COMMUNITY CONVERSION STUDY

Do field of membership expansions through community charter conversion or expansion improve or weaken the financial performance of credit unions?

Our conclusions are much the same as a similar Research Study conducted in 1987. Generally, credit unions expanding their field of membership by way of a community charter conversion or expansion (community conversion) suffer no material harmful effects. Credit unions that have undergone a community conversion typically incur a small decline in the Net Worth Ratio, a slight reduction in the Return on Assets (ROA), and a small increase in loan losses. Despite these relatively minor side effects, the financial and CAMEL performance of credit unions that have recently received a community conversion are very similar to those of the entire population of Federal Credit Unions (FCUs). Credit unions obtaining community conversions enjoy the following intangible benefits:

- Increased diversity of the economic base beyond that of a single sponsor.
- Increased variety of services provided to members and revenue opportunities for the credit union as a result of improved economies of a scale.
- Increased availability of qualified volunteers.
- Lower NCUSIF losses related to assisted mergers due to the inherent value of a community field of membership.

BACKGROUND

Table 1 - Community Charters (TOM Code 00)

	1998	1999	2000	2001	2002
Total Community Charter FCUs	421	464	517	781	854
Percent of Number of FCUs	**6.2%**	**7.1%**	**8.2%**	**12.8%**	**14.4%**
Total Assets (billions)	$16.0	$21.6	$26.7	$40.3	$50.3
Percent of Total FCU Assets	**6.9%**	**9.1%**	**11.0%**	**14.9%**	**16.7%**
Average Size (millions)	$38.0	$46.6	$51.7	$51.6	$58.8
Net Worth/Assets	10.4%	10.7%	11.1%	10.7%	10.8%

The number of Federal credit unions with community charters more than doubled during the last four years and now comprises 14.4 percent of all FCUs (see Table 1). The increase in the number of community charters is attributed to:

- The need to diversify the membership and economic base in order to withstand sponsor problems, such as plant closings and employment cutbacks, and to reflect the mobility of the U.S. workforce.
- Reaction to large field of membership expansions by state charted credit unions.
- Desire to expand services.
- Changes to NCUA chartering regulations to ease the burden on applicants for community charters, expansions or conversions.

In 1987, the Office of the Chief Economist prepared a similar Research Study titled *Effect of Field of Membership Expansions on Credit Union Performance*. The study involved 2,333 Federal credit unions that expanded their field of membership in 1983 and 1984. Some of the conclusions drawn from the study were:

- The majority of credit unions that expanded their fields of membership maintained their already good financial performance.
- "No deleterious effects were found due to field of membership expansions."
- Field of membership expansion, as a tool to help credit unions facing sponsor problems such as plant closings and employment cutbacks, may have prevented these credit unions from going out of business.

SCOPE OF STUDY

This study examined 474 FCU community conversions that occurred during the last 10 years. All of the credit unions in the study had at least six months of operations since the conversion. For this group of FCUs, there is an examination on record post conversion in 393 of the credit unions. We analyzed the financial condition and CAMEL ratings of the credit unions based upon the number of years since the conversion or expansion. The number of credit unions in the study based upon the number of years since the community charter conversion or expansion follows:

Table 2 – Years Since Community Conversion

Years	1	2	3	4	5	6	7
# FCUs	474	351	202	104	71	32	17

RESULTS OF REVIEW

CAMEL Ratings

An overall measure of the financial and operational condition of the credit union is its CAMEL rating. Table 3 discloses that the CAMEL ratings for credit unions in operation for more than one year since community conversion, who have received a subsequent examination, are virtually identical to the trend for all FCUs.

Table 3 – Community Conversion CAMEL Ratings

CAMEL	# of FCUs	Percentage	National Average
1	102	26.0%	22.3%
2	221	56.2%	56.1%
3	60	15.3%	19.7%
4	10	2.6%	1.9%
5	0	0.0%	0.1%
TOTAL	**393**	**100.0%**	**100.0%**

Table 4 shows the number of credit unions that experienced a decline in their CAMEL rating by the number of years since the community conversion. On average, 13 percent of credit unions involved in a community conversion deteriorated from a CAMEL 1 or 2 rating to a 3 or worse post expansion, only slightly higher that the average of 10% for all FCUs[1]. CAMEL declines occur more frequently 1 to 4 years post community conversion, declining in frequency in year 5 and thereafter. Of those credit unions receiving a CAMEL downgrade post conversion, 29 percent (34) have also subsequently been upgraded to a CAMEL Code 1 or 2. The vast majority of converting credit unions maintained or improved their already good CAMEL rating.

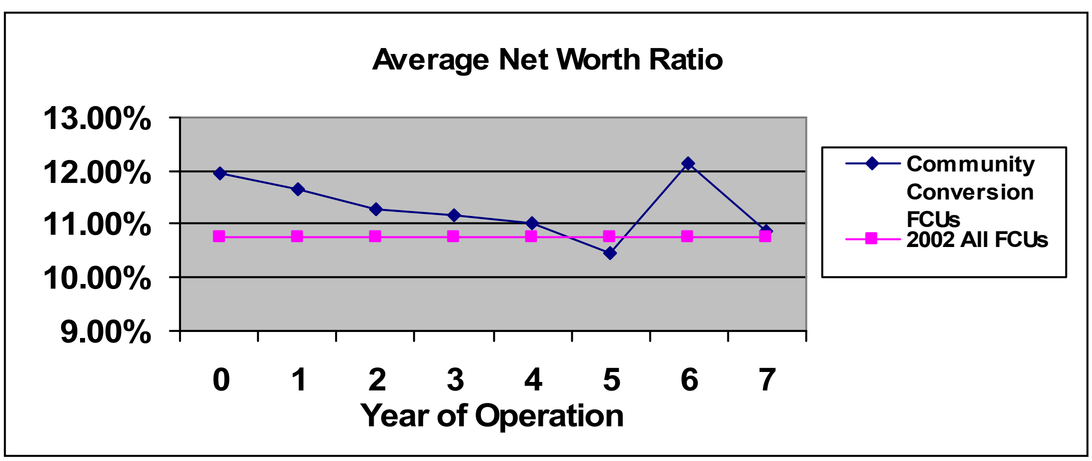
Table 4 – Community Conversion CAMEL Downgrades

Years Since Conversion	Number of CUs Downgraded	# FCUs in Range	%
Less Than 1	11	393	2.8%
1-2	51	351	14.5%
2-3	27	202	13.4%
3-4	17	104	16.3%
4-5	7	71	9.9%
5+	4	36	11.1%

The ROA declining below the CAMEL Matrix Code 2 for Earnings (0.8% for credit unions with over $2 million in assets) is the most common reason for the decline in the overall CAMEL rating. Since adjusting operations for the expanded field of membership would commonly occur with community conversions, examiners need to differentiate between a decline in the ROA as a part of an overall business plan and a decline in the ROA due to improper planning.

Financial Performance

Net Worth: Community conversions do not materially harm credit unions' Net Worth Ratios. Trend analysis shows some reduction in the Net Worth Ratios for credit unions post community conversion, but this is consistent with the national trend for the last two years (see Appendix Table A-1).



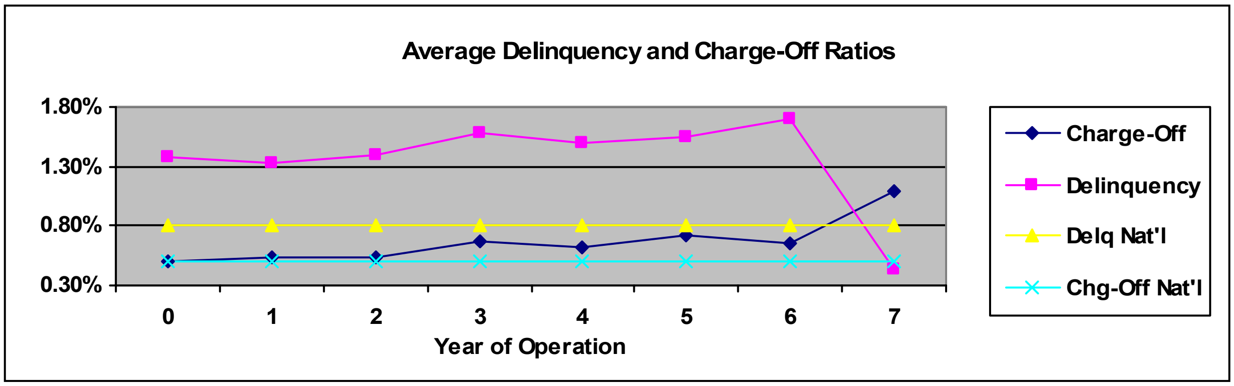
[1] For 2002.

The majority of credit unions involved in a community conversion experience a decline in their Net Worth Ratio. As Table 5 indicates, these institutions will experience elevated share growth resulting in a reduction in the Net Worth Ratio. However these credit unions generally start with a higher than average net worth ratio and, even after the decline, Net Worth remains strong.

Table 5 – Community Conversion FCUs with a Decline in the Net Worth Ratio

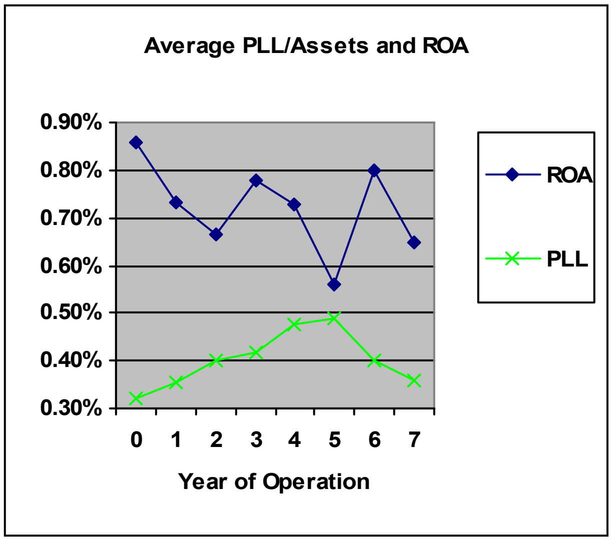
	Year 1	Year 2	Year 3[2]	Year 4	Year 5	Year 6	Year 7
% With Net Worth Ratio Decline	60%	62%	55%	59%	66%	53%	47%
Average Decline	97 bps	93 bps	79 bps	86 bps	88 bps	74 bps	69 bps
Average Share Growth[3]	16.1%	14.9%	14.2%	15.1%	13.3%	15.6%	11.8%
Average ROA	0.6%	0.5%	0.6%	0.6%	0.3%	0.7%	0.3%
% With Negative ROA	11%	16%	14%	13%	28%	5%	25%
Average Net Worth Ratio	11.5%	11.2%	12.0%	11.4%	10.6%	10.9%	10.4%

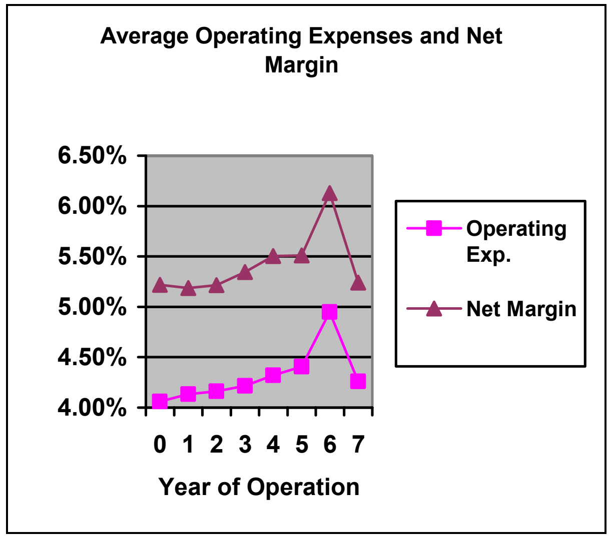
Asset Quality: The delinquent loan ratio shows some slight increase post community conversion and remains higher than average. Also, converting credit unions can expect an increase in loan losses after the second year of operations as a community charter. The rate of loan losses increases slightly each year. However, overall delinquency and loan losses are within manageable ranges.



Profitability: Credit unions that undergo a community conversion experience a small decline in their Return on Assets (ROA). The average ROA for these institutions typically begins below the average for all FCUs and remains lower than the national average (1.08% as of 12/31/02). The higher level of share growth (over 9%) and the increase in loan losses accounts for the below average ROA performance. Other trends include a small increase in the operating expenses to average assets that started and remained above the average for all FCUs (3.24% as of 12/31/02). The converting credit unions tend to cover the increased level of operating expenses by improving the net margin which remained above the average for all FCUs (4.62% as of 12/31/02).

[2] Numbers adjusted to exclude Parco FCU which experienced a negative ROA of 42.96%, a reduction in Net Worth of 42.03% and a Net Worth of -34.45%.
[3] The average share growth for all FCUs from December, 31 1998 to December 31, 2002 was 7.3 percent.





Failures: Fifteen credit unions included in the study are no longer active (see Appendix Table A-2). Most of these credit unions merged with larger credit unions for a variety of reasons. Four of the credit unions were merged, liquidated, or purchased and assumed due to their poor condition, and two required NCUSIF assistance. The credit unions in poor condition experienced problems with loan quality, insider abuse, and earnings. None of the failures are directly attributed to the community conversion.

<u>Other Issues</u>

Credit unions expanding their field of membership must be willing to enhance the quality of management to combat the following possible challenges:

- Erosion in member loyalty, affinity, and unity, affecting volunteerism, collection on problem debt, and use of the credit union as the member's primary financial institution. This also can have an impact on the traditional premium placed on core deposits and credit union mortgages.
- Increased competition amongst credit unions due to membership overlaps, impacting cooperation within the industry.
- Increased complexity associated with dealing with different membership demographics, including less reliance on direct deposit and/or payroll deduction.
- Short term growing pains associated with increased workload on credit union employees and risks resulting from adding new products and services.

APPENDIX

Table A-1
Selected Statistics Based on Year of Operations After Community Conversion or Expansion

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Number CUs in Sample	474	351	202	104	71	36	17
Increased Net Worth Ratio	40%	36%	45%	41%	34%	36%	53%
Reduced Delinquent Loan Ratio	50%	48%	49%	53%	52%	47%	47%
Reduced Charge-off Ratio	48%	48%	36%	43%	41%	47%	41%
Increased ROA	39%	33%	45%	43%	49%	64%	53%
Reduced Oper. Exp./Ave Assets	45%	52%	55%	53%	65%	67%	53%
Share Growth Exceeded Peer	54%	53%	53%	47%	48%	58%	53%
Loan Growth Exceeded Peer	58%	61%	56%	54%	55%	50%	71%
Median Net Worth Ratio	10.67%	10.53%	10.31%	9.86%	9.89%	9.42%	9.66%
Median Delinquent Loan Ratio	0.93%	0.96%	0.98%	0.96%	1.03%	0.94%	0.87%
Median Charge-off Ratio	0.40%	0.43%	0.46%	0.45%	0.58%	0.40%	0.29%
Median ROA	0.76%	0.87%	0.75%	0.76%	0.65%	0.74%	0.66%
Median Share Growth	10.29%	9.97%	9.44%	8.59%	10.03%	8.96%	6.32%
Median Loan Growth	7.76%	7.66%	7.66%	6.06%	6.31%	4.18%	8.91%

Table A-2 - Inactive Credit Union Summary

	Conversion/ Expansion Date	Date Closed	Comments/Assets in Millions
Alcoa -322	3/7/97	4/19/02	Merger into FCU– $5.1
Big Horn – 1024	9/15/98	3/21/02	Merger into FCU – Poor Financial Condition - $7.7
Umpqua – 1301	3/16/00	5/29/02	Merger into FCU – $10.5
Parco -1708	3/4/97	2/1/02	P&A into FCU – Poor Financial Condition – NCUSIF loss $634,900 – $2.8
Texas Star -5413	5/14/02	7/902	Merger into FCU – Declining FOM - $32.5
Southern Oklahoma - 6943	2/4/00	9/20/02	Merger into FCU – Expand Services - $4.3
First Charter – 9832	10/23/00	11/15/02	Merger into FCU – $75.4
AGE – 10519	4/16/98	7/11/01	Merger into NFICU – $268.7
Danbury Municipal - 15404	4/20/99	2/15/01	Merger into FISCU – $10.9
P.W.T – 19130	5/18/01	6/25/02	Merger into FCU – Poor Financial Condition – $1.0
Amphlett Employees – 1922	1/4/99	6/1/01	Merger into FISCU – $2.4
First Hialeah – 19936	4/16/97	5/10/02	Liquidation – Poor Financial Condition - NCUSIF loss $7.5 million – $29.3
Dickson – 21141	1/6/00	8/30/01	Merger into FISCU– Expand Services - $8.2
Western Trails – 22567	12/7/99	4/16/01	Merger into FISCU – $12.5
Community Advantage – 23207	6/10/00	6/4/02	Merger into FISCU– $2.5