



CUNA

Credit Union National Association

CUNA Mergers Task Force Report:

Concerns and Recommendations Regarding Assisted Mergers

MAY 2010

Concerns and Recommendations Regarding Assisted Mergers¹: Report of the CUNA Mergers Task Force

May 2010

Introduction

With the number of mergers likely to continue at a robust pace for now and the foreseeable future, credit union officials remain concerned about combinations and consolidations within the system.

The issues related to mergers are complex, and in some instances, far reaching, such as the impact of consolidations on the future of the overall credit union system. Other concerns include the impact of mergers on the dual chartering system, field of membership issues, continuing accounting matters, and how credit unions should best manage the merger process.

One set of merger issues has received considerable attention in recent times: regulatorily-assisted acquisitions, including supervisory and emergency mergers, and the process used by the National Credit Union Administration (NCUA) to effect or facilitate such mergers.

While the number of these mergers remains quite small², concerns about how such mergers are handled by the agency abound within the credit union system. More specifically, credit union concerns have focused on how the agency determines which credit unions should be merged, which credit unions can be chosen to acquire a target credit union, and what are the qualifications for credit unions selected as acquirers.

In comment letters and meetings with NCUA officials, CUNA has raised these issues, urging the agency to get more input from the credit union system on how the assisted merger process should work, and provide more explanations to credit unions on its approach in handling assisted mergers. However, CUNA felt effective advocacy should not simply raise concerns without reviewing the merger process and developing recommendations that would be useful to both NCUA as well as to credit unions.

¹ This report uses the term “assisted mergers” to refer to supervisory mergers that involve NCUA (or NCUSIF resources) as well as emergency mergers such as those NCUA feels are necessary to avoid liquidation of the merging or target credit union.

² The number of NCUA-assisted mergers in 2009 was 12 and there were 9 purchase and assumption transactions, according to NCUA’s call report data (See Mike Schenk’s presentation in Appendix A).

CUNA Mergers Task Force Report

With those objectives, CUNA Chairman Kris Mecham in early 2010 named a new CUNA Task Force to review the merger process and consider proposals that would result in improvements to address problem areas and deficiencies, not only those identified by credit unions, but also legitimate safety and soundness issues and processing practicalities raised by NCUA.

To lead the Task Force, Chairman Mecham appointed Paul Mercer, Ohio Credit Union League President. Doug Fecher, President/CEO of Wright-Patt Credit Union, OH; George McNichols, President/CEO of Hoosier Hills Credit Union, IN; John Hirabayashi, President/CEO of Community First Credit Union, FL; John Sackett, Board of Directors and Treasurer, Royal Credit Union, WI; and Mary Ann Clancy, SVP and General Counsel of the MA/NH/RI Credit Union Leagues served as Task Force members. The Task Force reached out to others within the system for input, including State Credit Union Leagues.

Also, the Task Force relied on excellent statistical analysis and data from CUNA's Vice President of Research and Statistics Mike Schenk. A copy of his PowerPoint presentation to the Task Force is included as Appendix A to this report.

In recognition of the significance of merger issues, the existence of the Task Force has been welcomed and encouraged by NCUA Chairman Debbie Matz, Board Member Gigi Hyland and Board Member Mike Fryzel, as well as by Executive Director David Marquis. The Task Force met with Marquis, Herb Yolles and Matt Balouris in early April and appreciated the perspectives they provided. The report will be shared with NCUA, the National Association of State Credit Union Supervisors (NASCUS) and with the credit union system.

We also want to emphasize that this report is one phase of the Task Force's work – focusing on how to achieve improvements in NCUA's assisted merger process. However, we also want to work with NCUA as the Task Force considers the utility of structural alternatives for credit unions such as holding company arrangements and other mechanisms that could help alleviate the need for mergers in some instances. The Task Force will continue working on these key merger issues in 2010.

Summary of Key Recommendations

This report discusses credit union and NCUA concerns with the current assisted merger process and proposes recommendations to address and correct those concerns. To facilitate the use of this report, the following is a summary of the most significant recommendations the Task Force has developed (other recommendations are also presented later in this report).

CUNA Mergers Task Force Report

- NCUA should develop a proposed rule or, at the very least, proposed guidance on its assisted merger process.
- The proposal should spell-out how the process works and how credit unions may apply to be considered as an acquiring credit union.
- The proposal should address the agency's criteria for using a purchase and assumption approach under which, for example, assets are sold to one or more credit unions, versus an assisted merger.
- The proposal should also address what role the agency assumes in the success of the merger, including the transition period following the merger approval.
- Further, for state credit unions, the proposal should address how NCUA coordinates with NASCUS.
- NCUA should solicit comments from the credit union system on the proposal.
- NCUA should provide more information on its website regarding mergers, including the process for considering merger candidates and expectations for the acquiring credit union.
- NCUA, working with CUNA, should conduct a thorough study involving the issues surrounding mergers, including the long-term impact on the credit union system of the current pace of mergers.
- The report should be made available to the credit union system and updated periodically.

Fundamental Principles on Which the Task Force's Recommendations are Based

The Task Force wanted to ensure that its report and recommendations were well-grounded in basic tenets that are wholly consistent with safety and soundness, legal requirements and credit union historic ideals of cooperation and maximizing service to members.

To those ends, the Task Force's report rests on key principles, which are:

- Credit unions are seeking an improved assisted merger process, and CUNA would like to work with NCUA to achieve that goal.
- Credit unions want NCUA's assisted merger process to be more consistent across all NCUA regions – while recognizing the need for a certain amount of flexibility depending on the circumstances.
- Credit unions want the assisted merger process to be efficient for credit unions and the agency.

CUNA Mergers Task Force Report

- Credit unions want the assisted merger process to be effective in protecting the National Credit Union Share Insurance Fund (NCUSIF) and the credit union system.
- At the same time, credit unions want to ensure that the process does not unduly favor some credit unions over others.
- Credit unions also want to ensure that NCUA does not arbitrarily utilize mergers to resolve problems that may have been addressed through less drastic measures.
- Further, because credit unions fund the NCUSIF and NCUA's operational expenses, and because they may be potential merger partners, credit unions need and want to have a better understanding of how NCUA's assisted merger process works³.
- While the focus of the Task Force's recommendations is on the federal process, the proposals could also apply to state assisted mergers⁴.

The Task Force Acknowledges Certain NCUA Concerns are Legitimate and Should be Addressed in Upcoming NCUA Guidance

The Task Force felt it would be inappropriate and counterproductive to focus singularly on credit union concerns regarding the assisted merger process, without also considering safety and soundness matters. To that end, the Task Force elicited the agency's perspectives from the key NCUA staff mentioned previously in this report.

Members of the Task Force fully recognize that safety and soundness and certain supervisory issues are critical, and that a number of concerns NCUA raised in that regard have merit.

Further, the Task Force proposes that these concerns be discussed in the proposed guidance the Task Force is recommending the agency issue for comments (addressed more thoroughly starting on page 8), to help educate and inform credit unions regarding safety and soundness objectives as they relate to mergers.

Below is a summary of the supervisory concerns that the Task Force believes should be included in the guidance.

³ As addressed further in this report, a more thorough understanding would include, among other things, an explanation of the agency's criteria for providing assistance in a merger, the factors for selecting an acquiring credit union, agency involvement in directing certain "voluntary mergers," and NCUA's general criteria for a successful merger.

⁴ The Task Force plans to discuss these issues with the National Association of State Credit Union Supervisors in the coming weeks.

CUNA Mergers Task Force Report

- **Impact to the National Credit Union Share Insurance Fund**
 - As the insurer, the NCUA Board's primary concern is to minimize losses to the NCUSIF.
 - Minimizing losses to the NCUSIF necessitates very timely resolution of troubled credit unions.

- **Confidentiality**
 - Information to the public must be carefully managed since publicity could have unintended consequences, such as members pulling money from an already weak institution.
 - There is also a concern about keeping information confidential while the agency is working out the merger, including information that could be damaging to the individual credit union as well as to other credit unions in the area or country.

- **Flexibility**
 - Agencies need some flexibility to act in emergency situations, which can be vital to stemming losses.
 - This includes having latitude to develop a merger process that is efficient for the agency and effective in terms of finding merger partners that will be able to handle the merger well.

- **Minimizing Member Disruption**
 - The process should minimize any disruption to members of both the merging and continuing credit unions.

- **Partner Familiarity**
 - Not all well-run credit unions want to take on troubled credit unions.
 - To facilitate the process, regulators generally prefer to work with credit unions they have already identified as good merger partners that are willing to merge with others.

CUNA Mergers Task Force Report

- **Physical Proximity**

- NCUA senior staff indicated they take the proximity of the merging and acquiring credit unions into consideration when reviewing possible merger partners.
- However, by their nature, emergency situations are exigent and may require the agency to be able to act quickly under those circumstances.
- This can lead to the selection of an acquiring credit union, regardless of its location, even if it is out of state or across the country.

- **Due Diligence**

- Even in an emergency merger situation, the acquiring credit union must perform due diligence to help determine whether it can handle the merger.
- Some credit unions that may want to merge may not be able to perform this review as thoroughly or quickly as others.
- In order to perform adequate due diligence, NCUA must reveal confidential information about the merging credit union, which is problematic when it turns out the credit union cannot conduct the due diligence properly because of the lack of time, resources or both.

Specific Issues and Concerns With Assisted Mergers

- **Lack of a Well-Articulated Process**

Credit unions are entitled to know how NCUA selects an acquiring credit union, what the qualifying criteria for the acquirer are, as well as the weight given to each of the various selection criteria.

Regrettably, NCUA's process for such decisions and for generally handling assisted mergers is a mystery to most in the credit union system. As a result, the agency's motives and actions regarding such mergers often appear arbitrary and not reflective of credit unions' concerns.

Based on CUNA's conversations with NCUA officials, there appears to be agreement within the agency that the process needs to be improved and better communicated.

CUNA Mergers Task Force Report

In light of these concerns, there needs to be an assisted merger process that is reasonable and well-balanced in addressing the immediate and longer-term concerns of stakeholders, including NCUA, credit union members, interested acquirers, other credit unions in the areas and the credit union system overall. Moreover, to address credit unions' concerns about their lack of knowledge regarding the process, NCUA should take steps to help ensure the process is well-understood within the credit union system.

The paramount concern when considering mergers should be whether and to what extent the transaction contributes to the strength of the entire credit union system. This includes taking steps to safeguard credit unions' positive public image as well as their strong financial condition.

Addressing problem case credit unions through mergers when appropriate does require timely action from NCUA. However, there is also a perception that NCUA is often too hasty in merging problem credit unions, particularly small credit unions, that may have recovered with time and patience.

In addition, there is a lack of understanding regarding what tools and actions NCUA as the regulator may utilize and undertake to help ensure the assisted merger is ultimately successful. The Task Force believes that NCUA can and should play a significant role in supporting the execution of the merger through, for example, reasonable regulatory flexibility for the resulting credit union to meet net worth or other regulatory goals, to the extent prompt corrective action and other legal requirements permit such latitude.

Recommendations:

- The NCUA Board should develop a proposed rule, or at the very least proposed guidance, on which it solicits comments.
- The proposal should describe the agency's criteria for deciding to effect a merger, its process for considering merger candidates and expectations for the acquiring credit union and its decision-making process in sufficient detail to facilitate credit unions' understanding of the assisted mergers process.
- Examiners, agency field staff, state regulators as well as credit unions and their representatives should be allowed to comment.
- NCUA's proposed merger rule or guidance should specifically address how NCUA balances the need to manage problem credit unions and minimize costs to the credit union system, with efforts to ensure the agency is acting with appropriate prudence and not "rushing to judgment" to arrange mergers.
- The proposal should also address the role of the agency in helping to ensure the success of the merger, including the transition period following the merger approval. This could include regulatory flexibility as needed and as

CUNA Mergers Task Force Report

permitted, consistent with prompt corrective action and other current statutory requirements.

- **Merger Eligibility and Selection Criteria**

In addition to the lack of knowledge about NCUA's merger process generally, a number of credit unions have raised concerns that they do not know how to apply to be considered as an acquiring credit union and do not know how credit unions are chosen as merger partners.

Recommendations

- NCUA's proposed regulation or guidance should spell-out how credit unions can apply to become acquiring credit unions.
- It should also describe the methodology NCUA uses when determining which credit unions to select as merger partners.
- For example, criteria that NCUA undoubtedly already reviews should be detailed, such as:
 - Well capitalized (at least 7% net worth ratio)
 - CAMEL rating of 1 or 2
 - How credit unions that are adequately capitalized yet otherwise well-managed could be considered as an acquirer
 - Evidence of the credit union's capacity to perform adequate due diligence
 - Evidence of the credit union's capacity to serve the new and continuing membership adequately
- The guidance should also discuss purchase and assumptions and the criteria the agency uses to determine whether to pursue a P/A transaction or transactions instead of a merger.
- NCUA should consider developing an on-line registry of potential merger partners. The registry could allow the credit union to indicate its level of interest in merging in general, prior to bidding for a specific merger.
- If NCUA provides the registry, then CUNA and the State Leagues should ensure credit unions are aware it exists and how to use it.
- Following the selection of an acquiring credit union, NCUA should inform the other candidates and document its decision-making process.
- The Federal Deposit Insurance Corporation's FDIC*connect* website is a secure, controlled access site that allows banks to obtain information about acquiring problem banks and to register with the FDIC if they are interested in acquiring such a bank.

CUNA Mergers Task Force Report

- The site allows the bank to specify personnel at the institution who will receive information about an acquisition and to indicate its area of geographical interest, as well as to designate the types and amounts of loan pools in which it is interested.
- In addition, other key information about the process is available on that website.
- NCUA should consider establishing a website similar to *FDICconnect*.
- Such a website should also provide ongoing, comprehensive data on mergers and purchase and assumption activity of all types.

- **Due Diligence Capabilities**

A concern that NCUA has raised is how to ensure that all credit unions that want to bid on a merger will be able to conduct the proper due diligence on the target credit union. Such due diligence helps to minimize unforeseen problems and ensure that the acquiring credit union has the necessary resources to absorb the merging credit union without undue strains.

Recommendations

- NCUA should address the issue of proper due diligence, including the scope and matters to be considered, in its proposed rule or guidance.
- NCUA should facilitate the due diligence process for acquiring credit unions that are listed on its registry mentioned above. This could be accomplished by posting sufficient, relevant key information for interested potential bidders on the secure website (mentioned above).
- Whether through the website or other means, all potential bidders should have access to the same information about the target credit union.
- Bidding credit unions that meet NCUA's criteria should have controlled, secure access to even more detailed information through that website.
- While on-site reviews would still be necessary, facilitating due diligence through posting information on a secure site would streamline the bidding process, reduce costs for potential bidders and assist the agency by helping to ensure a sufficient number of credit unions would be interested in mergers.

- **Costs and Loss Sharing**

Another concern credit unions have raised is how NCUA values merger bids and whether the agency is only looking for the highest offer. A related issue is that it is also unclear what conditions must be met in order for the agency to provide NCUSIF resources to the acquiring credit union to facilitate the merger.

CUNA Mergers Task Force Report

Recommendation

- The proposed guidance should address these issues regarding the priority of bids and the circumstances under which the NCUSIF will provide resources to encourage an acquiring credit union to take over a credit union.
- The proposal should also address what types of resources the agency could make available, such as loan guarantees, loss sharing arrangements and other incentives that could be made available to the resulting credit union.

- **Physical Proximity**

NCUA's decisions to merge credit unions from different regions and areas of the country have appeared to be arbitrary to some, while others share the view that proximity of the merger partners should not be an overriding concern.

According to NCUA staff, the agency does consider the proximity of the troubled credit union to the potential merger partner. However, it is clear, regardless of particular credit unions' perspectives, that how the agency handles the issue of proximity in assisted mergers is not well understood.

Recommendation

- While protecting the best interests of the NCUSIF and the credit union system should be the primary objectives when affecting a merger, NCUA's proposed regulation or guidance should also specifically address how the agency handles issues regarding proximity of the merging credit unions.

- **Credit Union and Task Force Concerns Regarding Mergers Generally**

While recognizing that there are legitimate safety and soundness issues that must be addressed and managed, particularly throughout the assisted merger process, credit unions have a number of additional, general concerns about mergers.

Overarching concerns regarding mergers generally include:

- The impact of mergers generally on the credit union system, including credit union members and their communities;
- Ongoing accounting concerns associated with the application of generally accepted accounting principles to mergers;

CUNA Mergers Task Force Report

- The lack of knowledge by credit unions of all sizes of the various types of mergers;
- Concerns regarding the impact of mergers on dual chartering;
- The impact of prompt corrective action on the need for mergers and whether more leeway under PCA should be exercised to minimize the need for mergers;
- The scope of NCUA's authority regarding mergers (whether it has too much power in this area or conversely, whether additional authority is needed to handle mergers, given the broader powers that the FDIC has at its disposal); and
- Whether legal restrictions should be lifted to allow credit unions to modify their corporate structures to help avoid mergers, such as under a holding company structure that would allow resources to be shared within the holding company network.⁵

Recommendations

- NCUA should conduct a thorough review of the issues surrounding mergers and make its report available to the credit union system.
- The report should address mergers that the agency considers a success as well as others that have not worked well or presented difficulties in implementing.
- The report should also address the range of overarching issues listed starting on page 10 of this report.
- Such a report could provide important perspectives on merger issues and help inform credit unions and regulators regarding the development of appropriate merger and related policies.
- The report should be updated on a periodic basis.
- CUNA would be pleased to work with NCUA on this endeavor.

Conclusion

Given the current state of our nation's economy and the agency's past practices, it is likely that the use of assisted mergers will remain an important tool for NCUA in managing problem credit unions and the resources of the NCUSIF in a safe, sound and efficient manner.

Because credit unions fund the agency, it is critically important to them that NCUA develop and utilize supervisory policies that are not only effective and

⁵ The CUNA Task Force has focused on assisted mergers for the purposes of providing recommendations to NCUA. However, the Task Force will also be looking at some of these other issues.

CUNA Mergers Task Force Report

efficient, but also that are well-understood and accepted by federally insured credit unions.

Despite the relatively small number of assisted mergers, many concerns have been raised by credit unions regarding the agency's process. CUNA has attempted to review a number of these issues in a comprehensive manner. The Task Force has not solely focused on problem areas. Rather, it has also considered and seeks to offer practical recommendations that give due regard to safety and soundness priorities while also addressing credit unions' primary concerns.

We urge the NCUA Board to consider these recommendations, and we plan to follow-up with the agency shortly to continue our discussions. Meanwhile, If you have any questions about the report, feel free to contact CUNA's Senior Vice President and General Counsel Mary Dunn at (202) 508-6736 or me. CUNA looks forward to working with the agency as it improves the assisted merger process.

CUNA Credit Union Mergers Task Force
Paul Mercer, Chairman

CUNA Mergers Task Force Report
Appendix A

CU Merger Overview

Mike Schenk
CUNA
mschenk@cuna.coop
800-356-9655 ext. 4228

Recent Research

Developing a Merger Competency

Jim Jerving, CUNA Councils | April, 2010

Characteristics of Credit Union Mergers: 1984-2008

Luis Dopico, Macromatrix; James Wilcox, UC-Berkeley | Aug 12, 2009

Costs and Consolidations

James Wilcox, PhD, Kruttschnitt Family Professor of Financial Institutions, Haas School of Business University of California, Berkeley | Jun 6, 2008

The Board's Role in Credit Union Mergers

William A. Brown, PhD, Associate Professor, Bush School of Government & Public Service, Texas A&M University | Nov 9, 2007

How Credit Union Mergers Affect Service to Members

Fried, Harold O., Union College, C. A. Knox Lovell, University of Georgia and University of New South Wales, and Suthathip Yaisawarng, Union College. | Jan 1, 1999

Costs and Consolidation

Wilcox 2008

- Non-interest expense in small CUs is substantially higher than in larger CUs
- Mergers account for the vast majority of the reduction in US CUs
- A large fraction of CUs (as measured by assets) are involved in mergers in any given year
- Larger CUs more likely to be acquirers; small are more likely to be targets
 - But most targets acquired by mid-size – not large CUs
 - Mergers had big impact on mid-size CU growth – very little impact on larger CU growth
- Non-interest expenses declined in 1984-2006 as assets shifted from smaller to larger CUs
- Scale matters but it isn't the only thing that matters

Characteristics of Credit Union Mergers: 1984-2008

Wilcox/Dopico 2009

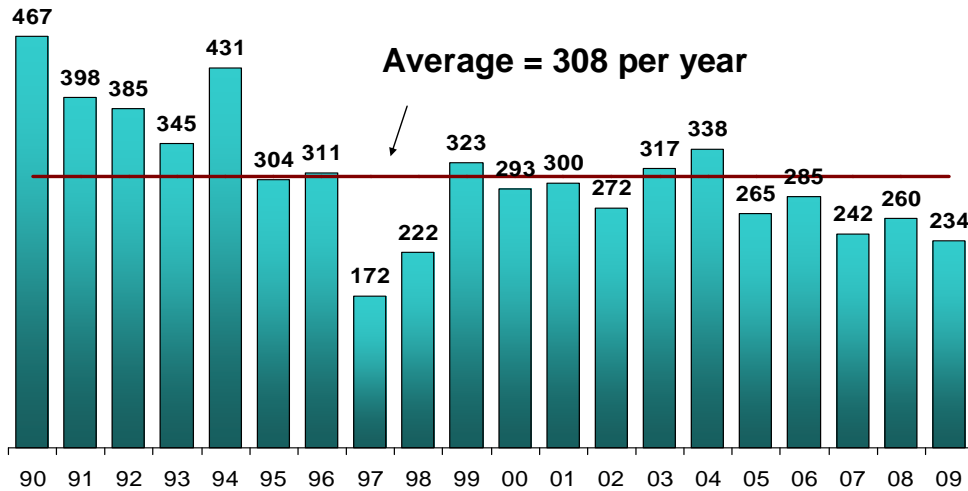
- More than 1/3 of CUs operating in 2008 had participated in at least one during 1979-2008.
- Targets transferred assets, members, etc. to acquirers that performed far better
 - lower non-interest expense (4.36% vs. 3.12%)
 - lower loan rates (int. inc. = 8.23% vs. 7.60%)
 - higher savings yields (int. exp. = 3.66% vs. 3.98%)
 - higher asset quality (PLL = 0.86% vs. 0.36%)
 - higher earnings (.08% vs 1.00%)
 - higher merger-adjusted asset growth (0.17% vs. 10.11%)
- Targets are generally much smaller than acquirers
- Some acquirers seem to use mergers to jump-start growth and lower average costs
- Mergers of equals in CUs larger than \$100 million were relatively rare in the analysis period
- Voluntary mergers (those without NCUA assistance) have been the main mechanism for CU exits
- Pace and types of CU consolidation will increase in coming years due to more intense external environment

Developing a Merger Competency

Jerving 2010

- Merger competency – essential skill set in coming years
- Attitudes are evolving
 - Last resort for failing institution vs. strategic response to competitive pressures
 - Sometimes flounder due to focus on mechanics rather than on integrating cultures
 - Effective two-way communication is key
- Can bring efficiencies/economies of scale but these are not automatic

Credit Union Mergers



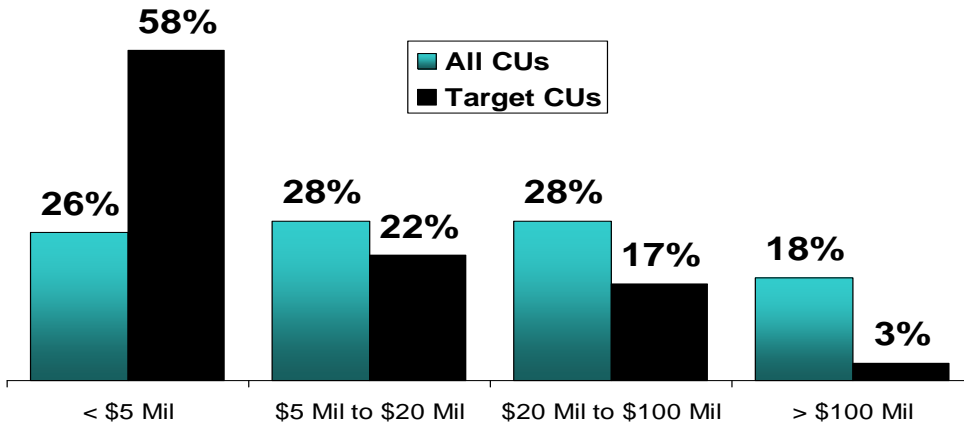
Source: NCUA & CUNA E&S

CUNA Mergers Task Force Report

CU Combinations: 20-Year Overview

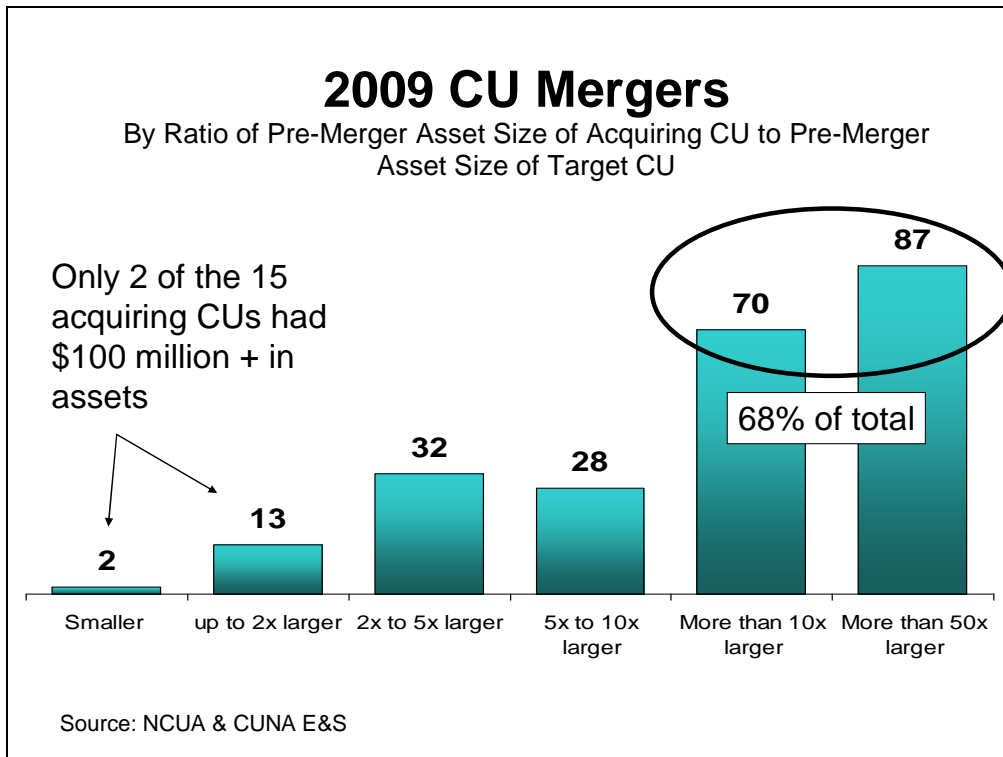
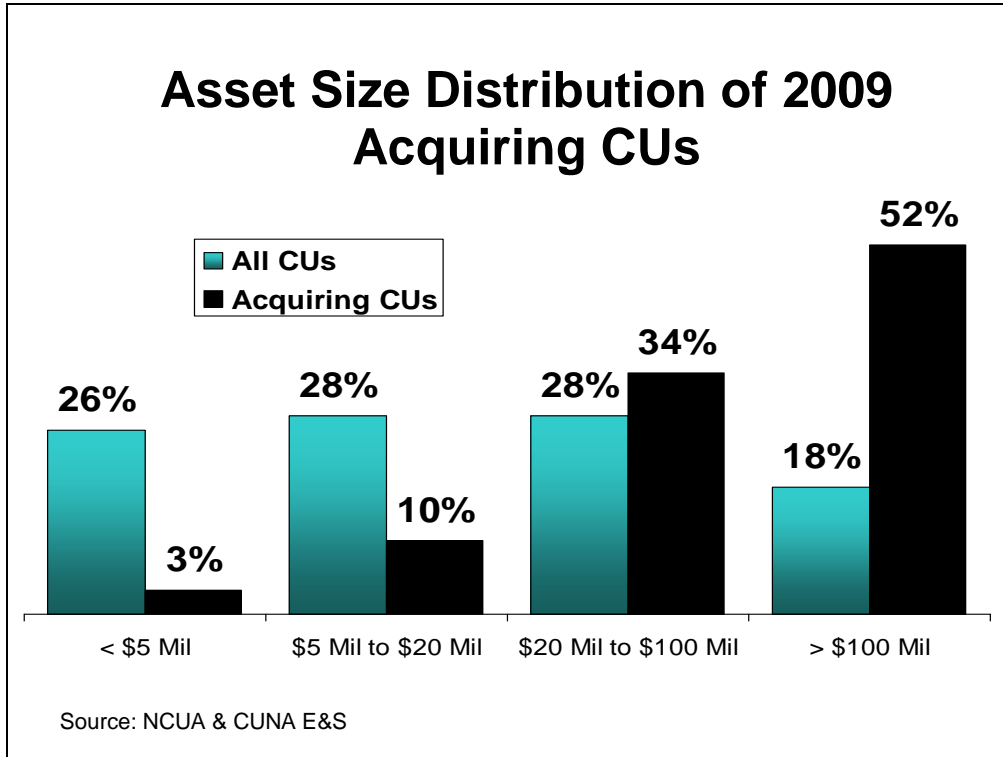
Year	Mergers			Purchase & Assumption Transactions
	Unassisted	Assisted	Total	
1990	386	81	467	0
1991	356	41	397	1
1992	345	33	378	7
1993	317	17	334	11
1994	418	8	426	5
1995	294	7	301	3
1996	301	6	307	4
1997	163	8	171	1
1998	214	5	219	3
1999	313	8	321	2
2000	274	9	283	10
2001	292	5	297	3
2002	265	1	266	6
2003	161	5	166	5
2004	324	7	331	7
2005	247	5	252	13
2006	275	4	279	6
2007	232	5	237	5
2008	260	3	263	6
2009	234	12	246	9
	5,177	270	5,941	107

Asset Size Distribution of 2009 Target CUs (Millions)



Source: NCUA & CUNA E&S

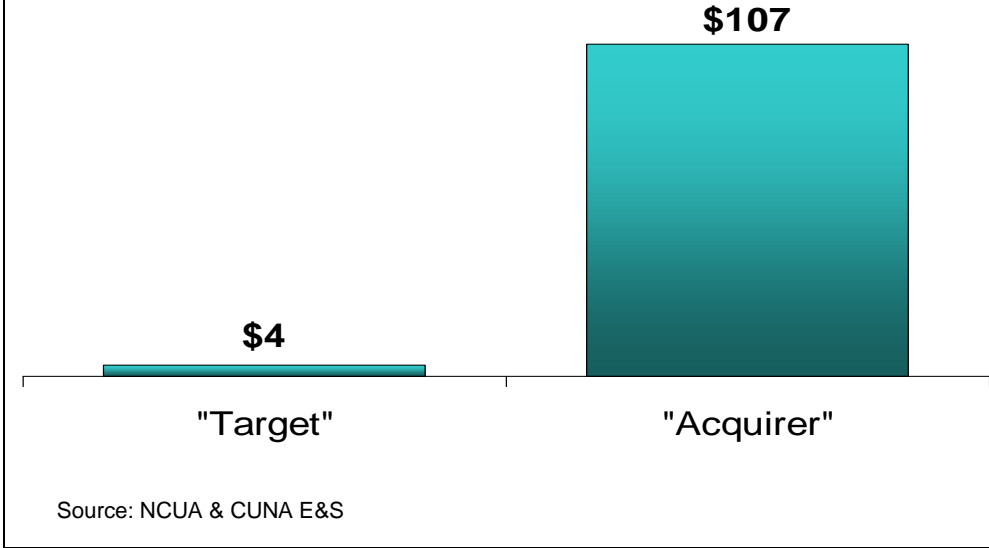
CUNA Mergers Task Force Report



CUNA Mergers Task Force Report

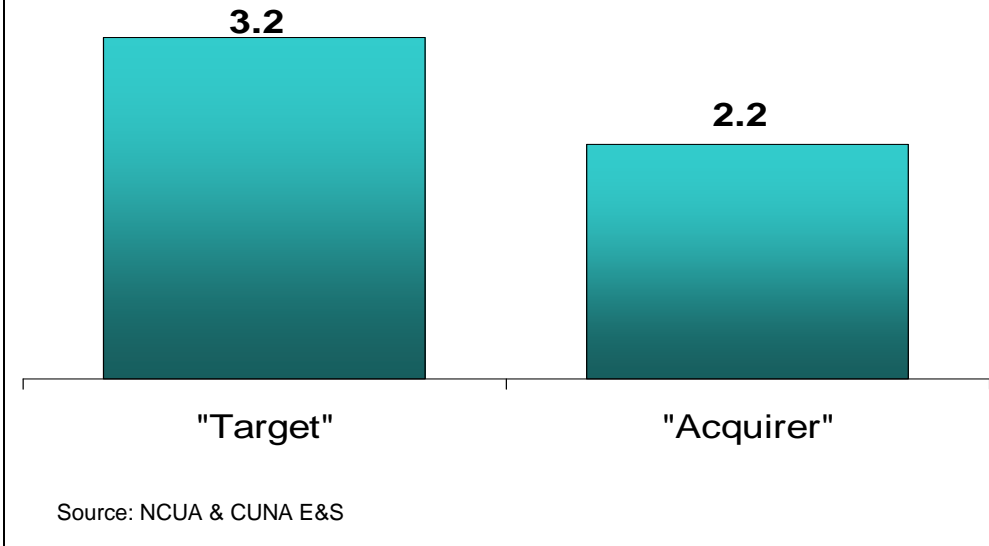
Median Pre-Merger Asset Size

(2009 Mergers - Millions)



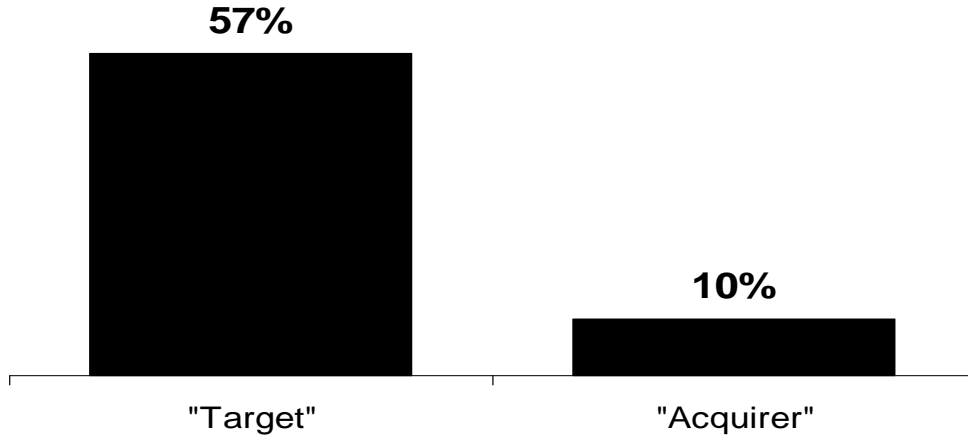
CAMEL-by-the-Numbers (CAE)

(Median for 2009 Mergers)



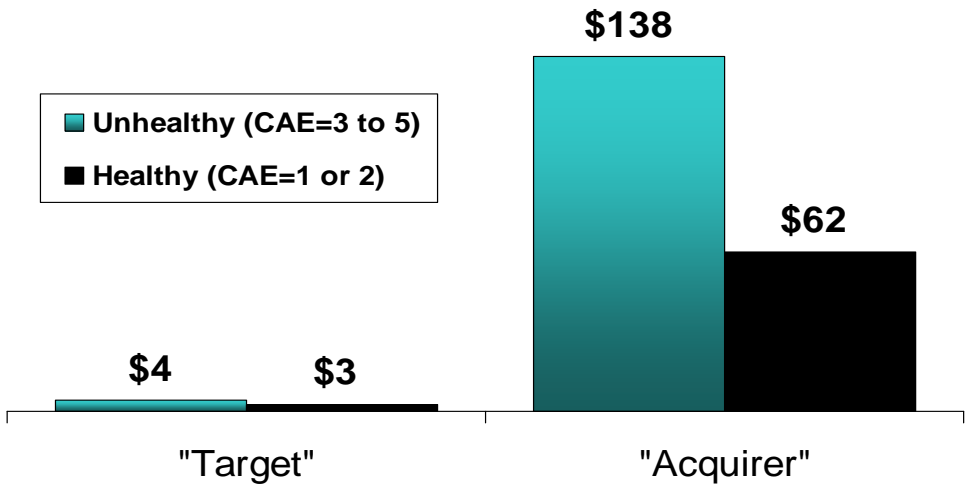
CUNA Mergers Task Force Report

Percent with CAMEL-by-the-Numbers (CAE) "3" or Greater (2009 Mergers)



Source: NCUA & CUNA E&S

Median Pre-Merger Asset Size By Merging CU Health (2009 Mergers - Millions)



Source: NCUA & CUNA E&S

CUNA Mergers Task Force Report

2009 Mergers		
By Distribution of Charter Type		
	Federal	State
All US CUs	61%	39%
Merger CUs:		
Target CUs	56%	44%
Acquirer CUs	47%	53%

Other Issues

- In 2009 44% of mergers resulted in target CU acquired into an Acquirer with a broader field of membership
- In 2009 96% of target CUs were located in the same state as acquirer CUs
 - Overall, just 11 were across
 - Targets tended to be large \$42 million
 - Targets tended to be sick (median CAE=5; avg=4.4)

Interesting Questions Raised by this Data

1. What prevents NCUA from providing more/better data & in more easily accessible formats?
2. Does recent decline in pace reflect undesirable regulatory or accounting barriers? Would proposed executive compensation guidelines be a significant barrier?
3. To what extent are examiners playing a role (encouraging) mergers (i.e., unassisted)? This is unknown – should we survey CUs to see how prevalent this is?
4. Do regulators push weak CUs into disproportionately large mergers? If so why?
5. Compared to state regulators does NCUA make life more difficult for acquirers? Or do state charters simply have FOMs that make mergers easier?