the interest rates paid by banks. In total, these differences currently add up to about $11 billion in annual benefits for CU members relative to banks. That's about $95 for each of the roughly 115 million CU members or $200 per member household (estimated at about 54 million households).

True, when it comes to fixed-rate mortgages, CUs are more likely to price like their competitors. But, it's the CU's ability to offer higher interest rates on deposits and lower rates on consumer loans that fuel the growth in CU membership and attract consumers to join a CU. Especially in the current rising rate environment, their competitively low-cost equity loans and HELOCs could attract many new members. When a consumer becomes a CU member, they become a relatively easy target for a mortgage sale.

"Once a CU member gets a mortgage from the CU, they tend to become a mortgage customer for life," says STRATMOR Senior Partner Garth Graham. "Credit unions frequently achieve high customer retention rates — recapture of mortgages that payoff. One of STRATMOR's CU clients has a 60 percent retention rate, which is several times the typical rate achieved by banks and independent lenders."

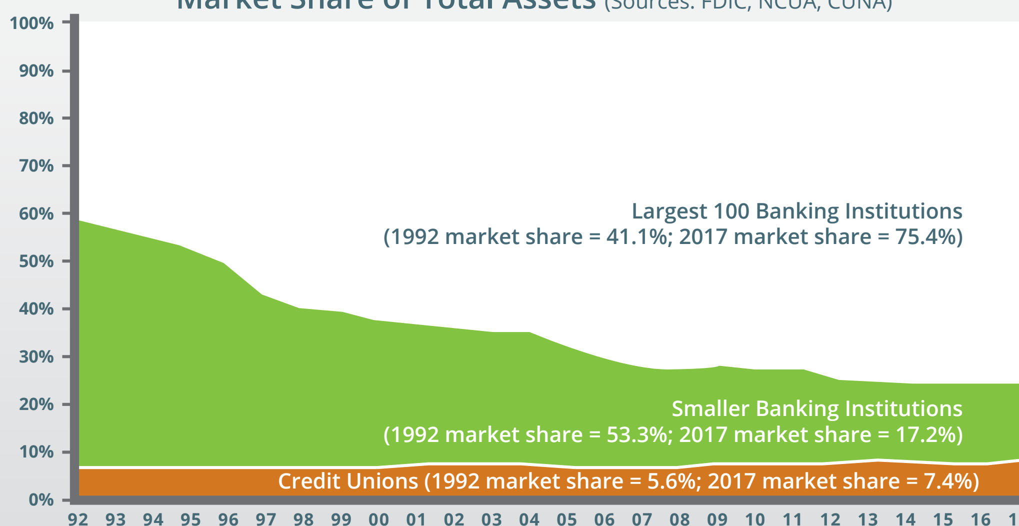
Tax Exempt

According to STRATMOR Principal Tom Finnegan, our bank-owned mortgage expert, the tax-exempt nature of CUs is a tremendous competitive advantage. So much so, that with respect to auto lending, for example, CUs have effectively knocked out community banks as competition. "Only larger banks with scale in the dealer finance auto lending business can possibly compete," says Finnegan. "Also, the CU regulator, the NCUA, keeps chipping away at limitations on credit union activity in mortgages. For example, non-owner occupied 1-4 family residential mortgages had previously counted as part of the 12.5 percent of assets business lending cap for CUs, but that restriction has now been eliminated."

Against this competitive backdrop, it's little wonder that banks — in particular, community banks — strongly oppose the taxation and regulatory advantages enjoyed by CUs. According to Finnegan, change isn't likely. "With about half of the country's households belonging to and loving a credit union, it would be a political third-rail," says Finnegan.

The precipitous decline in the market share of community banks has a lot more to do with the growth of large banks than it does with credit unions. Figure 2 shows the market share of total assets for large and small banks.

Figure 2



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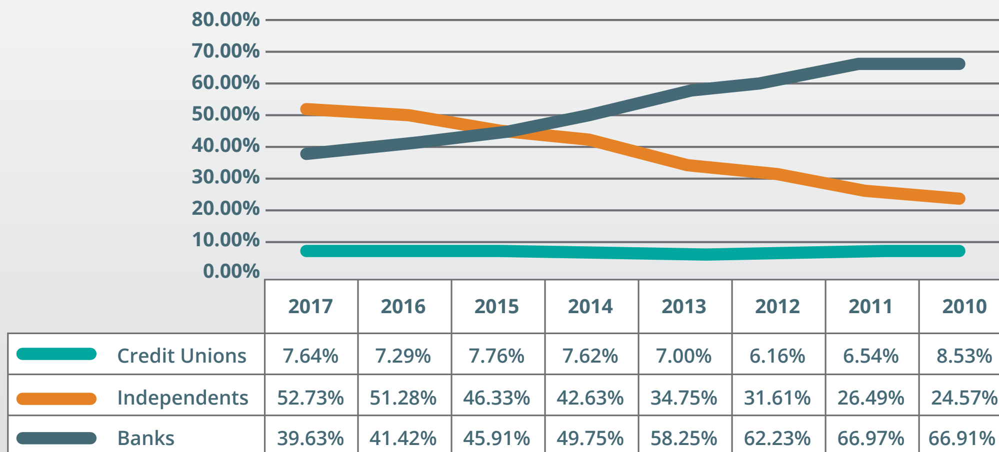
The Trendlines

From 1992 through 2017, the asset market share of the 100 largest banking institutions grew from 41.1 to 75.4 percent — an increase of 34.3 percent. This increase came almost totally at the expense of a much larger group of smaller banking institutions — largely comprised of community banks — which saw their market share dive from 53.3 to 17.2 percent. Over this same twenty-five-year period, the asset market share of CUs remained relatively steady, growing from about 5.6 to just 7.4 percent.

By loan count, the credit union share of the mortgage market since 2012 has remained steady between 6.16 and 7.64 percent; however, since 2012, banks have seen their mortgage market share decline by almost 23 percent, from 62.23 percent in 2012 to 39.63 percent in 2017. At the same time, the market share of Independent mortgage lenders went from 31.61 percent to 52.73 percent, an increase of 21 percent.

Figure 3

Mortgage Originations Market Share (based on #)



	2017	2016	2015	2014	2013	2012	2011	2010
Credit Unions	7.64%	7.29%	7.76%	7.62%	7.00%	6.16%	6.54%	8.53%
Independents	52.73%	51.28%	46.33%	42.63%	34.75%	31.61%	26.49%	24.57%
Banks	39.63%	41.42%	45.91%	49.75%	58.25%	62.23%	66.97%	66.91%

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CU Barriers to Growth: Culture, Capital, Marketing

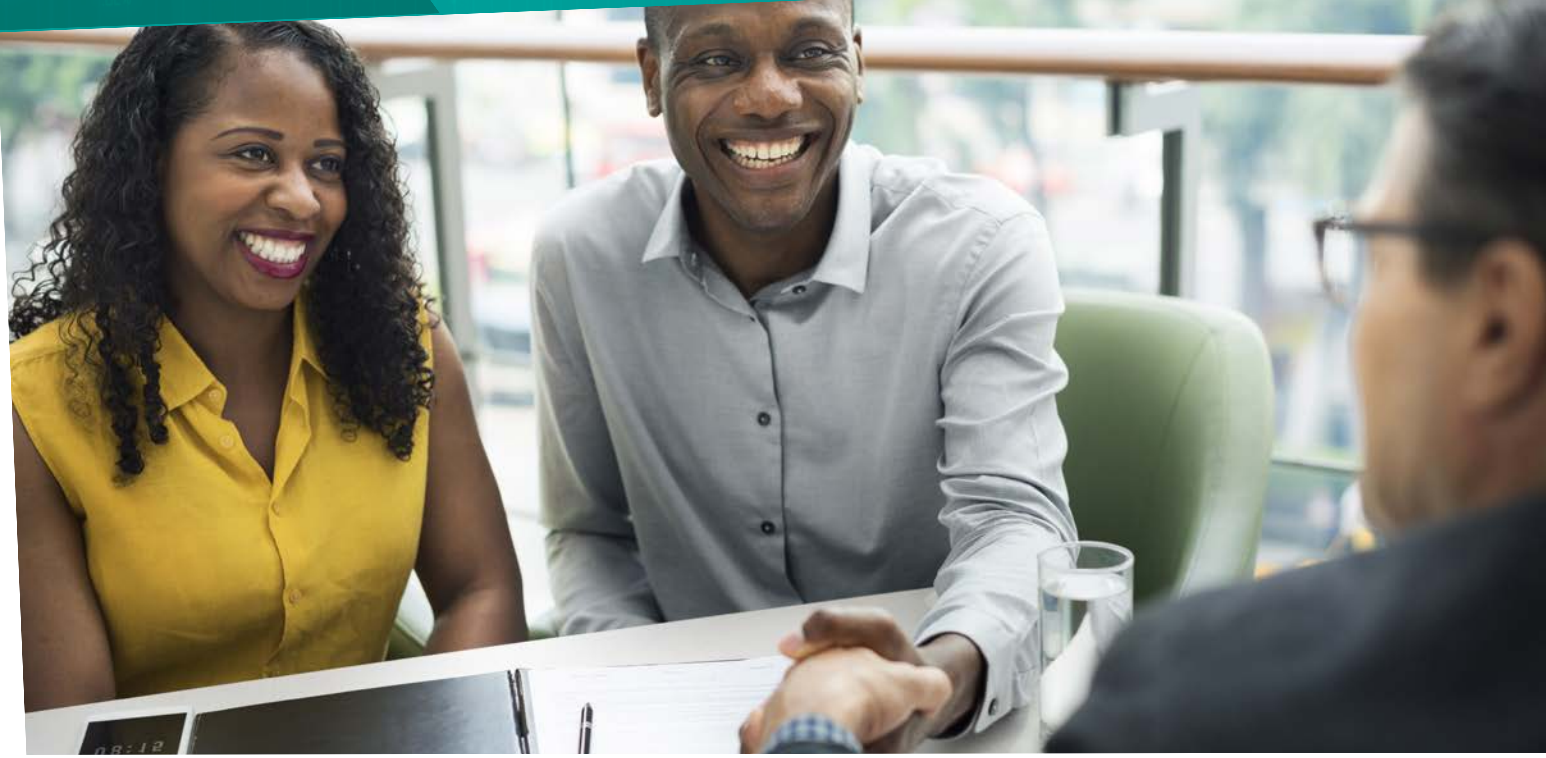
The 54 million households that currently have membership in a credit union represent roughly half of the economic households in the U.S. All U.S. households could belong to one or more CUs — membership requirements can be anything from where someone works or their trade or vocation to the state, county or community in which they live. Given this broad reach, with their competitive advantages and despite recent gains, what's keeping the CU mortgage market share at modest increases?

Just as a strength can also be a weakness in people, a 'Members First" focus can limit a CU's total investible pool and the resources needed for growth-oriented projects and strategy. While increasing the capture of the mortgage business of members is important, most credit unions would not seek to increase mortgage origination volume without the right supporting infrastructure in place to assure high quality member service.

For example, a large credit union STRATMOR consulted was faced with back-office capacity limitations. They referred members seeking a mortgage to a high-performance independent lender, explaining that they simply didn't then have the capacity to do a good job. Can you imagine this happening at a bank or independent mortgage lender?

"Member satisfaction is the primary metric for credit unions — not profit," says STRATMOR Senior Partner Michael Grad. "This approach would seem to put the CU's financials and their overall economic performance at risk, but this is why CUs are able to ride through what we're seeing in 2018 — they have such a strong, loyal customer base. Our PGR data shows that CUs are sitting on an enormous opportunity that could be realized with changes to their infrastructure that would benefit their members and the CU's bottom line."

A second limitation to CU growth is access to capital. Due to their status as not-for-profit, member-owned financial institutions, CUs typically have no source of secondary investment capital. Instead, they must rely on the cumulative surplus funds generated from their operations which, as of March 2018, averaged $69 million per CU, compared to average capital of $1,064 million per bank, roughly a 15:1 factor. While the 598 CUs with assets greater than $500 million (representing less than 11 percent of all CUs but 70 percent of CU members) have surplus funds averaging $496 million, this capital pales in comparison to the capital of the largest banks, much of which has been sourced from the capital markets.



As noted previously, if CUs concentrate their efforts on promoting mortgage products to their members, their ability to become a major competitor in the mortgage space would increase significantly. Rough estimates by STRATMOR, based on 2017 HMDA mortgage origination data for CUs and CUNA membership data, suggest that the 54 million households that belong to a CU did about three million mortgage originations in 2017, of which 500,000 or 16.7 percent were originated by a CU. Compared to banks, this is excellent capture of their potential market. Still, despite price, product, service and trust advantages, CUs are originating just one in six mortgages done by their members, which offers tremendous opportunity to capture more market share.

"You would think with such great rates over the last ten years, first mortgage business at CUs would have grown substantially," says Grad. "While CU sales and fulfillment processes would likely benefit from improving the digital experience for their borrowers, digital may not improve overall penetration in mortgage. What could? Having some type of advanced consortium model where 25 or more CUs share a data and analytics engine that runs in the background — one that does all the things big banks do, like lead generation and lead identification. Currently, even the large CUs have little or no retention program or lead generation/lead identification capability. The roughly 4,744 smaller CUs — comprising about 84 percent of all CUs — do not have the resources necessary to implement Big Data marketing techniques and analytics on their own."

"There is little pressure for CUs to up their marketing game," says Graham. "Even with lower commissions, CU loan originators do quite well financially because of their higher closed loan productivity realized just by servicing walk-in or call-in mortgage prospects. And, the generally no-growth CU culture gives CU mortgage executives little incentive to adopt the advanced marketing methods that could increase mortgage penetration of their member base."

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A Strategy for CU Mortgage Growth

CUs have been both aggressive and creative in expanding the "common bond" membership eligibility requirements which has broadened the reach of CUs across the U.S. population. But while expanded membership increases the size of the pond in which CUs can fish, they still must show up at the pond.

According to Graham, if increased penetration for mortgage is a strategic objective, a CU willing to invest in and implement advanced data analytics and lead management capabilities will have a winning strategy by:

- Using "trigger leads" generated by credit bureau searches and current home-listings to identify those CU members — including current CU mortgage borrowers — who are soon-to-be or actively in the market for a mortgage.
- Leveraging Big Data and third-party data sources and models to predict which CU members are likely to need a mortgage upstream of triggers. "The goal here is to get to such members early in the home-buying/mortgage process," says Graham. "Zillow, for example, using its Mortech Protector product, can assign a CU's members to buckets indicating their propensity to need a mortgage, e.g., Joe Member is in the top decile. And, 70 percent of homebuyers conduct a home-search on Zillow."
- Proactively going after — via out-bound calling, emails, text messaging etc. — those members who have been "triggered" or assigned to a high-propensity "likely-to-need-a-mortgage" bucket. "Identifying such members without reaching out to them accomplishes nothing," says Graham. "Using lead management and tracking applications assures that mortgage leads generated by data analytics are contacted, tracked and not lost in the sales process."

"Implementing such strategies are likely affordable by only the large CUs," says Graham. "Mid-size CUs, of which there are several hundred, will likely need to rely upon third-party service providers or perhaps participation in some type of consortium as Michael Grad suggests that offer data analytic services with the costs spread across many CUs. A Credit Union Service Organization (CUSO) may be the right vehicle for accomplishing this; or, a non-CUSO back-office service provider."

"When CUs adopt these strategies, they will break out from their currently small mortgage penetration of their member base," says Graham. "Talk about a threat to the rest of the mortgage banking industry — when this happens, CUs will be fishing the big mortgage lake from the back of a very large boat."

WE WELCOME YOUR FEEDBACK

STRATMOR works with bank, independent and credit union lenders on strategies to solve complex challenges, streamline operations, improve profitability and accelerate growth. Please contact your STRATMOR partner or principal for assistance or email STRATMORinsights@stratmorgroup.com.