Sacramento Valley Chapter of the California Credit Union League
Sacramento Hilton Arden West
2200 Harvard Street
Sacramento, California

"The Good, the Bad, and the Ugly"

Thank you for the opportunity to speak before the Sacramento Valley Chapter of the California Credit Union League.

Congratulations to Patsy Van Ouwerkerk, Travis Credit Union and the new Board of Governors of the Sacramento Valley Chapter of the California Credit Union League.

Credit unions are one of nine separate licensees supervised by the Department of Financial Institutions and are vitally important to the recovery and stability of California. As you are very much aware, credit unions are non-profit public benefit organizations, democratically controlled for the wise management of its resources, without profit, and for the mutual benefit of its members.

This speaks to the fundamentals of credit unions in California. This evening I will share with you the Good, the Bad and the Ugly that I have experienced with credit unions in my now six months with the Department of Financial Institutions.

The Good

The good news is that the financial condition of the California credit union industry is cautiously optimistic. The percentage of satisfactory credit unions is increasing and the trend is positive and improving.

At the end of the 2nd quarter of 2012 net worth improved to nearly 10% due to earnings accumulation and slower asset growth. With the exception of the first quarter of this year, this reflects a positive trend which started at fiscal yearend 2009.

Asset quality ratios also showed improvement in 2012. In particular, delinquencies dropped substantially in the 2nd quarter, mostly due to changes in reporting requirements for troubled debt restructured loans (TDRs). Effective 6/30/12, as you are well aware, credit unions are to report TDR delinquency based on restructured contracts, and are no longer required to report TDR delinquency based on the original loan terms until six consecutive payments are received.

Improved loan credit quality and the liquidation of one credit union this year also contributed to asset quality improvement. Delinquent loan balances have declined 3 consecutive quarters, with the 2Q sharply down 30%, primarily due to the relief in TDR delinquency requirements as previously mentioned.

Reportable real estate delinquency is below 2% as of June 30, 2012, down two straight quarters. Early real estate loan defaults 1-2 months declined at the 2nd quarter, after rising three straight quarters. Real estate risk exposure continues to trend downward due to increasing net worth and declining portfolio balance.

MBL defaults >1 month dropped to the mid-4% at 2Q, having escalated to nearly 8% at 1Q. Reportable MBL delinquency continues to improve 2 straight quarters, dropping to mid-2% at 2Q.

Earnings performance also saw some improvement at 2nd quarter 2012, mainly driven by lower PLL funding and dividend expenses, along with higher fee and other operating income. ROA was 0.96% annualized at 2Q12, improving 27 basis points from the prior year-end. 29 credit unions still experienced a net loss, reflecting 19% of all credit unions at 2Q12 vs 31% the prior year-end. Loan and investment yields continue to hamper earning potentials.

Liquidity remains adequate at 21%.

Loan originations increased an annualized 7% as of 2Q12. Fixed rate real estate portfolio reflects 59% of total real estate outstanding, with the fixed rate 1st deed of trust portfolio edging up slightly.

These improvements are most meaningful in the context of how California credit unions are serving your members.

First, what are the demographics of California that comprise your membership?

- California is the most populous sub-national entity in North America. If it were an independent country, California would rank 34th in population in the world. Its population is one third larger than that of the next largest state, Texas;
- No single racial or ethnic group forms a majority of California's population, making the state a minority-majority state;
- Nearly 43% of California residents speak a language other than English at home, a proportion far higher than any other state.

Much of the above statistics represent a population that comes from countries where deposits are uninsured and there is little opportunity to have a financial relationship with a credit union.

Credit unions have an opportunity to take advantage of a program now administered by the Department of Financial Institutions, called “Bank On California”.

Bank On California is a voluntary collaborative initiative that gives unbanked and underbanked households access to mainstream financial products and services, including no- and low-cost checking and savings accounts with participating credit unions and access to financial education.

The public’s trust and confidence in the financial system is dependent in part on how credit this nation’s insured depository institutions serve the public’s need. In its September 2012 Executive Summary of the “2011 FDIC National Survey of Unbanked and Underbanked Households”, the FDIC reported that more than one in four households are either unbanked or underbanked. The unbanked include households where there is no person in the household who currently has a checking or savings account. The underbanked households may have a checking and/or savings account, but also used non-bank money orders, non-bank check cashing services, payday loans, rent-to-own services, pawn shops or refund anticipation loans or other alternative financial service providers (AFS), in the last 12 months.

8.2% of US households are unbanked, representing nearly 10 million households or approximately 17 million adults.

20.1% of US households are underbanked, representing 24 million households with 51 million adults. One-quarter of households have used at least one AFS product in the last year, and almost one in ten households have used two or more types of AFS products. In all, 12 percent of households used AFS products in the last 30 days, including four in ten unbanked and underbanked households.

Bank On California has made significant progress expanding financial education opportunities and has conducted over 2,000 financial education workshops, while reaching out to several thousand unbanked low- and moderate-income families and individuals throughout the state. Bank On California has survived and thrived because we are collaborating hand in hand with our community partners, including community-benefit non-profit, organizations, local, state and federal government agencies, credit unions and banks.

But how do I count my sister in these numbers? She lives in St. Paul, Minnesota and just happened to owe me $100. I had no doubt that I would receive her payment. I was not prepared, however, for her to spend $18.95 to send me one hundred dollars in cash by Express Mail last Friday. Tell Alana's story. No one is immune from the risks in financial services that plague the unbanked.

I applaud and commend Patelco Credit Union, SAFE Credit Union, Schools Financial Credit Union and Travis Credit Union that are active participants in Bank On Sacramento. Keep up the good work and encourage your credit union colleagues to join Bank On Sacramento. Who knows? Maybe one day, we will serve as the model for Bank On Minnesota.

California recently enacted legislation that allows state-chartered credit unions to offer "lifeline services" to nonmembers for a fee. This legislation is intended to bring parity between federal and state chartered credit unions. When I think of lifeline services, I think of the "unbanked" and the "underbanked" who are often desperately in need of financial services at no cost. I hope and trust that the California credit unions will continue to be supportive of Bank On California and Bank On Sacramento and take meaningful efforts to bring the unbanked into your membership.

The Bad

One of the most compelling aspects of the Department of Financial Institution that I have come to admire and respect is the examiners perspective of the credit unions they examine and supervise. Credit unions provide a business model that the examiners at DFI truly believe in. You offer a financial alternative that your members hold dear. This might sound corny or cliche-ed, but it is true! And is clearly demonstrated by Tech Credit Union today, when its members voted not to convert to a mutual savings bank.

The culture of your membership often guides your credit unions' unique strategies and how a given credit union chooses to address the challenges it is facing. It was refreshing for me to be able to discuss this evening the positive financial trends demonstrated by the California credit unions.

For every credit union there is something unique to your members, including the very definition of your field of membership that creates distinctive challenges from those faced by other credit unions.

Home values are depressed in the interior, but relatively healthy on the coast.

Employment opportunities for members vary across the different regions.

Choices made by credit unions in the past, like second mortgages and underwriting standards have created their own opportunities and challenges.

One of DFI's credit union examiners likens the running of a credit union to being the captain of a ship. The sea must be kind before you can go very far. On the other hand, you must know where you are going and how you will get there to complete your journey. Credit unions throughout the state are selecting different routes to their destinations.

Some pick a profession and service the members of that profession. Others serve the residents of a county. In the recent downturn, some have chosen to become investors, while others have developed new loan products. Each credit union evolves in its own way.

And for the DFI examiner, it is often about trust, and more importantly, mutual trust.

A respectful and cooperative discussion of the issues and the means for achieving a positive and productive result are the most meaningful way to a healthy credit union industry in California.

DFI is keen on credit unions solving your specific problems, and created opportunities, ultimately for your members and your community. But it is not a one-way street.

DFI often learns from each of you, from your areas of strength, and hope to help you and suggest best practices when we see weaknesses with the common goal of a stronger and healthier credit union in California.

We very much appreciate and welcome your questions. It is important for us to know that management has not only heard from the DFI, but also appreciates how DFI's advice will directly or indirectly affect the credit union and your members. Sometimes, if management accepts DFI's findings passively, we are not quite sure if management has a real appreciation and understanding of the concerns that we may have raised.

Or perhaps the examiner is missing a part of the picture. Maybe the concerns raised by DFI have been addressed by the credit union in another way. Maybe the credit union officials know of a better way to solve the problem given the nature and culture of your members.

If management does not bring its concerns to DFI's attention, we will not know that a better solution may be possible or even available. The "bad" result may be that the credit union goes completely off course, and is miss-directed with a sub-optimal solution.

DFI prefers to know up front if management has concerns. It is best not to learn much later that management did not understand the findings or that DFI may have sent the credit union on a “wild goose chase”. This is not only “bad”, it is also very “sad”.

It is especially sad if an avoidable expense is being made where it was not required in the exam.

It is also bad, and sad, to see misplaced trust.
Too many of the credit unions that are still struggling have put too much faith in others, including stockbrokers and participation loans, without a true understanding of the asset and its associated risks.

We know of credit unions that as a matter of policy do not wish to sell mortgage loans, but will buy Mortgage Backed Securities in their investment portfolio. We have observed credit unions, who acknowledge that they are unprepared to write business loans, yet will trust another institution and buy their business loans, without proper due diligence and risk analysis.

We ask, why has the credit union decided to trust an outsider's judgment over its own? The other person's interest may not be aligning with the credit union’s interest.

Management might ask, why is this person selling the loan?

If it is a participation, how much is the seller keeping?

What is the strength of the seller’s servicing operations?

What other relationships does the seller have with the borrower?

Is there adequate collateral?

What other potential collateral does the borrower have?

Is that other collateral supporting other loans from the seller?

How do they make their money on this loan? ... on other loans?

Never be afraid to ask questions. There is no business without risks, but by making an informed decision management may avoid the "bad" by controlling and minimizing the risks.

The Ugly

Early afternoon on my very first day at DFI, several DFI lawyers asked if they could meet with me. I was very excited at being at DFI and looked forward to meeting with fellow attorneys. The meeting started cordially, but quickly became very serious. DFI was faced with a problem credit union and a definitive decision had not been made on how best to proceed. The Deputy Commissioner and the attorneys were recommending that the credit union be placed into conservatorship … immediately.

This was my first day as Commissioner.

I knew nothing about the credit union at that moment to be able to make a decision, and I so informed the attorneys. I asked to see the entire file for the credit union.

My first thought was not to move too quickly. Let me just get settled in. Learn my way around the DFI. Surely this can wait.

I had represented two banks that were put into receivership with the FDIC. I knew firsthand how emotionally and economically devastating the closure of financial institutions can be on the customers, the employees and the community. So I was not looking forward to taking any serious action against a credit union my first week at DFI.

Over the next three days, I read and considered all that there was to know about the credit union. And at 1:30 am Thursday morning, I knew that the only responsible course for me to take would be to put the credit union into conservatorship on Friday.

I knew that Friday, March 23, 2012, would be an "ugly" day.

As luck would have it, I had agreed the morning of my first day to speak the following week before the NASCUS Director's College. After I gave my presentation that next week, the first question from the audience was actually a statement. The gentlemen rose and said, "Thank you for taking care of the Telesis situation."

At that moment, I knew that what was an "ugly" day for Telesis was actually a "good" day for credit unions in California. It was a good day for each California credit union that:

- operates without profit and for the mutual benefit of its members;
- has an effective framework for enterprise risk management consistent with its size, complexity, structure and risk profile;

- monitors risk exposures on an ongoing basis and determines corresponding capital and liquidity needs;
- controls and mitigates risk exposures through effective processes that work as intended;
- has a board of directors and management with the expertise and integrity to fulfill their roles;
- has effective board oversight and corporate governance practices, policies and procedures;
- presents information to the board in a complete, accurate and understandable manner;
- has established processes to properly and timely oversee and evaluate management and control functions, and assess the boards' own effectiveness.
- has an internal audit function that conducts independent, risk-based and effective audits and has access to the board;
- has knowledge of and controls over all actual and potential conflicts of interest at board and management levels;
- has MIS and analytical capabilities to perform stress tests/scenario analyses for all key exposures;
- has risk mitigation strategies and contingency plans that are informed by such analyses;
- understands and effectively adapts to changes in the economic, financial and competitive environment;
- has compensation systems that are effectively aligned with prudent risk taking; and
- operates in a safe and sound manner, with integrity and in compliance with applicable laws and regulations.

Let's stay focused on "good" management, steer our ship around bad decisions and practices and avoid the "ugly" consequences.

I look forward to our successful journey together.

Good evening.