"I am invisible, understand, simply because people refuse to see me"

Ralph Ellison, *Invisible Man*

IMPROVING THE FINANCIAL HEALTH OF CREDIT UNIONS AND THEIR MEMBERS

A MEMBER AND CAPITAL RECOVERY PLAN FOR AMERICA'S CREDIT UNIONS

CU Revest

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EXECUTIVE SUMMARY

According to the Consumer Financial Protection Bureau and the Federal Trade Commission, "American consumers are $11.23 trillion in debt, eight percent of which – or about $900 billion – is delinquent, while $678 billion is seriously delinquent at 90 days or more late".

--*Bank Credit News*, August 20, 2013

The United States is experiencing a Consumer Negative Credit Epidemic that is far worse than the Great Depression. More than 100 million consumers do not qualify for mainstream financial services and that number is accelerating.

- According to a 2013 survey or U.S. consumers by Aite Group, 43% of respondents rate their financial health as inadequate, poor or very poor.
- In the wake of the financial crisis, more than half of American consumers ended up with credit scores below 600.
- More than three quarters of Americans reported this year that they do not have enough saved to cover six months of living expenses and more than one quarter report having no savings at all.[1]

Sources of the consumer negative credit epidemic can be traced to the burst of the US housing bubble which peaked in 2006 and was followed by Great Recession, creating historic levels of prolonged unemployment. Millions of Americans have lost their homes to foreclosure. Unplanned life changing events such as divorce, natural disasters, and medical emergencies have exacerbated the worsening financial condition of many American households.

During the five year period from 2008 through 2012, America's 400 largest credit unions, those with $500 million or more in total assets, charged off more than $17.5 billion (net of recoveries) in non-real estate secured consumer debt, an average of $43 million per credit union.

Exiled from mainstream banking and quarantined to alternative financial services, these "prior prime" former credit union members have - out of necessity - helped fuel the growth of the payday lending industry which has an estimated annual volume of 85 million loans. The fastest growing segment (37.2%) of payday loan customers generally have the same salary as they did as a prime borrowing consumer and many likely remain fairly reasonable credit risks. Prior to

[1] "Forget Semantics – Focus on Improving Consumers' Financial Health", *American Banker* August 2013

an unplanned negative financial event in their credit history, they were considered creditworthy.

In time, the immediate and trailing effects of negative financial events diminish and prior prime credit union members are better positioned to satisfy their obligation(s) to the credit union and return to good standing. Most are motivated to return to the credit union. Unfortunately, this usually occurs long after the credit union, and its collection agencies, have abandoned their collection efforts. Most credit unions do not have the resources necessary to identify and recover these qualifying members who, although written down to zero value, represent hundreds of millions of dollars in present and future value.

Part One of this study defines the consumer credit epidemic and its negative impact on the credit union industry. Part Two presents the solution.

CU Revest, LLC
September, 2013

PART TWO:

RECOVERING CAPITAL AND THE DISENFRANCHISED CREDIT UNION MEMBER

CAPITAL RESTORATION AND MEMBER RECOVERY

In Part One we addressed the rapidly accelerating transformation of credit union members to subprime loan customers. In Part Two, we will define the value proposition and methodology of recovering requalifying members who restore capital by satisfying their charged off obligations to the credit union and once again become income producing assets.

In order to illustrate the value proposition of recovering requalifying members, it is useful to compare the cost associated with the acquisition of new members. There is a high cost associated with attracting new members – a cost that is significantly higher than that associated with recovering prior prime members. Average estimated retail checking acquisition costs are as follows:[2]

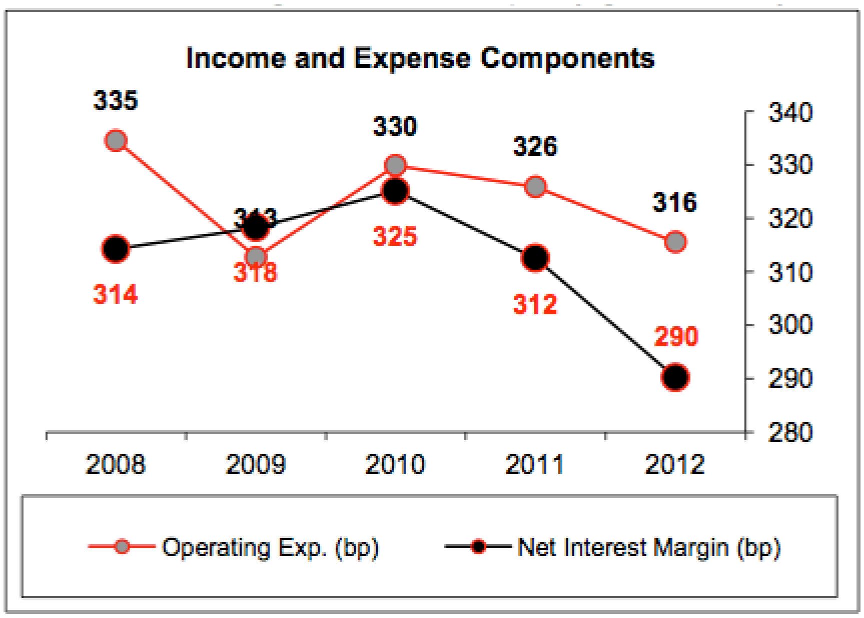
Cost of opening account at branch:	$171.57
Issue debit/ATM cards:	26.00
Activate Bill Pay	12.20
Online Banking	11.70
Check Order	62.05
Process Deposit/Branch	3.58
Maintain Online Banking/Bill Pay	2.18
Maintain Accounts, Debit/ATM Cards	2.16
Subtotal	291.44
Overhead (20%)	58.29
Total	**349.73**

Although we are currently in a rising rate environment, operating expenses including compliance costs and regulatory assessments are likely continue to outpace interest income and there is no relief in sight.

[2] Optirate, Strategy Consultants to Banks and Credit Unions

Studies show that most credit unions engage in member acquisition strategies that generate operating losses and that it takes a checking account average balance of $9000 just to break even on member acquisition costs. Acquisition efforts (or, as discussed below, "re-acquisition efforts") should be focused on those members who will generate a better-than-break-even return on the acquisition investment. In other words, it is better to re-acquire qualified seasoned members with numerous deposit and borrowing requirements than to attract new members with no credit history, limited deposit needs and no investment requirements.

The "PCA Trap": Credit unions must identify new sources of income and capital. Credit unions continue to experience a difficult operating environment. Industry-wide, operating expenses have exceeded net interest margin for several years. Since 2010, the gap has grown from 5 basis points to 26 basis points.[3] Although we are currently in a rising rate environment, operating expenses including compliance costs and regulatory assessments are likely continue to outpace interest income and there is no relief in sight.



[3] CUNA *U.S Credit Union Profile – Year End 2012*, April 17, 2013

THE NEW NEED FOR INCREASED CAPITAL. In addition to the inverted yield curve illustrated on the previous page, credit unions need new sources of capital. "Credit unions provide essential retail financial services in the form of depository accounts and consumer loan products and services. Perhaps at no point since the Great Depression has the role of credit unions been of greater importance to consumers than the present financial crisis.

Consider the following excerpt from "Credit Union Capital Requirements Stifle Access to Credit" by Clifford Rossi, PhD, Tyser Teaching Fellow at the Robert H. Smith School of Business at the University of Maryland. "Historically, credit unions provided a countercyclical balance when the economy weakens by offering a ready source of lending to members and as a safe harbor for deposits. However, the current statutory framework for credit union capital introduces a set of unintended consequences that constrain lending and deposit-taking activities while increasing customer costs at the very time that services are needed most.

Credit Unions…may be forced to raise fees on customer services, lending and products offered to members, as well as reduce noninterest operating expenses and member services in order to improve their retained earnings position. This is a problem that must be fixed.

Clifford Rossi, PhD, *The American Banker*, September 7, 2012

Under current law, retail credit unions cannot raise capital. Unlike all other federally insured depository institutions that have access to some form of supplemental capital (including low-income credit unions), retail credit unions can only improve their net worth through retained earnings.

Like all other federally insured depository institutions, credit unions are subject to Prompt Corrective Action rules, a set of capital-based supervisory standards. The combination of PCA rules and a restrictive statutory definition of net worth, however, create unique challenges for retail credit unions during stress periods and make it more difficult for them to address capital deficiencies should they arise.

In the years following enactment of PCA, credit unions largely enjoyed a favorable economic environment resulting in sustained strong performance. But as the recent financial crisis unfolded, credit unions faced unique challenges.

As markets became volatile and a general uneasiness fell over the investing public regarding the relative safety of instruments traditionally viewed as low-risk, credit unions were viewed as a safe haven. But at the very time consumers were looking to move their money into credit unions to shelter them during a crisis, the influx of deposits was causing a reduction in the net worth ratios of many credit unions.

As the crisis grew, banks tightened underwriting terms. The result is the credit crunch that has yet to abate.

Recent evidence from the crisis indicates that several well-capitalized credit unions slowed deposit gathering in apparent response to eroding net worth ratios. An unintended consequence of PCA for credit unions is that without a mechanism other than retained earnings to raise capital, credit unions are forced to take drastic measures to ensure their capital ratios remain at well-capitalized levels. This is called the "PCA Trap."

> **Seven percent would remain the floor, as required by the Federal Credit Union Act. However, credit unions with assets over $50 million would be subject to improved risk-based capital requirements to better correlate required capital levels to risk.**
>
> **NCUA Chairman Debbie Matz, July 12, 2013**

The alternatives faced by credit unions caught in this PCA Trap have the effect of penalizing consumers and sidelining credit unions from helping to do their part to stimulate an economic recovery. For example, credit unions may be forced to lower the rates they pay on deposits to limit inflows. Or they may be forced to raise fees on customer services, lending and products offered to members, as well as reduce noninterest operating expenses and member services in order to improve their retained earnings position. This is a problem that must be fixed."[4]

Don't look for capital requirements to be eased anytime soon, as the NCUA is building a "New Risk-Based Capital Framework". According to NCUA Chairman Debbie Matz, "The one-size-fits-all credit union capital regime is outdated and insufficient. For many, if not most credit unions, seven percent of assets may still be appropriate. For higher-risk credit unions, it can be a prescription for disaster when the next crisis hits. We need a flexible, forward-looking standard that makes sense for today and tomorrow…Seven percent would remain the floor, as required by the Federal Credit Union Act. However, credit unions with assets over $50 million would be subject to improved risk-based capital requirements to better correlate required capital levels to risk."[5]

The recovery of qualifying disenfranchised members can generate both income and capital for the credit union industry. As we discussed in Part One, when economic catastrophe strikes,

[4] Clifford Rossi, PhD - *Credit Union Capital Requirements Stifle Access to Credit. The American Banker, September 7, 2012*

[5] Remarks of NCUA Board Chairman Debbie Matz at the 46th Annual NAFCU Conference, July 12, 2013

whether caused by divorce, natural disaster, medical emergency, unemployment or some other unforeseen negative event, member borrowers may find themselves unable to meet their financial obligations. While many such events might be cured within a short period, others are protracted, causing consumer credit to deteriorate and accounts to be written off. Credit unions make prudent efforts to work with defaulting members but often to no avail due to the gravity and impact of the negative economic event. Charged off accounts may be subsequently assigned to outside collection agencies that will "work" the accounts aggressively for a relatively short period of time and ultimately abandon their efforts, focusing on the low-hanging fruit of newly assigned accounts. The usual result of all of this effort is missed opportunity for both the credit union and the member.

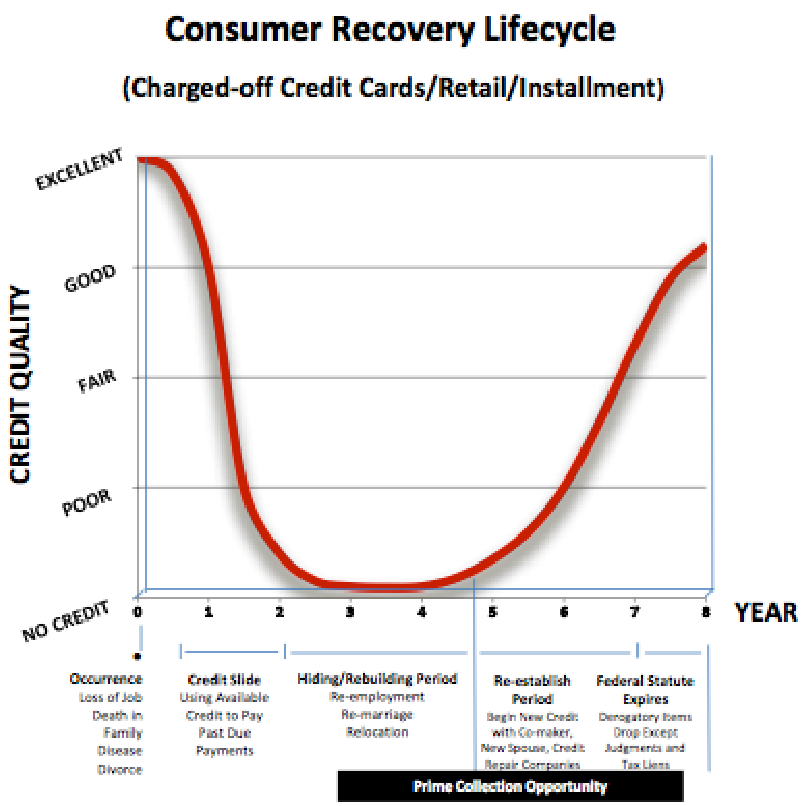
> **Members may be able to temporarily achieve a state of being "golden", only to be thrown off track when life hands them an unexpected lemon. Credit unions must recognize that changing conditions will impact the member's ability to achieve his or her golden mean and act accordingly.**
>
> ***The Culture of Borrowing and Debt: an Ethnographic Approach,*** **Filene Research Institute, 2012**

Financial crises have both immediate and trailing effects. The immediate effects are obvious – there is not enough money to solve the crisis and/or to honor existing credit obligations. Trailing effects result from the domino-effect of non-payment, "robbing Peter to pay Paul", making payments on long term loans with short term, expensive credit from payday lenders, maximizing credit card limits to pay bills, and so forth. The immediate and trailing effects of an individual consumer financial crisis may last several months or several years during which the member's FICO score travels a "death spiral".

During the "crisis period" – an undeterminable length of time during which both the immediate and trailing effects of the negative economic event preclude the borrower from honoring his or her credit obligation, the collection cycle (*initial collection efforts → charge off → further credit union collection efforts → collection agency collection efforts → litigation or abandonment*) result in the disenfranchisement of the "prior prime" credit union member who by this time has become a payday loan customer.

By the end of the individual account collection cycle, the credit union has incurred newer charge offs, received older charge off accounts back from the agencies, and no longer can dedicate the resources to "work" old "abandoned" accounts. ***Herein lies the paradox: it is at this point in time that the charged-off, disenfranchised member has partially or even wholly recovered from the negative financial event that set the disenfranchisement process in motion***.

He or she needs and wants to get back in the mainstream financial community, may have the ability to repay the charged-off obligation to the credit union and wants to become once again a member in good standing. It is also likely that the member has demonstrated good credit habits while a part of the alternative financial services subculture. As illustrated below, this is the prime collection and recovery opportunity":



CREDIT UNIONS AND MEMBER RECOVERY MANAGEMENT. More than all other mainstream financial institutions, credit unions are in a position to help members achieve and maintain a balance between financial and emotional well-being, to which the Filene Research Institute refers as "the golden mean". Credit unions occupy a position that's more than just a financial institution and more of a trusted advisor. If any financial institution can help play a role in helping a consumer achieve a sense of balance, it's a credit union.[6] Many members perceive credit unions as social institutions first and financial institutions second. The implications are that high-touch and education-based interactions are expected, as are underwriting criteria that are more flexible. Members tend to have an innate sense that the credit union wants to serve them as individuals. They have a strong belief that the credit union is there not just for

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[6] *The Culture of Borrowing and Debt: An Ethnographic Approach,* Filene Research Institute, 2012

the community but for them. Credit unions should maintain some "second chance" and low-dollar loan products even if volume is low.[7]

However, the consumer credit epidemic continues to spread. More and more consumers, many of whom are disenfranchised "prior prime" credit union members, are finding themselves members of the alternative financial services subculture. And while they may have demonstrated good credit habits with high-cost short term alternative lending products, they cannot find their way back to mainstream banking – to their own credit union. To exacerbate the issue, most credit unions do not have available resources to work with these members.

> **Credit Unions "should increase prospecting efforts on the larger, faster growing segment of pure Prior Prime population who might be recovering from a personal credit crisis. This fast growing segment of the U.S. population are stable, higher earning consumers who exhibit good credit behaviors, even though they may have a traditional credit score that identifies them as non-prime".**
>
> **Changing Patterns and Behaviors of Unsecured Short Term Loan Consumers, Clarity Services, Inc., 2011**

CU Revest, LLC., a unique, multiple credit union-owned Credit Union Service Organization (CUSO) was created in 2012 to focus exclusively on two critical issues: (1) the recovery of "prior prime" member borrowers from the consumer credit epidemic and (2) the restoration of capital from charged-off non-real estate secured consumer debt. CU Revest, LLC is partially owned by Servatus Corporation, the parent of a captive finance company and Credit Solutions Corporation, an established servicer dedicated to working with consumers. Credit unions do not invest or contribute capital to the CUSO; they contribute the old, abandoned consumer charged off accounts that they have long finished trying to collect. Working with member credit unions, CU Revest, LLC re-qualifies disenfranchised prior prime credit union members in accordance with the standards established by each credit union, as long as any and all charged off obligations to the credit union are paid in full.

CASE STUDIES: Consider the following examples, both actual accounts of prior prime, disenfranchised credit union members who, by working with CU Revest and their credit union, were able to pay off their old charged off balances, re-establish their credit, and once again become active and valuable members:

[7] ibid

Case Study #1: *Charles, a long time credit union member and employed homeowner, suffered a prolonged period of unemployment subsequent to a layoff and became yet another victim of the Great Recession. Through no fault of his own and unable to pay, he found himself to be a former member in good standing with a $4,600 MasterCard charge off in mid-2009. In early 2011, Charles was rehired by his former employer and is once again financially stable, but is now carrying the stigma of bad credit.*

Charles' charged off account was assigned to CU Revest. Its captive servicer, Credit Solutions Corporation, contacted Charles and worked closely with him to determine a course of action that would be the best solution for the member and the credit union, resulting in repayment in full of the charge off amount. A new refinance agreement required that Charles (a) pay $1,000 up front, (b) deliver titles to two free and clear vehicles with a combined book value of over $10,000, (c) establish direct payroll deposit into a new checking account and (d) authorize automatic loan payments on the remaining $3,600 balance plus interest at the credit union's prevailing risk-based interest rate.

Charles is proud to be back in good standing with the credit union, rebuilding fresh, new credit. The credit union quickly recovered 100% of the charge off account by taking 20% down and collateralizing the balance with a new performing well-secured loan at risk-based pricing and a new direct deposit share account with automatic loan payments.

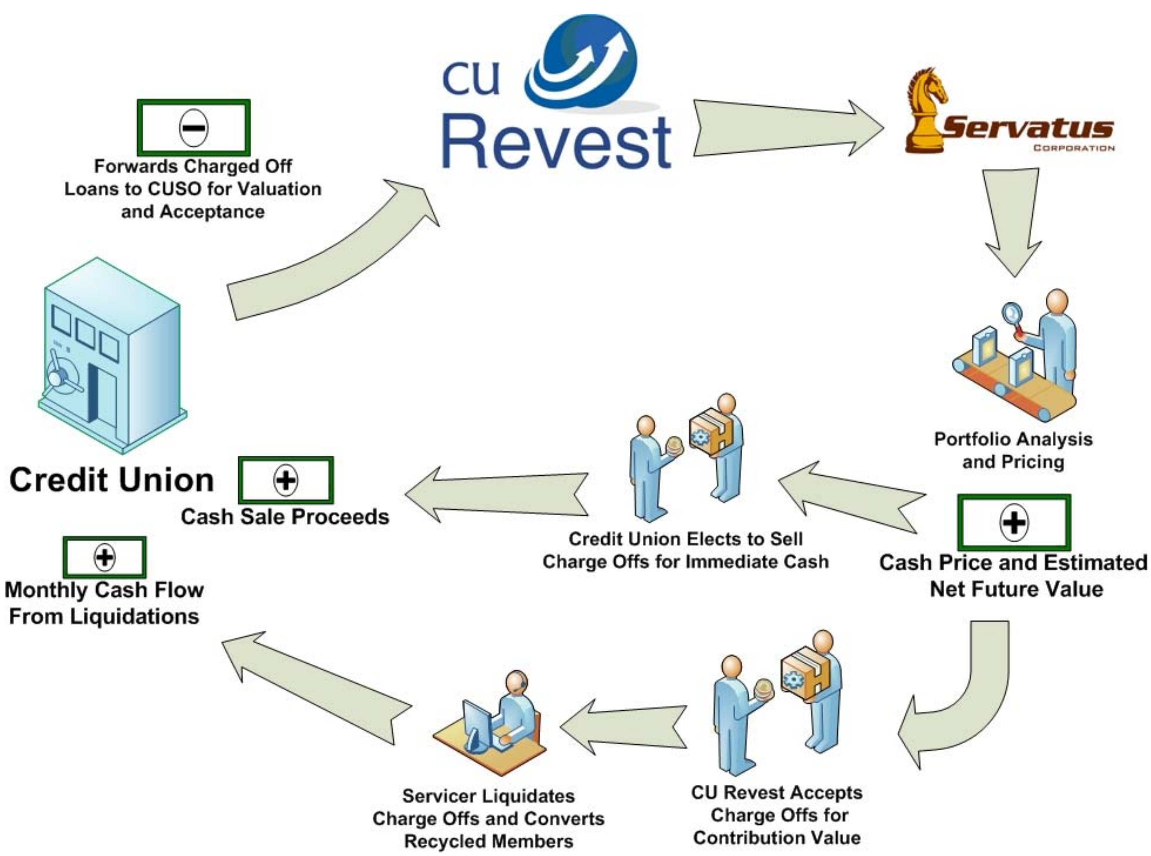
Charles *and the credit union have agreed to revisit his budget and credit score in December for a possible refinance of the first mortgage on his home once the "paid by refinance" charge off no longer holds his credit score below the mortgage qualification threshold.*

Case Study #2: *In September 1995, Dorothy, a credit union member in good standing, opened a MasterCard account which she always paid on time. A few years later at age 62, she retired, paid off her home and began collecting social security. The economic downturn caused increased living expenses that were much higher than Dorothy expected and she was forced to use her credit union MasterCard and other available credit to supplement her social security income.*

Soon, Dorothy had used all of her available credit to keep other obligations current causing a "borrowing death spiral". Her MasterCard reached its assigned limit of $17,000, subsequently resulting in a charge off. Dorothy was embarrassed that she had had lost her credit union membership privileges and felt there was nowhere to turn.

Dorothy's charged off account was assigned to CU Revest. Its captive servicer, Credit Solutions Corporation, worked closely with the former member, to determine the best course of action for Dorothy and so the credit union would recover 100% of the charge off amount. CSC promptly arranged for an immediate refinance of Dorothy's residence using a reverse mortgage that paid off all her delinquent consumer debt, including her $17,836 charge off credit union MasterCard account. Thanks to her credit union and the work of CU Revest, Dorothy now has a monthly income from the reverse mortgage to last her foreseeable lifetime. She has no other debt, has regained her self-respect and feels like she once again "belongs" in her credit union. Her social security income is being directly deposited into her credit union share account.

The flow chart below illustrates the CU Revest process of restoring capital and members to client credit unions.



SUMMARY:

CAPITAL AND MEMBER RECOVERY USING THE POWER OF COLLABORATION

WALKING THE WALK: "SERVING THE UNDERSERVED" AND "PEOPLE HELPING PEOPLE"

Originally chartered in 1934 to serve the underserved, credit unions have an obligation to make every effort to reverse the accelerated flow of disenfranchised, prior prime members to the alternative financial services subculture. **However, most credit unions do not have the resources available to dedicate to effective member recovery**.

More consumers have been financially challenged during the Great Recession and its prolonged "recovery" than any time in American history. Nearly one third of those consumers are credit union members.

The desire and motivation to help members is found in the credit union industry's DNA. The power to resolve the consumer negative credit epidemic lies in collaboration between credit unions and experts who are part of the credit union "family". Credit unions, working together with CU Revest, LLC are making historic improvements not only in the lives of credit union members but also in credit union financial health.

ABOUT CU REVEST, LLC.

CU Revest, LLC is a multiple credit union-owned Credit Union Service Organization that is partially owned by Servatus Corporation. Using proprietary methods, CU Revest institutes a unique strategy using the founding member's (Servatus Corporation) servicing subsidiary, Credit Solutions Corporation, to dedicate its 16 years of experience to the collection of non-real estate secured consumer charge offs through member friendly, non-litigation means and recycling charge off members into new performing assets secured by new share accounts. This is accomplished through:

- A highly trained systems integration team;
- Proprietary software to analyze portfolios and project recoveries;

- Reporting and analytics such that credit union partners and regulators can reliably quantify results;
- Seasoned recovery professionals to maximize credit union returns while treating members with dignity and potentially providing them the opportunity to re-establish a positive relationship with the credit union.

In addition to member recovery, credit unions benefit from the restoration of capital generated by the CU Revest model. Charged off consumer account portfolios that have been written down to zero asset value are contributed to the CUSO and monetized which entitles the credit union to a new source of cash flow. Under very favorable capital recovery accounting treatment provisions, each credit union may benefit from an expert valuation, a new asset class and the attractive GAAP treatment using AICPA SOP 03-3, where the credit union may elect to treat this interest as an asset or recognize cash flow as income as received. There is also a provision for immediate cash payment in the event the credit union elects to forego CUSO membership and the accompanying cash flow payout.

CU Revest, LLC has earned the following: SSAE 16 Certification, PCI DSS Version II Compliance, HIPAA Compliance, ISO 27002 Compliance, Massachusetts 201 CMR 17.00 Compliance, Nevada NRS 603a Compliance, FTC Red Flags Rule Compliance, GLBA Compliance. In addition, CU Revest LLC is a Platinum Partner with the National Association of Credit Union Service Organizations.

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Definition: re·vest (r-vst)
Re.v. re·vest·ed, re·vest·ing, re·vests

1. **To invest (someone) again with power or ownership; reinstate.**
2. **To vest once again in a person or an agency.**