July 27, 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 NCUA's proposed rule especially the areas of improved transparency, greater opportunity for member to member communications and the expanded time for notice and deliberation.

One area that needs greater clarity however is NCUA's role in the overseeing the merger process. Today that oversight is largely ministerial (were forms properly completed?), review of the latest call reports and the most recent examinations. In the limited cases where we have reviewed the merger file, there appears to be limited documentation of any effort to review the assertions of the merging credit union, its due diligence, or even the necessity for giving up its independent operations.

NCUA's proposals to require greater transparency including a 24 month look back of board minutes for merger related items, will improve the opportunity for merger review.

However, if the new rule is merely a more detailed roadmap for the forms and disclosures necessary for regulatory approval, then individuals who want to game the system for advantage will continue to do so at the member-owners' expense.

We believe that NCUA's oversight role should continue to include reviewing the requirement that CEO's and directors have indeed fulfilled their fiduciary responsibility in this irreversible decision to surrender their credit union charter.

Today NCUA will only grant a new charter after years of effort, pages of documentation, commitments for funding and even then, often still further limit potential services through a letter of understanding if a charter is granted. This statement is not to critique NCUA's difficult chartering process, but rather to emphasize the extraordinary value of an existing, operating credit union charter. It's "replacement value" would easily cost in the millions of dollars.

Under the existing regulation that "license" can be surrendered with a minimum of ten day's board notice to the members –even though most charters have been active for fifty years or longer.

Moreover, the merger "option" can be manipulated by both boards and NCUA personnel to "solve a problem." Credit unions report that NCUA "encourages" mergers as a solution to worrying financial trends, CEO retirement and/or turnover, or other factors such as a lack of board involvement. These mergers decisions promted either examiner direction, or by CEO and board intent to shed responsibilities, are frequently listed factors motivating merger.

Both parties in these transactions, NCUA examiners and disinterested boards, have a responsibility to members to seek new leadership from within the credit union or the membership at large before the option of giving up the charter is considered a reasonable choice.

We believe the fiduciary responsibility of a board should be reasserted in the new rule. NCUA has issued a number of statements on the directors' duties, two of which are cited in the case study below.

However we believe that for this fiduciary responsibility to have effect, it should be explicitly stated as part of the merger review process. Specifically, in any proposed merger where the continuing credit union is booking a gain through "negative good will" then the burden of fiduciary disclosure should be accordingly more substantive. Giving away members' collective ownership, especially in the situation of a sound, well run credit union as described below, should always be subject to increased scrutiny.

We recommend that in the preamble or in the rule itself the following should be included:

1. NCUA reference and publish relevant fiduciary statements that directors and senior management should be aware of when considering a merger;
2. That NCUA provide no formal or preliminary merger approval until the member voting process has been completed, all required paperwork filed and any challenges or issues in connection thereto have been resolved.
3. That NCUA reserve the right to <u>not</u> approve a merger if it determines that a board or senior management have not fulfilled their fiduciary responsibilities.
4. NCUA's use of mergers as a supervisory action should be a last resort to resolve negative trends or other concerns about a credit union's sustainability.
5. When management or a board has fallen short in its fiduciary responsibilities, NCUA should first seek new volunteer and/or operational leadership versus the current tendency to seek out another credit union to absorb and resolve the problem;

In a market economy, the common wealth created by credit unions, can be a considerable temptation for those in authority to covet versus member-owners who have no organized voice . The credit union system cannot rely solely on the nobility of its leaders for proper behavior.

The success of the credit union cooperative system is important to the future wellbeing of tens of millions of Americans. That success however means credit unions may often work counter to the dominant market driven culture of profit making firms.

Credit unions have achieved unprecedented wealth and success because of our cooperative design intertwined with a legacy of values and member trust. Using mergers as a means to overcome temporary institutional shortcomings will only result in fewer credit unions able to demonstrate to members the relevance of their "counter-cultural" model.

Legal Heist Of $41 Million In Member Capital Shows Need For New Merger Rule

Summary: *Payouts to senior managers also show need for transparency after PenFed takeover of Belvoir FCU.*

The merger of Belvoir Federal Credit Union into Pentagon Federal Credit Union in early 2016 seemed to come out of nowhere, at least to members and movement stakeholders who weren't the senior managers receiving golden parachutes for handing over seven decades of building goodwill and cooperative capital.

On February 23, 2016, Belvoir's press release ballyhooed a new branch serving the Northern Virginia community, but that announcement made no mention of the merger notice signed by the Chair the next day.

It also took months of asking and Freedom of Information (FOIA) filings to pry loose what really happened. Here's the story, a cautionary tale why **more transparency is desperately needed, something the NCUA is now proposing to add to the merger process**.

The Source of the $41 Million

The February 2016 Special Membership Meeting Notice sent by Belvoir FCU's board chair announcing the credit union's intent to merge with PenFed included a combined statement of the two credit unions' financial condition as of June 2015. The merger adjustments included an entry for "negative goodwill" totaling $40.7 million which would be added to PenFed's balance sheet when the combination was completed.

This amount was the total of Belvoir's book capital plus additional gains from the estimated market value of its assets and liabilities. **This is what Belvoir FCU members paid PenFed** to have PenFed take control of their credit union in this so-called "voluntary" merger.

Unlike the sale of a bank where the owners are paid for their ownership plus estimates of future earnings value (real goodwill), the 27,458 Belvoir members at March 31, 2016, instead paid an average of $1,482 to join PenFed. This happened despite the fact that j**oining PenFed was always an option for any Belvoir member merely by purchasing one redeemable share.**

PenFed recognized this negative goodwill (or extraordinary gain) as "non-operating income" in 2016. It was used to pay PenFed's operating expenses, support the dividend and to add to retained earnings. Without this extraordinary income, PenFed's ROA would have been $41 million lower, or 69 basis points versus the reported 89 basis points. Even with this one-time revenue item, PenFed's gain in net income over 2015 was only $22.2 million, meaning a portion of the $41 million income was used to enhance PenFed's dividends.

HOW DID SUCH A ONE-SIDED DEAL GO DOWN?

How could such a transfer of member wealth from a sound, successful credit union with a 70-year operating history occur? What did the board tell its members? Was the NCUA involved? Are there lessons for other credit unions from this transaction?

A review of the public record and the FOIA file for the merger shows **Belvoir's board** did not consult or request member input, but rather **operated completely in secret** from board approval in August 2015 **until it sent out its required notice** to members of the special meeting to vote on the merger. That notice although **dated Feb. 24, 2016, was mailed March 11**.

On February 23, 2016, the day before the date on the Chairman's Members Meeting Notice, Belvoir issued a press release announcing its New, Modern Branch on the Fort Belvoir Base. The CEO is quoted, "We always look to bring the latest technology to our members. . .**these advancements enable Belvoir Federal employees to focus on service excellence** and promote greater communication between members and Member Service." Not a mention of the merger notice signed the next day by the Chairman.

By keeping the entire plan secret except to those benefitting directly and limiting member notice to a period of just two weeks, it would have been difficult if not impossible for members to have time to analyze or learn about other options.

The member notice, while lacking specifics was clear in its recommendation: "I am pleased to inform you that we are proposing to merge Belvoir FCU into Pentagon FCU (PenFed). In today's ever-changing economy, our Board of Directors evaluated strategic possibilities to assure you, our member, receive the full range of products and services you deserve. After considering alternatives, we determined that a merger with PenFed is in the best interest of the members."

No specifics, no mention of alternatives, no recognition of the unique market niche and three generations of member loyalty since the doors were opened 72 years earlier.

Moreover, the FOIA merger file shows only a two-sentence so-called "merger agreement" and a merger "plan" that just recites the general capabilities and history of PenFed.

There is no documentation of either the board's or managers' due diligence in fulfillment of their fiduciary responsibility.

So, what was the driving force **behind this merger**?

NCUA FORCES DISCLOSURE OF PAYMENTS TO SENIOR STAFF

Reinforcing this insider-arranged sale: **The CEO would receive a bonus of $250,000; the CFO and COO payments of $125,000 each,** upon the merger's approval. These disclosures were added to the official notice only after the NCUA insisted they be put in the required mailing.

What was not disclosed, however, were any promises to pay other staff bonuses upon approval of the merger or employment guarantees which PenFed did disclose in subsequent mergers with other credit unions. These additional payments would be in the millions.

Read more about PenFed's merger disclosures in this look at its takeover of Miramar Federal Credit Union in California.

Seven months following the May 1, 2016, merger date the board chair of now-defunct Belvoir FCU was named to PenFed's board.

MANAGING THE VOTE

By keeping the process secret, Belvoir's board and senior managers were able to control the discussion and messages sent to members. Nowhere in the announcement was a comparison of rates, products, or services provided. The notice gave lists of general PenFed services and its "low loan rates" and a description of PenFed's distribution system including its "36 worldwide branches."

There was no description of PenFed's business model including its "Drive to 75" ambitions — its plan to grow from $17 billion to $75 billion in assets by 2025 — and how PenFed's products and services would compare with Belvoir's five-branch, locally focused, high personal service approach.

Nowhere was there a description of what might be lost in the merger. For example, Belvoir offered member business loans, which PenFed does not offer, and which were sold prior to the merger. It offered courtesy pay and a much-broader credit underwriting approach. PenFed's policies and business strategy are much different than Belvoir's, which listed 189 local businesses and employee groups in its FOM.

One example of these policy differences is that Belvoir's mortgage loan portfolio as reported in the HMDA data had twice the level of CRA qualified loans (income at 80% or lower of the median income in the MSA) than did PenFed's. For the most recent year's data, 2015, 18% of Belvoir's mortgages were CRA eligible versus 9% for PenFed.

Further there was **no explanation of why PenFed which at $21 billion, or 63 times larger than Belvoir, would be able to provide better personal service**. On Jan. 29, 2016, or a month prior to the merger announcement, Belvoir was named one of the best places to work in Virginia for the third consecutive year.

Even with this very one-sided, time-restricted voting process, **the members voted against the merger at the required special meeting on March 30.** Unfortunately, that result was overwhelmed by the ballots submitted where members relied on the notice information. For if a member trusts the credit union enough to send their money to it, why should they not believe the Board when the recommendation is to close up the shop?

What PenFed Gained

In the March 31, 2016, press release announcing the merger vote, **PenFed made clear what it was gaining** in this transaction:

"PenFed expands its field of membership to include the Fort Belvoir military community which . . . is home to some of the top national defense organizations. . .The largest employer in Fairfax County, Virginia, Belvoir boasts twice as many employees as the Pentagon. PenFed also gains an employee team that is dedicated to member service, five convenient branch locations, and an outstanding membership base focused on America's national security." In other words, PenFed bought from Belvoir management **the exclusive on-base right the Defense Department grants to serve this massive, important military installation and its civilian community.**

Belvoir's board and management, while responsible for their members' "best interests", also transferred $41 million in collective book and market value in addition to the unique franchise opportunities described above. The members received nothing.

How did such a transaction ever get past the NCUA and its oversight of member interests and consumer rights? How could this event pass any standard of fiduciary duty by either Belvoir or PenFed's leadership?

A Blind Eye or Dereliction of Duty?

When a Belvoir member who joined in the mid-1960's received the FOIA merger file **(after nine months and multiple requests),** he wrote a request that PenFed disgorge its wrongful gain. The NCUA replied:

"(we) reviewed the materials submitted . . .and determined that the merger's disclosures and procedures complied with applicable NCUA regulations."

NCUA further stated that once NCUA regulations are met, "there is ample room for the application of business judgment, both by management of the respective merger partners and by members of the merging credit union. . ." As if the members of the merging credit union were given any information upon which to make an informed "business" judgment.

In other words, the transaction was legal even if it was corrupt. The outcome is that Belvoir's owners lost everything created by three generations of members.

But this was not the standard of fiduciary "business judgment" that NCUA had previously declared.

In prior opinions NCUA has been explicit in some of its statements of fiduciary responsibility by directors and senior managers. **Two such statements are especially relevant in this context**:

1. In a February 2011 letter to federal credit unions (11-FCU-02), the NCUA stated what the duties of directors' entails:
   - "Directors must always focus on the best interest of the membership as a whole;"
   - "The requirement for "reasonable inquiry" means that the more complex a decision, and the more important the decision is to the financial interests of the members, *the more due diligence the directors need to do in an attempt to make a good decision." (emphasis added)*
2. The General Counsel letter of March 15, 2011, directly addresses the central issue of fiduciary responsibility in Belvoir's board's merger recommendation: "We believe that fiduciary duties are properly owed to people and not to entities … the danger is that, if the directors are allowed to focus only on the credit union when making a decision — without regard to how the members are affected — *the directors can justify making self-serving decisions, or decisions that serve primarily the FCU's insiders, under the guise that the directors are simply doing what is best for the credit union.*" (emphasis added)

Were NCUA employees negligent in overseeing these fiduciary standards the agency's General Counsel had clearly promulgated? Have the current merger practices of some credit unions become simply a market place assault by the more powerful under the cover of regulation?

Making A New Rule Matter

The difficulty of a new, more transparent rule is that for those who want to game the system, the new regulation can just become a more involved roadmap. The maneuvering outlined above undermines both the values and principles that cooperatives depend upon for stewardship of common wealth.

Credit unions are designed to be an alternative to the profit-driven ambitions of other financial institutions. **Member-owner interest must be the dominant consideration if** credit unions want to continue to claim a special role in the marketplace.

Cooperative design depends on principled leaders. The credit union system cannot be financially prosperous and morally bankrupt.

If the new rule merely provides boards and CEOs better guidelines for self-dealing, then **no rule is going to eliminate tragedies such as the Belvoir merger.** Boards, senior managers, and NCUA must recognize that "fiduciary duties" are meaningful even if they can never be fully codified by rule.

Just as terms like democracy and justice and freedom are always being reviewed against events, so too must the cooperative structure be constantly defined and defended. Credit unions are a powerful and successful system that operates alongside the market economy. Even with good intentions, **credit unions are always at risk of betraying their mission to gain the tempting rewards of the for-profit sector**.

Credit unions have shown time and again that they can survive adversity. But the real test of their character is how they use their success. Will it be to seek institutional glory and personal gain or to further the member-owners' well-being? **The Belvoir-PenFed merger is, I believe, an example** of two credit union boards and senior managers who have forgotten what the cooperative model means and requires.