

Client Alert

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Charter Opportunities for Credit Unions

In today's highly competitive financial services marketplace, credit unions (as well as banks) are seeking ways to grow and increase earnings to address increasing regulatory burdens and the cost of new technology. In addition to organic growth, a number of methods are available to credit unions: (1) acquiring a bank; (2) acquiring a credit union; (3) acquiring a branch of a bank or a credit union; or (4) converting to a bank. Each has its own advantages and disadvantages, which must be balanced against the costs of the transaction and the prospects of success. Many small institutions willing to consider a merger partner face a number of concerns, such as management succession, limited growth opportunities and regulatory burden. As one of the leading financial services firms, we are seeing an increasing interest in these matters by our clients.

The Bank Acquisition Option

A number of credit unions have acquired banks in their quest to increase size and access to new market areas. Moreover, acquiring a bank may bring commercial lending talent to the credit union. Although there are a number of issues raised in a bank acquisition (e.g., field of membership, asset compatibility, and others discussed below), they are usually overcome. Typically, because it must have the capital to accommodate the bank's balance sheet, the credit union is two to three times the size of the bank.

Unlike a credit union acquisition, however, there is generally greater cost to acquire a bank since the shareholders are paid for their ownership. In addition, the bank may have stock benefit plans in the nature of an employee stock ownership plan, stock option plan, and restricted stock plan. The shares in these plans must also be purchased. Bank executives usually have employment contracts which contain a golden parachute payment for a change in control. This payment can be two to three times the executive's annual compensation. Because a credit union only has cash consideration to offer (unlike a bank, which can offer cash, stock, or a combination of both), a merger option has some financial limits to it.

A bank acquisition by a credit union also raises a double taxation issue. Under the current policy of the National Credit Union Administration ("NCUA"), a credit union acquisition must be structured as a purchase and assumption transaction and not a direct merger. Consequently, federal income tax is imposed at the corporate level (i.e., on the bank) as well as at the shareholder level. Unless the bank has sufficient net operating carryforward losses to cover any taxable gain, a tax will be due on any gain that the bank realizes on the transaction. This is one reason why certain transactions involve banks with profitability issues. Double taxation may also likely raise the price that a credit union has to pay for the bank in order for the shareholders to receive fair value for their shares after satisfaction of any federal and state tax liability.

Another issue that must be overcome in negotiations is the fact that a cash transaction creates an immediate taxable gain for the shareholder. In a stock transaction, the gain may be deferred by the shareholder and incurred when the shareholder decides to sell his shares at a later point in time (when it may be more advantageous to the shareholder – for example, sheltering gains with other capital losses). A stock transaction also permits the selling shareholder to participate in the upside of the seller's stock price following the transaction. The basis that the selling shareholder has in the stock carries over to the

stock of the buyer. Many savvy bank investors retain their shares over a number of mergers and do not recognize any gain until the shares are sold, either voluntarily or through a cash out merger.

A bank acquisition, as well as a credit union acquisition, may also create goodwill that is carried on the balance sheet until it becomes impaired. Although goodwill is not deducted in calculating a credit union's capital compliance (unlike the rules for a bank), the examiners will discount its contribution to capital since it does not serve to protect the National Credit Union Share Insurance Fund ("NCUSIF"). Further, the new risk-based capital rules require goodwill, as well as the NCUSIF deposit, to be deducted from capital in calculating compliance. Thus, institutions will have to pay close attention to its impact.

Asset compatibility typically does not present a problem for an acquiring credit union. When it does arise it is usually with respect to commercial loans. The NCUA usually provides a brief transition period to bring the non-conforming assets into compliance or the credit union sells the assets. If the amount of commercial loans would put the credit union over the statutory limit, it can participate the loans out to other credit unions.

Acquiring a Credit Union

Acquiring a credit union is the option most likely to be considered by a growth-oriented credit union. It is probably also the best understood strategic option. There are obstacles, however, that must be addressed in connection with the transaction. Field of membership compatibility is often an issue, but in light of the broad geographic and associational memberships that exist today, there is usually an avenue that can be taken to accomplish the transaction. We encourage and work with our clients to have in place a merger benefits proposal that describes the member benefits of merging with the acquirer, such as products and services and accessibility features (e.g., more convenient branch locations and mobile banking). This will allow the acquirer to move expeditiously on a merger opportunity.

As you may know, the NCUA has proposed regulations that would require federal credit unions (1) to disclose financial benefits to management of the target institution in connection with a merger involving a federal credit union and (2) provide to members the ability to communicate directly with other members in connection with the merger. This proposed rule raises a number of issues that must be addressed. Richard Garabedian, an attorney in our Washington, DC office, wrote about this proposed rule in a recent opinion piece posted on the Credit Union Executive Society's website (September 2017). We are one of the few firms that have experience in dealing with the NCUA's administration of the proposed member-to-member communication rule.

In addition to mergers, we have also served as counsel on branch acquisitions that allowed the institution to expand its field of membership and enter a very attractive banking market. Such a transaction is most likely only available where the two institutions have compatible geographic fields of membership.

The Bank Charter Option

A number of credit unions have taken the option of converting to a mutual savings bank charter to address strategic challenges over the coming years. Although the number of institutions reported in the press have been reduced over the past few years, there is still considerable interest. The mutual savings bank charter provides the opportunity for an unlimited field of membership and the opportunity to raise equity capital. With regard to the field of membership expansion, the NCUA recently adopted regulations expanding the geographical field of membership option. However, that regulation has been challenged by the American Bankers Association. Clearly, that is not an issue with a federal mutual savings bank charter. In addition, there are a number of other benefits to the mutual savings bank charter that we can discuss with you at your request.

Although converted institutions must pay state and federal income tax, that burden can be overcome with growth opportunities that the charter provides. The available data tends to show that larger institutions

are more profitable and therefore can invest in the new technology that consumers continue to demand. With increasing regulatory burden and competition from Fintech companies, many institutions are struggling to stay competitive and secure the resources to invest in the necessary technology. The mutual savings bank charter option provides the opportunity for the credit union to remain independent rather than being pressured to find a merger partner. In such a case, the members do not receive any direct consideration for their ownership interest (unlike with the sale of a stock bank).

There are any number of articles in the press that credit unions offer better rates on loans and deposits, but these are averages and not reflective of the competition in any particular market area where the credit union competes with other financial institutions, including other credit unions. Further, even assuming the rates may not be as attractive, is having a more vibrant institution a worthy trade to enable it to provide more products and services to the members?

The NCUA conversion process is somewhat complex, but a number of institutions have successfully gone through the process and obtained the benefits of the mutual charter. Under federal law, a federal credit union must obtain a majority of the members actually voting, not a majority of the outstanding membership. Because a conversion involves an existing institution with an operating history, the challenges of starting a new bank are not present.

Capital Flexibility

To raise capital there is no need to sell stock in a full stock conversion. Mutual savings institutions may form a mutual holding company (“MHC”) to issue stock to the members of the institution through a minority stock offering where the parent mutual holding company retains control over the institution and the members retain their voting rights at the holding company level. The MHC structure was authorized under federal law a number of years ago to allow a mutual institution to reorganize into a holding company structure. Many institutions have formed MHCs in connection with issuing stock to their members through a minority stock offering or just using the structure for potential future diversification through subsidiaries under the MHC. Through the MHC structure, the banking organization always remains in control. Importantly for mutuals, however, the MHC structure permits the mutual institution to convert debt to equity for growth and additional resources to address the ever increasing regulatory burden and financial technology investment.

Hunton & Williams LLP has one of the largest financial services practices in the United States and our clients include a number of the largest credit unions. We are consistently ranked on SNL league tables within the top few law firms in the number of merger transactions annually. We bring to our clients considerable experience in all facets of any type of merger or acquisition including cross industry transactions. In addition, industry league tables reflect that the attorneys at Hunton & Williams have served as counsel on more credit union charter conversions than any other national law firm.

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