July 18, 2017

Mr. Gerard Poliquin
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, VA. 22314
(Sent by email)

Dear Mr. Poliquin,

Thank you for the opportunity to provide comment on the proposed rule changes for "Voluntary Mergers of Federally Insured Credit Unions."

Sandler O'Neill + Partners, L.P. is a full service investment-banking firm based in New York City.

Sandler O'Neill is a leader in transacting with credit unions and banks on merger advisory, capital markets strategy and execution, balance sheet management including asset liability analysis, investments, hedging strategies and loan sales.

Should you wish to discuss our comments, please call me at 212-466-7871 or email me at pduffy@sandleroneill.com.

More transparency a good idea.

We support increasing the transparency of merger details for CU members and on a level more closely aligned with how banks and other industries provide disclosure. The proposed changes combined with the current rules generally accomplish this, with one exception.

We are limiting our comments to one aspect of the proposed rule change, while also providing certain vital questions and considerations regarding the CU industry's merger history and importance to the industry of a healthier merger environment.

Summary

Consumers enjoy many choices on where to bank, from CUs to banks to internet options which means, among other things, that every CU must meet increasing consumer expectations for competitive rates, new products and enhanced delivery systems, or risk irrelevance. Research we share demonstrates that many CUs and banks are not keeping up in what has become a highly commoditized and competitive business that makes growth not only difficult but also extremely expensive.

Scale matters in a commoditized business and this fact is born out when analyzing the performance of smaller institutions. Over many years, the aggregate group of CUs with assets less than $500M has experienced little to negative member growth and continues to generate a negative ROA without fee income (this group has a negative 50-75 bps income before fees). Institutions reliant on fee income for positive earnings will continue to struggle to provide overall value on rates, fees and convenience, *while likely unable to meet minimum standards for compliance and technology.*

For their member's benefit, it would seem appropriate that more boards whose CU is not performing to standard over a sustained period, should seek a merger partner. We provide research indicating there likely exists many such CUs. Over the years, however, voluntary mergers have not kept pace with banks and have actually declined recently. Most CU mergers remain tiny.

An appropriate level of merger activity is a necessary part of an industry's overall health and performance, given that struggling institutions bring increased reputation risk and loss to the insurance fund, while draining regulator resources.

We support the transparent disclosure of all material facts to members as a necessary component for an informed voter. In so doing, NCUA's proposal related to disclosure of material changes to management compensation could lead to calls from members and stakeholders to disclose the total current compensation of CEOs for FCUs, as is the case for state chartered CEOs and banks. Regardless, we are in favor of providing clear and accurate information to members, which fulfills a key responsibility of a board of directors seeking merger.

"Member to member communication", however, is a bridge too far and could work against the best interest of both the CU industry and NCUA.

"Member to member communication" requires the merging credit union to send the unsolicited opinion of one member to all members by utilizing its member email registry (or physical addresses). This process provides a forum for negative comments, potentially untethered to facts, while not being subject to the disclosure requirements the CU must meet. If implemented, the "member to member communication" will have a chilling effect on potential merger activity and exacerbate the underperformance in the group of CUs where growth and capital metrics have been below industry and market standard for years.

The following provides considerations on the proposed "member to member communication".

We also offer discussion of the implications stemming from a lack of mergers as well as the potential benefits resulting from a higher level of voluntary mergers.

Member to Member Communication- an unnecessary and potentially damaging idea

The proposal to require a "member to member communication" platform is both unnecessary and potentially damaging to institutions on both sides of the transaction contemplating a merger. Indeed, ***without*** the imposition of a "member to member communication", but with all the current and other proposed rules implemented, the member would have everything required to make an informed decision.

Importantly, the opportunity to present opinion is available at the member's special meeting as part of the current merger process. Those wishing to make a comment can do so and ***those wishing to hear opinions*** are welcome to attend.

Forcing the unsolicited opinion of one member onto all members has the potential to annoy many members and, taken to its extreme, could prove irritating enough to produce backlash on the credit union whose members may justifiably ask why the communication was allowed to be transmitted. The process also invites comments that are potentially harmful such as a misguided recommendation that members should liquidate the CU and cash out instead of merge. Another distinct possibility is the potential for lawsuits such as with the First Federal Bank of Kansas City, Mo. transaction. In the First Federal case, 2 depositors have filed a lawsuit claiming they should have been paid for their ownership in a now merged thrift-(both the Office of the Comptroller of the Currency and the U.S. Supreme Court disagree with the depositors, see footnote).

The "member to member communication" idea, while well intentioned, has an unlimited potential for unintended consequences that can prove embarrassing not only to both credit unions attempting merger, but the industry as a whole and including NCUA. There is no way to understand how (or by who) commenters are influenced. For example, what is to stop a rival institution opposed to the merger from finding a sympathetic member to communicate vigorously against the transaction?

Additionally, the proposed "member to member communication" appears to address a consideration (ownership) that may not be relevant to a majority of current day credit union members compared to those before H.R. 1151. In 1998, Congress (thru H.R. 1151) enacted legislation permitting CUs to open their fields of membership beyond the original charter. Since then, consumers have been selecting credit unions in much the same manner as they select banks. Today's CU member profile is now closely associated with the customer of a bank and since voluntary mergers amongst banks occur without "customer to customer communication" ; requiring CUs to do so seems to be an unnecessary burden.

The vast majority of CUs we speak with tell us that the original "common bond" has become a much smaller percentage of total membership. In addition, although call report data does not provide a clear count, we believe the number of "single sponsor" credit unions now represents significantly less than 10% of total credit unions. This is relevant as one considers the original intent of chartering a credit union amongst people with a common bond of employment, religious affiliation, etc. "Common bond" people came together with a shared vision to fill a void left by large banks and formed the CU. The founding members sought to provide credit and deposit alternatives to their co-workers, congregation, etc.

Since 1998, credit union membership has evolved from the original definition of common bond to a CU with multiple common bonds made up of a disparate group of unrelated companies or a community charter where the "common bond" is a town, multiple counties or an entire state. The member profile today features persons largely unknown to each other, as with banks, who deposit and borrow from the same financial institution and in a manner different from that of the originally chartered credit union.

As the U.S. Treasury wrote in 2008, “Congress established the FCU charter in 1934 to make credit available to people of small means through a national system of cooperative credit. *Over time, a key aspect of the credit union system, the field of membership, has become less meaningful* (italics mine). Some credit unions have arguably moved away from their original mission of making credit available to people of small means, and in many cases they provide services which are difficult to distinguish from other depository institutions.”

Additionally, CUs tell us the vast majority of CU members are not aware of or perhaps do not care about ownership, a fact demonstrated by the members’ legacy of not participating in the board election process, both as candidates or voters, and by their absence from annual meetings. The members’ historic behavior makes sense because with their ownership, nothing is at risk. Deposits are insured up to $250,000, as with banks. What’s more, the member/owner “claim” to capital occurs only in the rare (if ever) case when the CU is liquidated (see footnote for discussion by the US Supreme Court).

We suggest a high standard of disclosure is achievable without stoking up “robust member debate” through “member to member communication”.

The proposed requirement also seems unnecessary since *post-merger, if a member becomes dissatisfied with her “new” CU; she has no shortage of alternatives and therefore is not “stuck”. (For perspective, see U.S. supply/demand information of banks and credit unions below).*

The introduction of “member to member communication” would likely have an unintentional chilling effect on the willingness of credit union “buyers” and “sellers” to seek each other out, a likelihood that seems seriously incongruent to the operating environment and the number of underperforming CUs, which we discuss later.

The CU industry would seem to benefit from *a more rigorous level of accountability for boards whose credit union has a history of performance indicating they are unable to deliver market level value, convenience and security for members*.

Please consider the following information in support of increased accountability for such CU boards.

Background

There is an oversupply of lenders in the U.S. when compared to other countries, which significantly distorts the pricing power in favor of consumers.

According to Sandler O'Neill research, there are 27, 624 people per bank and credit union in the U.S. The next closest country to the U.S. is Canada with over 54,000 and then Japan with over 84, 290 people per bank and CU. (For our market to reach the same relative capacity as Canada, the U.S. would need 6,000 banks and CUs (versus 11, 629 at year end 2016).

The market seems to be indicating that America needs fewer institutions as the following information implies.

American consumers, aided by technology, shop the oversupply for the best rates on both loans and deposits, which has led to a long-term and nefarious erosion of net interest margin.

Sandler O'Neill research indicates the aggregate group of CUs with assets less than $500M produces a negative .75 bps ROA when subtracting expenses from margin (before fees are added). This is a long-term trend dating back over 15 years and made worse by increased cost of compliance and technology. Unlike most industries, banks and CUs compete for a consumer's business on both sides of the margin; products offered (loans) and raw material (shares and deposits). This dynamic drives margin tighter from the bottom up (cost of funds) and the top down (yield on loans) and while exacerbated by the oversupply.

Although CUs are "not for profit", the reality is that profit pays for investment in products and services that members demand and can get from countless providers. CUs of all sizes are reliant on fees for aggregate net income and in many cases experiencing overall negative income. The net worth of these CUs is deteriorating and they are losing members. According to NCUA call report data, 51% of CUs had a net loss of members in 2016. We looked at metrics of the top 150 performing CUs based on growth in members and shares, among other things. The 5,735 CUs not in the top performing group had aggregate membership growth of .57% in the past 5 years while shares grew by less than 2% per year. Fifty-three percent experienced a net loss of members. For perspective, the aggregate member growth of the Top 150 was 45% and share growth was 54%.

1,411 CUs experienced a decline in equity, representing a removal of millions of capital dollars from the system.

A CU with little or negative growth signifies the consumer is not seeing the value that is readily available from other CUs or banks. Their board of directors can fulfill its fiduciary responsibility by seeking out a combination with a stronger credit union for its members. *Merger trends indicate that this rigor is missing and could eventually lead to a conundrum for the NCUA when strong credit unions decide against expending the effort to merge in a CU with little remaining capital.*

A healthy merger environment would make for an even healthier CU industry.

The U.S. has 11, 629 combined banks and credit unions totaling $22.7 trillion in assets. 16% of the banks and CUs (1,847) have assets greater than $500M and represent 95% of the total assets. These larger institutions are typically better able to spread their costs over more transactions and therefore generate income in ways smaller institutions cannot. However, while banks have been able to add scale through both organic growth and merger, CU merger activity has been limited to very small institutions and often only after much of the capital has deteriorated due to years of low or no profit and stagnant growth.

Larger CUs are at a disadvantage to banks due to the inability to grow thru merger; potentially resulting in many of the best credit unions becoming less competitive.

Since 1/1/10, merger of banks has increased every year totaling 1,696 banks for an average of over 200 banks per year. Total assets of the merged banks is $1.2T for an average asset size of $721.6M and a median asset size of $146.8M.

Voluntary merger of CUs are trending down:

Year	Number of Voluntary Mergers
2013	258
2014	262
2015	238
2016	200
Q1, 2017	43 (172 annualized)

The typical asset size of a merged CU in the last 10 years ranges from approximately $10M-$40M.

Rarely does a CU merger occur whose assets are greater than $100M (May 2017 saw three such mergers, however).

Going back further, the banking industry has more efficiently absorbed underperforming institutions:

There are 4403 banks with assets less than $500M (3% of total assets) and 5730 total banks.

There are 5379 CUs with assets less than $500M (26% of total assets) and 5899 total CUs.

Arguably, the overall competitiveness, safety, and soundness of the credit union industry would benefit from a more active merger environment that brings credit unions together for the benefit of both memberships. This would further fortify the already strong CUs by allowing them to keep pace with competition, while providing significantly better overall value for many members.

Conducting a competitive merger process that allows a CU to identify, evaluate and select a partner that already delivers better value and with a modern technology platform seems a mandatory requirement of CU volunteers. In a competitive process, where more than one CU is invited to offer a proposal, there exists a higher probability that members' interests can be further served. Mergers such as this would represent a win/win for their members and the industry as a whole.

(All data is from December; 2016 call reports of banks and CUs).

Footnote: First Federal Bank. In commenting, the OCC's brief refers to a U.S. Supreme Court decision addressing the nature of ownership in a mutual institution [Society for Savings v. Bowers, 349 U.S. 143,149-150 (1955)]:

"The asserted interest of the depositors is in the surplus of the bank, which is primarily a reserve against losses and secondarily a repository of undivided earnings. So long as the bank remains solvent, depositors receive a return on this fund only as an element of the interest paid on their deposits. To maintain their intangible ownership interest, they must maintain their deposits. If a depositor withdraws from the bank, he receives only his deposits and interest. If he continues, his only chance of getting anything more would be in the unlikely event of a solvent liquidation, a possibility that hardly rises to the level of expectancy. It stretches the imagination very far to attribute any real value to such a remote contingency, and when coupled with the fact that it represents nothing which depositors can readily transfer, any theoretical value reduces almost to a vanishing point."

The OCC also refers to previous cases:

"The mutual form of organization is an odd duck. Nominally the customers own the mutual, but it is ownership in name only. They cannot sell what they 'own,' and if they withdrew savings they receive only the nominal value of the account rather than a portion of the mutual's net worth, which is valuable to them only to the extent it permits the bank to pay higher interest. Ordower v. Office of Thrift Supervision, 999 F. 2d 1183, 1185 (7th Cir.1993)

"Although the depositors are the legal 'owners' of a mutual savings and loan association their interest is essentially that of creditors of the association and only secondarily as equity owners. Depositors' rights are circumscribed by statute and regulation. They are not allowed to realize or share in the profits of the association, but are entitled only to an established rate of interest. The depositors do not share in the risk of loss since their deposits are federally insured, and their only opportunity to realize a gain of any kind would be in the event the savings and loan dissolved or liquidated." York v. Federal Home Loan Bank Board, 624 F. 2d 495, 499-500 (4th Cir. 1980)