Client Alert

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Unlikely Marriage Partners

The merger of a credit union and a bank is a transaction that not very many financial institution executives have considered until the past few years. But with the development of credit unions acquiring banks, community bank executives are considering the opportunity to acquire credit unions as well. Although these types of transactions present some challenges, a bank has more acquisition tools to acquire a credit union than the credit union has to acquire a bank. Since a credit union does not have shareholders or control groups there may be more pricing flexibility as well. Further, considering credit unions vastly increases the pool of acquisition candidates for banks.

I. Purchase a Credit Union

From time to time banks have considered buying credit unions. The first such transactions were completed by mutual banks. After a number of credit unions were acquired by mutual banks by having the credit union first convert to a mutual bank and then merging into the bank, the National Credit Union Administration ("NCUA") adopted regulations setting forth the process for a bank to buy a credit union. Many components of the rule are similar to the rules that apply when a credit union seeks to convert to a bank, such as NCUA mandated disclosures and a 90 day notice for the member meeting to consider the merger. Our presentation at the recent ICBA national conference on this topic has created considerable interest in these transactions. Through our discussions with banks and investment bankers it appears that few bankers know of this opportunity (or if they know of the opportunity they believe the process to be so burdensome as to not consider it a viable option).

The consolidation taking place in the credit union industry is just as active as in the bank industry and presents opportunities for bank acquirors. One hurdle is to create interest in credit unions seeking to merge to consider a bank acquiror just as bank sellers are considering credit unions acquirors. The NCUA has been approving about 25 credit union to credit union mergers per month over the past few years and there is no reason to believe that trend will abate. Many credit unions have the same reasons to consider a merger as do community banks such as lack of management succession, shrinking loan opportunities, increasing compliance costs, lack of resources to fund the latest in technologies, encroaching Fintech competition and inability to attract new board members and management.

Recently, a transaction was reported in the press where Alliance Bank Central Texas, Waco, Texas ($315 million in assets) purchased the loans and branch office of the Texas Farm Bureau Federal Credit Union, Waco, Texas ($6.7 million in assets) but left the credit union charter and the deposits intact. Very little is known at this time about the transaction, including the purchase price, and other details of the transaction. It appears, however, that the transaction was completed without any involvement of the NCUA which greatly reduced the cost of the transaction and the completion time.

There are currently about 3,800 credit unions under $100 million in assets and about 4,400 under $200 million in assets or 81% of the industry. Many small credit unions do not have a realistic prospect of long term viability and are just waiting for the right merger opportunity. It can be a challenge, however, to get the credit union board to face reality since there is no strong fiduciary duty to shareholders. In our view, far too many credit unions wait for a merger until it becomes too late to forge a merger on their own and they are then forced into a merger by their regulator. Having the potential for a bank merger significantly increases the buyer acquisition pool for the credit union.

Why Acquire a Credit Union?

A credit union offers many of the same opportunities that a community bank would offer a bank acquiror among them market expansion, additional managerial talent, complimentary product lines, expanded customer base and technology enhancements. The commercial loan underwriting talent and a commercial loan portfolio would likely not be as robust but that is an area that credit unions are expanding. Most likely, a good target credit union would be one with a complementary community field of membership since an associational or employee group membership could have members widely dispersed and not be practical to assimilate.

Banks Have More Acquisition Tools

In a credit union merger there are no direct financial incentives for management and the board to consider a merger. Federal credit union directors may not be compensated (although a number of states do allow board compensation for state charters) and thus even an advisory board with modest board fees is not available. A bank acquiror may offer the opportunity for a compensated advisory board as well as participation in stock based incentive plans. Employees may also participate in an ESOP if the bank has one. Further, a bank may use cash or stock as consideration to enhance the acquisition success

Benefit to the Credit Union and its Members

We believe that there are a number of benefits to credit union members that are overlooked by credit unions as well as by the banking industry. In a typical credit union merger with another credit union the target credit union's members receive no compensation for their "ownership" interest. They only receive the ability to share in the combined net worth of the acquiror and to take advantage of any additional products or services that the acquiror offers but the target credit union does not offer. Quite often, as is well known in the industry, only the senior management of the credit union receives any direct financial benefit from the transaction though an extended employment agreement, expanded retirement benefits or other financial incentives. In a purchase by the bank, however, the members are paid for their ownership interest (i.e., the equity in the credit union) plus any premium that the bank would pay. The members may also benefit from a greater variety of loan products and services, such as greater commercial loan products and services, trust services and more branch locations.

The Question of Rates

The credit union industry touts that credit unions offer better rates on loans and deposits. This may be true on some products but not on others and it all depends on local market conditions. Services that report rates on a national scale, however, are really not relevant to a local market. Further, credit unions rely heavily on fee income more than banks. Thus, the rate issue should not be an obstacle to negotiating a successful merger.

The Process

The process to acquire a credit union is not vastly different from acquiring a bank and thus many of the steps are replicated in the credit union acquisition process. A few things to note, however, are that (1) the advance notice of the members' meeting to consider the merger is 90 days, (2) the members are given the opportunity to submit comments to the credit union before the credit union board approves the merger agreement and (3) at least 20% of the members must vote on the merger <u>but only a majority of those voting</u> must approve the merger. Thus, the voting approval standard is well below what is typically required for a bank merger. The merger would have to be approved by any applicable state regulator and by the FDIC as well (and not the primary federal regulator) since the bank would be acquiring non-FDIC insured deposits. The process should take about eight to ten months.

The credit union may also have assets that are non-conforming with the bank charter such as equity in a corporate credit union and relationships with vendors that only service credit unions. The loan and investment portfolio, however, is unlikely to present any compatibility issues. A transition period would likely be provided to address these non-conforming items.

II. Sell to a Credit Union

In recent years there have been a number of banks purchased by credit unions, typically though a purchase of assets and assumption of liabilities structure. This structure has been required by the NCUA for federal credit unions that seek to acquire a bank. Although the merger consideration is not made public since all the transactions to date have involved banks that are privately held, the general discussion in the industry is that credit unions are willing to pay more for a bank that a similarly sized bank would pay for the target bank.

There are probably at least two factors that support this pricing result regardless of the reasons for the credit union acquiring the bank. First, credit unions are subject to a net worth requirement for capital compliance which is calculated under GAAP. Under GAAP, intangibles like goodwill are not deducted from equity. Thus, the amount of goodwill created in a transaction will not have to be deducted from the credit union's capital in calculating its compliance with the regulatory capital requirements which are 6% for adequately capitalized status and 7% for well-capitalized. Second, credit unions do not have shareholders, they are cooperatives that are owned by their depositors or members. Thus, there is less concern on return on equity, return on assets or payment of dividends for that matter.

One aspect of the merger consideration analysis is that in a credit union and bank merger the consideration has to be high enough so that the shareholders receive the fair merger value of their shares. In light of the use of the purchase and assumption transaction in which the bank receives the merger consideration and first pays any income tax that would arise and then distributes the remainder to the shareholders in exchange for their shares, the credit union actually must pay more than the fair value of the shares to overcome the tax burden at the corporate level. One might ask whether a board should approve such a transaction and is it in the best interests of the credit union and its members? In the event the bank has accumulated losses the net operating loss carryforward could help to ease the tax bite at the corporate level.

The regulatory approval process will include the NCUA and any state regulator for the acquiring credit union as well as the FDIC because the bank is moving its insured deposits to a non-FDIC insured institution. In addition to shareholder approval, under the NCUA requirements for federal credit union acquirors the depositors of the bank must approve joining the credit union. The vote necessary for the depositors is a simple majority of those voting to join the credit union. The process should take about eight to ten months.

It is not well known how well these transactions have succeeded since there are few reports following the completion of the transaction. Banks with heavy commercial loan portfolios might not be a good fit due to credit union limits on commercial loan concentration on their balance sheet and credit unions not being recognized as commercial lenders. On the other hand, banks with vibrant residential mortgage portfolios might be a good fit since many credit unions have transitioned over the past twenty years from being heavy automobile loan and consumer loan lenders to residential mortgage lenders as well. In the end, it depends upon the local market and what it will support. As with the bank purchases of credit unions, any non-conforming assets will need to be disposed of within a transition period.

Hunton Andrews Kurth LLP has one of the largest financial services practices in the United States. 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.

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