

NCUA LETTER TO CREDIT UNIONS

**NATIONAL CREDIT UNION ADMINISTRATION
1775 Duke Street, Alexandria, VA 22314**

DATE: June 2010

LETTER NO.: 10-CU-11

TO: Federally Insured Credit Unions

SUBJECT: Information on NCUA's Merger and Purchase & Assumption Process

Dear Board of Directors:

This Letter and Appendix provide information on NCUA's merger and purchase & assumption (P&A) process. NCUA has received numerous inquiries and questions on the subject. In an effort to improve transparency, this letter addresses several topics involving mergers and P&As including:

- An explanation of the P&A process and the various types of mergers;
- The criteria used to evaluate mergers and P&As;
- The identification of merger and P&A partners; and
- The selection of an acquirer in the limited circumstances when NCUA is involved in making the choice.

Available Options

When a credit union's board of directors determines it is no longer feasible for its credit union to continue as a going concern, or NCUA or the respective State Supervisory Authority (SSA) for a state-chartered credit union determines the credit union's problems cannot be resolved permitting it to continue as an independent entity, the following options are available.

- A voluntary liquidation;
- An involuntary liquidation;
- An involuntary liquidation followed by a Purchase and Assumption;¹ or
- A merger (voluntary, unassisted supervisory, or assisted).

¹ Generally referred to as a Purchase and Assumption or P&A.

NCUA's involvement in each of the above options varies. For those options where continuing credit union service is maintained (e.g. mergers and P&As), information on the level of NCUA's involvement is discussed in this letter. For additional information and a comparison of each of the options, please refer to the Appendix to this letter.

Voluntary Mergers

NCUA generally does not participate in the identification and selection process concerning voluntary mergers, which typically occurs when two healthy credit unions decide to merge based on business decisions made by their respective boards of directors. Voluntary mergers generally do not involve financial assistance from NCUA to consummate the action for the continuing credit union, nor NCUA approving a waiver of the membership vote.

NCUA's role in voluntary mergers is limited to the appropriate regional director providing a decision (e.g. approval, deferral if incomplete, or denial) on the merger application. The selection of the continuing credit union partner resides solely with the acquired credit union's board of directors. However, NCUA can deny the acquired credit union's selected partner based on safety and soundness issues, or field of membership compatibility if the acquirer is federally chartered.²

Unassisted Supervisory Mergers

NCUA may or may not participate in the identification process concerning unassisted supervisory mergers. Unassisted supervisory mergers, like voluntary mergers, do not involve financial assistance from NCUA to consummate the action for the continuing credit union, nor NCUA approving a waiver of the membership vote. However, unassisted supervisory mergers generally involve credit unions which are less than adequately capitalized under Prompt Corrective Action, Part 702 of NCUA's Rules and Regulation. NCUA has authority under certain net worth classifications to either require a credit union to merge or to accept a credit union's Net Worth Restoration Plan identifying a timeframe for which it will merge.

In fact, if a credit union is solvent but has a net worth ratio of "critically undercapitalized" (less than 2 percent), than within 90 calendar days after the effective date³ of the credit union being classified as "critically undercapitalized," NCUA is mandated to take one of three actions. NCUA must place the credit union into conservatorship, into liquidation (possibly followed with a purchase and assumption), or take other corrective action (including requiring a merger).

NCUA's involvement will generally be at a level to ensure the action is completed as needed or as agreed upon.

² NCUA determines field of membership compatibility when the continuing credit union is a federal charter. The respective SSA determines the field of membership compatibility requirements when the continuing credit union is a state charter.

³ When a board of directors is officially notified of the classification, i.e. joint conference date.

Assisted Mergers and P&As

NCUA's role concerning assisted mergers and P&As is much greater, including the identification and selection of the continuing credit union partner, since assisted mergers and P&As generally involve financial assistance from NCUA. Also, P&As can involve NCUA retaining some of the failing credit union's assets, liabilities, contracts or off balance sheet items. However, the degree of involvement and approach taken largely depends upon the unique set of circumstances in each case, such as the:

- Potential loss to the National Credit Union Share Insurance Fund (NCUSIF);
- Size and complexity of the acquired credit union;
- Financial stability of the acquired credit union; or
- Degree of urgency⁴ to consummate the assisted merger or P&A.

Evaluation Criteria for Mergers and P&As

NCUA evaluates and analyzes the following three general criteria when making its decision to approve, defer, or deny a merger or P&A application:

- 1) Whether the continuing credit union can safely and soundly absorb the financial and operational impact that will result from the acquired credit union;
- 2) Whether the acquired credit union's field of membership is compatible with the continuing credit union's field of membership as required by NCUA's Chartering and Field of Membership Manual (exceptions exist for P&As and emergency mergers); and
- 3) Whether the required membership notice sent by the acquired credit union properly informs the membership about the action.⁵

When NCUA determines whether the acquired credit union's field of membership is compatible with the continuing federally-chartered credit union, there are two circumstances which may apply that will either remove or reduce this requirement.

⁴ NCUA determines the degree of urgency based upon various internal and external factors surrounding the acquired credit union; therefore, the degree of urgency may evolve over time. An example of an internal factor could be where credit union management cannot effect the merger in a timely, efficient, and effective manner thereby increasing the risk of loss to the NCUSIF. An example of an external factor could be where members become knowledgeable of problems at the failing credit union and begin withdrawing shares (generally referred to as a run on shares) thereby creating, or adding to, a liquidity concern.

⁵ Membership notification for an acquired state-chartered credit union is reviewed by the respective SSA.

1. If a merger or a P&A is classified by NCUA as an “emergency,” any continuing federal credit union can acquire the failing credit union.⁶ For NCUA to approve an emergency action, the acquired credit union must be either insolvent or in danger of insolvency, and NCUA must also determine:
 - An emergency requiring expeditious action exists;
 - Other alternatives are not reasonably available; and
 - The public interest would best be served by approving the action.

Part 701, Appendix B, Chapter 3, Section III.B.1, of NCUA’s Rules and Regulations (Chartering and Field of Membership Manual) defines “in danger of insolvency” as the credit union falling into one of more of the following categories:

- Net worth is declining at a rate that will render it insolvent within 24 months;
 - Net worth is declining at a rate that will take it under two percent net worth within 12 months; or
 - Net worth, as self-reported on the call report, is significantly undercapitalized, and NCUA determines there is no reasonable prospect of the credit union becoming adequately capitalized in the succeeding 36 months.
2. Where the acquired credit union is a single or multiple common bond charter and the continuing federal credit union is a multiple common bond charter, the merger may be classified by NCUA as “supervisory” when NCUA determines supervisory concerns⁷ exist. In a supervisory merger, any group in the acquired credit union’s field of membership having 3,000 or more primary potential members would automatically transfer to the continuing federal credit union’s field of membership without the group having to document the formation of a separate credit union is not practical.

For the membership notice process, NCUA has the authority to waive the requirement for a membership vote if the merging federal credit union is insolvent or in danger of insolvency; and NCUA determines the merger would reduce the risk, or avoid a loss, to the NCUSIF. The membership notification waiver for a merging federal credit union is not automatically granted by NCUA – a waiver must be requested by the failing federal credit union. Membership notification is not required for a failing federal credit union placed into liquidation and followed by a P&A.

⁶ An emergency merger or emergency P&A also permits a continuing federal credit union to permanently retain the acquired credit union’s field of membership regardless of future changes to its own charter (i.e. converting to a single common bond charter, a multiple common bond charter, or a community charter).

⁷ Some examples constituting supervisory concerns would include abandonment of management and/or officials and an inability to find replacements, loss of sponsor support, serious and persistent record keeping problems, sustained material decline in financial condition, or other serious or persistent circumstances, etc. These examples are not meant to be all inclusive.

Identification Process When NCUA Is Involved (e.g. Assisted Mergers and P&As)

In the identification process for assisted mergers and P&As, NCUA generally develops a potential partner list of those credit unions having the ability to manage the combined credit unions both financially and operationally. NCUA identifies the specific criteria a continuing credit union partner must have and develops its candidate list based on this information, including, but not limited to:

- A list of credit unions based on asset size, CAMEL code, net worth level desired, and/or other appropriate selected criteria;
- Demonstrated ability of the potential continuing credit union's management team to handle the size and complexity of the failing credit union including any unique products or services that may be present in the failing credit union's balance sheet;
- The field of memberships of other credit unions with groups in the geographic area(s) serviced by the failing credit union; and/or
- A list of credit unions that have expressed interest in being considered a continuing credit union partner.

Depending on the failing credit union's condition and other factors unique to each case, a wider geographic search may be warranted. Regional and national searches may be necessary when one or more of the following conditions are present:

- The failing credit union's assets are large and/or problems are complex;
- The failing credit union requires specific expertise or has special circumstances or characteristics, such as designations, diversified groups in the field of membership, and/or location restrictions. Such examples may include agricultural or member business lending, low income and/or CDFI⁸ designations, language barriers existing in the membership, foreign nationals served, non-public access to branches, etc.;
- NCUA does not receive a sufficient number of interested candidates and/or bids from the initial local search; and/or
- NCUA finds the requested assistance from interested acquirers is unreasonable and/or unjustified.

⁸ CDFI stands for Community Development Financial Institution, a designation obtained from the Treasury Department by entities serving underserved populations and communities. The designation is removed if the continuing credit union is not also CDFI designated.

NCUA generally tries to contact as many credit unions as practical to ensure a competitive bidding process which will result in the least cost to the NCUSIF. There is no set number of credit union candidates NCUA must contact. However, there are practical limits to the number of credit unions that can conduct onsite due diligence without disrupting the operations of the failing credit union. Generally, larger credit unions or larger anticipated assistance results in NCUA contacting more potential candidates and/or using a larger geographic area in its search. In addition to the size, complexity and level of potential assistance, the limit on the number of candidates is also influenced by:

- The ability of the failing credit union to host potential credit unions to complete due diligence as part of the bidding process without disrupting daily operations;
- The rate of deterioration of the failing credit union (the faster the erosion, the quicker final resolution must occur to minimize the potential loss to the NCUSIF); and
- The process must be conducted in a manner which does not create membership panic and cause a run on shares at the failing credit union.

Once NCUA develops the potential partner list, a bidder's meeting is held when practical or warranted by the circumstances. Before providing an interested party with a bidders' information packet, NCUA will obtain a signed confidentiality agreement.⁹ NCUA staff answers questions related to the credit union's operation and provides an overview of the conditions at the failing credit union. However, the burden of completing a due diligence review and determining the amount of assistance, if any, is the responsibility of the bidder.

All interested parties meeting NCUA's identification criteria will be given an opportunity to complete a due diligence review and NCUA will establish the timeframe for the submission of bids. The amount of time provided will depend on the nature and extent of the problems, the size and complexity of the failing credit union, and the number of potential bidders. Each of NCUA's regional offices presently maintains a manual listing of credit unions that have expressed an interest in expanding their respective fields of membership through mergers and/or P&As which is used to help identify initial potential interested parties.

National Registration Process

NCUA has evaluated and determined the establishment of an automated national registry will improve the efficiency of identifying potential credit union partners and provide greater opportunity for more interested credit unions to be involved. NCUA is developing an automated national registry where a credit union can identify the

⁹ A document signed by a bidder acknowledging receipt of the bidders' information packet and as a condition of receiving such information agrees to treat confidentially the information and any other information furnished to them by NCUA or the failing credit union.

parameters in which it would like to be considered as a merger or P&A partner. These parameters could potentially include asset size range, geographic limitations, field of membership types, and minimum net worth limits, to name a few. The registry would be available for use by NCUA and SSAs to identify potential interested credit union partners. NCUA and SSAs will be able to incorporate specific criteria being evaluated in their identification process. For assisted mergers or P&As, the number of credit union candidates meeting NCUA's specific identification criteria will determine whether NCUA needs to expand its search beyond the local geographic area, such as regionally or nationally. Until the automated national registry is available, interested credit unions should notify their respective NCUA regional office.

Selection Process When NCUA Is Involved (e.g. Assisted Mergers and P&As)

Upon NCUA receiving all written bids by the specified deadline(s), NCUA evaluates and analyzes each bid to determine the amount and type of assistance being requested by each bidding credit union. Each bidding credit union must provide justification for its assistance request and complete information to support its valuation of loans, other assets, liabilities, shares, contracts, and/or off balance sheet items.

NCUA generally awards the bid to the selected bidder with the "no cost" or "least cost" proposal. NCUA gives consideration to additional factors before finalizing its decision and notifying the selected bidder in writing. These factors include, but are not limited to:

- The effect on the bidding credit union's safety and soundness;
- Whether the continuing credit union partner is a "good fit" for the failing credit union's membership or special circumstances (i.e. does the continuing credit union have the expertise to manage the failing credit union's issues);
- The ability of management to successfully integrate the failing credit union's operation into their own;
- The ability of the bidding credit union to provide the same or enhanced services to the failing credit union's membership; and/or
- Any additional offerings by the bidding credit union such as maintaining an existing location(s), provisions for continuing certain services or products, provisions for continuing employment for employees, etc.

Questions concerning NCUA's identification and selection process for merger and P&A partners can be directed to the appropriate NCUA regional office.

Sincerely

/s/

Debbie Matz
Chairman

APPENDIX

Voluntary Merger

- A voluntary merger¹⁰ is initiated by a credit union's board of directors. The selection of the continuing credit union partner is made by the acquired credit union's board of directors, subject to NCUA approval.
- All of the credit union's assets, shares, liabilities, contracts, field of membership, intangibles, off balance sheet items, etc. transfer to a continuing credit union.
- Continuing credit union service to the credit union's membership is maintained (e.g. the field of membership is either transferred to the continuing credit union or the continuing credit union already services the transferring field of membership).

Unassisted Supervisory Merger

- An unassisted supervisory merger¹¹ is processed without assistance from the NCUSIF.
- An unassisted supervisory merger is initiated by a credit union's board of directors or NCUA pursuant to Part 702, Prompt Corrective Action of NCUA Rules and Regulations. The selection of the continuing credit union partner resides primarily with the acquired credit union's board of directors, subject to NCUA approval.
- All of the credit union's assets, shares, liabilities, contracts, field of membership, intangibles, off balance sheet items, etc. transfer to a continuing credit union.
- Continuing credit union service to the credit union's membership is maintained (e.g. the field of membership is either transferred to the continuing credit union or the continuing credit union already services the transferring field of membership).

Assisted Merger

- An assisted merger¹² generally involves assistance from the NCUSIF and/or NCUA waiving the membership vote.
- An assisted merger is initiated by a credit union's board of directors, NCUA, or the respective SSA. If financial assistance is required by the NCUSIF to consummate the merger, NCUA selects the acquired credit union's continuing credit union partner. If financial assistance is not requested and only a waiver of

¹⁰ Voluntary mergers may meet NCUA's supervisory classification.

¹¹ Unassisted supervisory mergers may meet either NCUA's emergency or supervisory classification.

¹² Assisted mergers may meet either NCUA's emergency or supervisory classification.

the membership vote is requested, the selection of the continuing credit union partner will reside solely with the acquired credit union's board of directors.

- All of the credit union's assets, shares, liabilities, contracts, field of membership, intangibles, off balance sheet items, etc. transfer to a continuing credit union.
- Continuing credit union service to the credit union's membership is maintained (e.g. the field of membership is either transferred to the continuing credit union or the continuing credit union already services the transferring field of membership).

Voluntary Liquidation

- Action initiated by a credit union's board of directors to dissolve the credit union.
- None of the credit union's assets, shares, liabilities, contracts, field of membership, etc. are transferred to a continuing credit union.
- The credit union's charter is cancelled when its liquidating agent has dissolved and/or resolved all of the credit union's affairs and matters.
- Continued credit union service to the credit union's membership is lost (e.g. the field of membership is not transferred).

Involuntary Liquidation

- Action initiated by NCUA or the respective SSA when the credit union is insolvent or pursuant to NCUA Rules and Regulations, Section 702.204, Prompt Corrective Action.
- All of the credit union's assets, shares, liabilities, contracts, etc. are transferred to NCUA for final disposition.
- The credit union's charter is cancelled upon NCUA dissolving and/or resolving all the credit union's affairs and matters.
- Continued credit union service to the credit union's membership is lost (e.g. the field of membership is not transferred).

Purchase and Assumption

- Before a failing credit union can be purchased and assumed, it must first be placed into involuntary liquidation by NCUA or the respective SSA. No credit union board exists in liquidation. Therefore, further action must be initiated by NCUA or the respective SSA.

- A P&A¹³ can be processed “at no cost” to the NCUSIF, and is generally requested by a continuing credit union when a merger is not desirable, as a continuing credit union might not desire to have all assets, shares, liabilities, contracts, field of membership, off balance sheet items (e.g. lawsuits, bond claims) transferred.
- Continuing service to the credit union’s membership is maintained if the continuing credit union requests it (e.g. the field of membership is either transferred to the continuing credit union or the continuing credit union already services the transferring field of membership). Otherwise, only members of record are transferred.

¹³ P&As, by definition, generally meet NCUA’s emergency classification; however, NCUA’s supervisory classification does not apply to P&As.