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LEGAL UPDATES AND NEWS

NCUA Proposes Process and Procedures For Reviewing and Approving Credit Union Acquisitions of Banks and Other Non-Credit Unions

The National Credit Union Administration (the "NCUA") recently issued a notice of proposed rulemaking (the "Proposed Rule") that prescribes procedures for reviewing and approving acquisitions by federally-insured credit unions ("FICUs") of banks or other non-credit union financial institutions (whether by merger or purchase of assets and assumption of liabilities), which are referred to by the Proposed Rule as "combination transactions." The NCUA will issue its final rule after reviewing all comments submitted on the Proposed Rule, which is subject to change.

I. Background.

Acquisitions by credit unions of banks have become much more common over the last few years. The NCUA noted that there were 15 NCUA-approved combination transactions in 2019 and 17 combination transactions pending its approval for 2020, which is a substantial increase from prior years. Although Section 205 of the Federal Credit Union Act (the "FCU Act") permits FICUs to engage in combination transactions, the NCUA has not, prior to the Proposed Rule, issued specific rules governing the regulatory approval process of combination transactions due to (until recently) their infrequency and, instead, evaluated each transaction informally on a case-by-case basis.

The Proposed Rule attempts to provide greater clarity of the NCUA's process and procedures for reviewing and approving combination transactions. Specifically, the Proposed Rule: (1) stipulates the information about the proposed combination transaction that must be provided to the NCUA; (2) provides that all combination transactions require the prior approval of the NCUA and, for state-chartered FICUs, the prior approval of their state regulators; and (3) ensures that the directors of the FICU proposing a combination transaction understand the nature and ramifications of the transaction.

II. Summary of Material Provisions of the Proposed Rule.

Definition of a Combination Transaction. The Proposed Rule provides that a "combination transaction" includes: (1) a merger or consolidation with a non-credit union, where at least one entity's charter is extinguished in the transaction; (2) the assumption of liabilities from a non-credit union; or (3) the transfer of assets to a non-credit union in consideration of the assumption of certain of its liabilities.

A "combination transaction" would not, however, include other types of transactions, such as mergers between FICUs, mergers between FICUs and noninsured credit unions, FICU conversions to banks, the merger of a FICU into a bank and FICU purchases of loans that are not part of a merger or consolidation. These transactions would not be governed by the Proposed Rule and remain subject to existing applicable NCUA rules and regulations.

Approval Required for Combination Transactions. The Proposed Rule requires that the FICU's board of directors approve a proposed combination transaction before the FICU submits an application for regulatory approval, which ensures that the board is adequately informed about the transaction.

The prior approval of the NCUA and the FICU's state regulator (if a state-chartered FICU) is also required before a FICU may engage in a combination transaction. The Proposed Rule cites six factors that the NCUA must consider in evaluating a combination transaction. The first four factors relate to safety and

soundness, such as: (1) the history, financial condition and management policies of the credit union; (2) the adequacy of the FICU's reserves; (3) the economic advisability of the transaction; and (4) the general character and fitness of the FICU's management team. The last two factors require the NCUA to consider: (1) the proposed transaction's effect on FICU members and potential members; and (2) whether the proposed transaction is in keeping with the FICU's mission. The NCUA indicated that the failure to satisfy these two requirements may result in the rejection of the proposed transaction, even if there are no safety and soundness concerns.

Submissions to the NCUA. In order for the NCUA to properly evaluate the combination transaction, the Proposed Rule requires that the applying FICU must, as part of the application package: (1) address how it plans to make non-credit union customers FICU members; (2) provide basic information about the transaction, such as balance sheet and income statements for both institutions, the impact of the transaction on the FICU's net worth, information about the FICU's due diligence of the proposed transaction, including an analysis to support the proposed transaction price and a summary of delinquent loans and the adequacy of the FICU's allowance for loan and lease losses; and (3) a list of the target bank's assets that would be impermissible for the FICU to hold under the FCU Act or state law, with a plan for disposing these assets.

In addition, each member of the FICU's board of directors must certify to the NCUA that the FICU's management team explained how the combination transaction will affect the FICU's net worth and balance, as well as how the FICU determined the purchase price, and how the transaction would be beneficial to current members and prospective members gained in the transaction. Moreover, each director must certify he or she does not have a personal or financial interest in the transaction.

Insurance of Deposits. An FICU proposing to engage in a combination transaction must demonstrate that any customer deposits assumed as part of the transaction ("transferred deposits") will be insured by the National Credit Union Share Insurance Fund ("NCUSIF") immediately upon the transaction closing. For banks selling to credit unions, the Federal Deposit Insurance Corporation ("FDIC") will not approve the transaction unless it determines that the transferred deposits will have immediate NCUSIF coverage. The Proposed Rule notes that transferred deposits will immediately be insured by the NCUSIF in any of the following instances:

(1) The FICU has a low-income designation, which means it can immediately insure the transferred deposits (up to 20% of its total shares) even if the depositors are not within the FICU's field of membership or, if they are within the FICU's field of membership, do not consent to become members of the FICU prior to the transaction closing.

(2) The transferred deposits are from a public unit (i.e., the United States or any state) or a political subdivision thereof.

(3) A federally-chartered FICU without a low-income designation demonstrates that the depositors of the acquired bank have satisfied the two-step process for becoming members of the FICU. The first step is that the depositors are within the FICU's field of membership. The second step is that the depositors have affirmatively approved to become members of the FICU, which may be satisfied either through an authoritative vote or by individual consent (the "affirmative approval rule"). In the case of a vote, the acquired bank's regulator, charter and bylaws must permit such a voting process, in which case the vote of a certain percentage of depositors will demonstrate affirmative approval for all affected depositors in satisfaction of the second step without an affirmative act by each individual.

(4) For a state-chartered FICU, its state regulator provides a statement confirming that customers of the acquired bank will be members of the FICU at the transaction closing under relevant state law and policy. Certain state regulators have been less restrictive than the NCUA regarding membership and have allowed customers of the acquired bank to become members of the FICU at the transaction closing without satisfying the second step of the affirmative approval rule.

III. Observations and Planning Considerations

Observations. While it is welcomed news that the NCUA is proposing a formalized process for evaluating combination transactions, we believe certain changes to the Proposed Rule are warranted based on our experiences with these transactions. First, the NCUA should strongly consider allowing depositors of an acquired bank who are within the FICU's field of membership as of the transaction closing to immediately become members of the FICU, without regard to satisfying the affirmative approval rule. Based on our discussions with FDIC staff, the FDIC will not allow a stock bank to conduct a vote of its depositors to satisfy the affirmative approval rule because, in their view, there is no legal basis for such a vote since depositors have no voting rights in a stock bank. As a result, the affirmative approval rule is drafted in a way that could make it very difficult for a federally-chartered FICU without a low-income designation to acquire a stock bank because obtaining the required individual consent of each depositor prior to the transaction closing may be too burdensome or impractical depending on the size of the acquired bank.

Second, to be consistent with the FDIC's timeframe for processing bank merger applications, the NCUA should consider imposing a time limit of 60 days (or 45 days through expedited procedures) to process a combination transaction. The NCUA acknowledged that the Proposed Rule does not impose a limit on the length of time it may take to consider a combination transaction, as the NCUA prefers to evaluate the transaction without a deadline.

Lastly, the NCUA should designate a specified time frame or grace period following the transaction closing for FICUs to resolve or bring into compliance any non-conforming assets and liabilities of the acquiring bank, such as non-conforming loans or conforming loans that would result in the FICU exceeding its member business lending cap, or the need to eliminate certain municipal or brokered deposits. Although not contemplated by the Proposed Rule, the NCUA has, in the past, granted an FICU 180 days to restructure or sell any non-conforming loans and 90 days to dispose of non-conforming deposits received from the acquired bank.

Planning Considerations. Given the unique issues of credit union acquisitions of banks, credit unions seeking to acquire banks should consider the following:

(1) Assess whether their charter and field of membership is optimal to acquire a bank. For example, a federally-chartered FICU should consider converting to a state-chartered FICU, particularly if its state regulator would allow eligible depositors of the acquired bank to immediately become members of the FICU at the transaction closing without having to satisfy the affirmative approval rule. A credit union not subject to the affirmative approval rule would be a more attractive buyer to a selling bank, as this would streamline the process for depositors to become members of the FICU and reduce the time, cost and execution risk of the transaction.

(2) Prior to signing a definitive agreement, identify and formulate a plan to address customer retention and field of membership issues and the potential impermissible assets, liabilities and activities of the bank. A credit union should consider meeting and having informal discussions with the NCUA and, if applicable, its state regulator about its proposed plan and assess the feasibility of the plan, including the restructuring of non-conforming assets and liabilities, to ensure that the purchase price is commensurate with the assets and liabilities of the acquired bank that will actually be transferred or assumed.

(3) Because the Proposed Rule mandates that the board understand the nature and ramifications of a combination transaction, it is important for the board and management to consider: (a) the manner in which the transaction will be structured and its effects; (b) the regulatory approval process required to complete the transaction, including the process applicable to the target bank, and any potential transaction risks or hurdles; (c) the impact that corporate taxes, the cost of liquidation of the target bank and the redemption of certain impermissible assets and liabilities, such as trust preferred securities and subordinated debt, may have on the purchase price; (d) whether the proposed purchase price is appropriate in consideration of potential competing bids and market conditions generally; and (e) the credit union's post transaction liquidity and capital positions after the reduction of net worth following the payment of the purchase price and how field of membership issues and impermissible assets and activities will be addressed.

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