July 21, 2017

Via: Electronic Mail

Gerard Poliquin
Secretary to the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314-3425

Dear Mr. Poliquin:

Re: Proposed Rules: Bylaws; bank conversions and mergers; and voluntary mergers of federally insured credit unions (12 CFR Parts 701, 708a, and 708b) (the Proposal)

We support the proposed revisions to the merger rule, including enhanced transparency. However, we believe the disclosures regarding the transfer of the member-owners' collective wealth need to be much more prominent and specific.

Members own the collective reserves and retained earnings accumulated in the multi-generational operations of their credit union. Their ownership of this capital, accumulated through decades of member loyalty, is confirmed by statute in that it would be distributed pro rata should a solvent credit union decide to voluntarily liquidate.

However, in many voluntary mergers of sound, operationally successful credit unions, this "common wealth" is being transferred away from the members who created it, into the acquiring credit union's control. Often the continuing credit union is many times larger, negating any meaningful post-merger influence by the acquired credit union's members over their commonly owned surplus.

When this occurs, the acquiring credit union records this net worth, plus any other mark-to-market gains, as "negative goodwill." This "extraordinary value," in accounting terms, is then recognized as income, which enables the surviving credit union to use the funds for whatever expenses it chooses. These options include paying operating expenses, supporting dividends, or adding to reserves.

This assumed event of automatically transferring this surplus is contrary to everyday market practice in which the owners of an acquired, sound institution — for example, a bank — would be paid not only the book value, but also a premium representing the ongoing earnings potential for the business.

As shown in the case study below, when Achieva Credit Union acquired Calusa Bank in a whole-bank purchase, the cash price paid the bank owners was 135% of book value. In contrast when Belco Community acquired Cornerstone FCU in a "voluntary merger" on July 1, 2017, the member-owners received nothing, not even a token "special dividend."

The "negative goodwill" outcome is contrary to ordinary, common-sense market practice. Moreover, this commercially indefensible transfer of member-owners' wealth has created an environment facilitating insider self-dealing and opportunistic corporate acquistion strategies devoid of tangible member benefit.

Across the credit union system, this accumulated capital averages more than $1,000 per member-owner ($1,371 at March 31, 2017). In the case study below, we also see that Cornerstone's member-owners

received nothing in return for joining Belco. In fact, each Cornerstone member paid the equivalent of a fee of $922 (before any market valuation gains) from their collective wealth (as of March 31, 2017) to become a Belco member. However, joining Belco was an option available for purchase of a regular share at any time prior to the merger!

To ensure member-owners are fully informed about the impact of the transfer of control of a credit unions assets, and especially its capital, to another institution, we recommend the new rule require:

1. A full disclosure of the current book value and the estimated market value of the credit union as of the date of the merger proposal. These calculations should also be presented as a "per member number" so the owners are fully informed about their ownership value.
2. That any adjustments to the merging credit union's book value, and the reasons therefore, be fully disclosed, including changes to loan loss allowances, unrecorded liabilities, merger expenses, and any other write-downs which are part of the merger event;
3. That required sales or planned disposition of assets of the merging credit union be disclosed, such as the sale of member business loans, other member loans and any other asset used in the operation of the credit union (e.g. branch office);
4. That any promised "contributions" to organizations from the merging credit union's assets be fully described including reasons therefore;
5. That the Board's disposition of the member-owners' capital, if not in the form of a special dividend, be fully disclosed, including the reasons for transferring any capital to the acquiring credit union.

The general principle guiding disclosure should be that any time "negative good will" is being booked in a voluntary merger, a full explanation of this transfer must be justified.

By focusing on the "social capital" that member-owners have created and collectively control, the unique cooperative design of a credit union is reaffirmed. It reduces the possibility of insider self-dealing and increases the prospect that directors will indeed act in the members' best interest as they consider giving up their operating charter.

Why A Stronger "Voluntary Merger" Rule is Necessary

(first published June 26, 2017 on creditunions.com)

Summary: The proposed NCUA rule would require payoffs to take place in the open, exposing merger deals to transparency before members are asked to give away millions ("negative good will") in equity and member value.

The NCUA's proposed new merger regulations would help stop the abusive practice of board members and executives robbing members of their collective wealth, or at least make them be up front about it.

But the new rule, proposed in May and now up for comment, has been greeted with ambivalence, even though the agency itself says that approximately 80% of the mergers it reviewed included payments to insiders.

This self-dealing is an attack on the very core of the credit union movement and of what the financial services cooperative should be; yet some commentators are voicing reservations about the need for such changes.

We're not one of them. This rule may be the most important regulatory action NCUA takes this year. So-called voluntary mergers have become a business strategy increasingly used by some credit unions to take over solvent, well-run institutions by inducing insiders to compromise their fiduciary duties to their member-owners.

These insider sales provide financial incentives to management and employees, but rarely do members receive any benefit from their generations of loyalty. Instead, a valuable charter disappears, insiders pocket years "bonuses," and the movement suffers another blow to its image as a not-for-profit that exists for the common good.

Calusa Bank Purchase vs. Cornerstone FCU Merger

Because the corrective power of market competition is absent in the collective model, examples to demonstrate the magnitude of this corrupt transfer of member wealth have been lacking. But now that several credit unions have completed whole-bank purchases, it's feasible to show how harmful this expropriation of member's collective ownership can be.

Among the first, Achieva Credit Union ($1.5B, Dunedin, FL) completed the purchase of $165 million Calusa Bank in Punta Gorda, FL. The small bank had total deposits of $133 million, $114 million in loans ($108 million in real estate), $38 million in investments, and operated four full service offices. Total book value of net worth was just over $17 million.

The sales price was $23.2 million in cash, as credit unions can issue no stock. The price was 136% of tangible book value. The price to estimated 2015 earnings was 54.4x. The bank's shareholders had contributed capital of $10.3 million, and so received over two times this amount for the bank, which had operated since 2007 until the sale in 2015.

Achieva's December 2015 call report records an increase of capital of $20.1 million. Of that, $3 million was internal earnings and $17 million was Calusa's capital. The credit union also recorded an increase in goodwill of $9.0 million to account for the price paid in excess of book value.

The bank's owners doubled their capital, received cash, and could remain members of the credit union or take their gains and business elsewhere. And it was all out in the open.

Credit Union Member-Owners Receive Nothing

Compare this to what the 11,000 member-owners of Cornerstone FCU ($109.1M, Carlisle, PA) get when their 43-year-old, highly regarded hometown financial institution merged July 1, 2017, with Belco Community Credit Union ($470.9M, Harrisburg, PA).

Cornerstone has three wholly owned offices and a high school branch operated by students under the supervision of a credit union employee. Along with serving as a longtime provider of mortgages and other loans to the community, the credit union has helped finance hundreds of locally owned small businesses and organizations, including a radio station, restaurants, a bicycle shop, several church renovations and the Muslim community center, and vital long-haul truck servicing firms.

Cornerstone has been able to respond quickly to market conditions and member needs, providing lower-cost loans and fewer fees and service based on local knowledge and relationships. Sounds like what a credit union is supposed to do.

The acquiring Belco Community CU (Harrisburg, PA) is more than four times as large as Cornerstone and has an expense ratio that over the past five years has been over 1% of average assets higher than the much-smaller Cornerstone. Cornerstone's rates and fees are superior to Belco's in nearly every instance because of its cost advantage.

Cornerstone's board and management provided members no due diligence, no product or service comparisons, and presented the merger as an opportunity for a "brighter future." More than 35% of its members voted against the merger.

Unlike the Calusa Bank owners, the member-owners of Cornerstone FCU received nothing for this insider sale. It was the members' loyalty, savings and support that built this credit union's $10 million in net worth. The leadership, future opportunities, local focus and all legacy assets are now transferred out of their control.

The final irony is that any Cornerstone member could have long joined Belco already if they perceived that credit union provided better value. Belco eliminates a competitor and members lose everything they have invested in creating their cooperative institution. The Carlisle community, meanwhile, loses its # 1 rated financial services provider.

No Commercial Sense

This charade of "voluntary mergers" is becoming more frequent. Stealing members' collective wealth may not violate NCUA rules, but it's certainly corrupt. No objective observer comparing what Achieva had to pay to acquire a bank of similar market benefits versus the zero cost and free assets acquired by Belco would see this as a commercially justifiable action.

The longer bad behavior goes on, the worse it gets. When credit unions use their size and power to "arrange" mergers which serve only institutional greed, then the credit union model has been perverted from its core purpose.

The NCUA's efforts to protect members' ownership rights and collective property with a revised merger rule is much needed and long overdue.