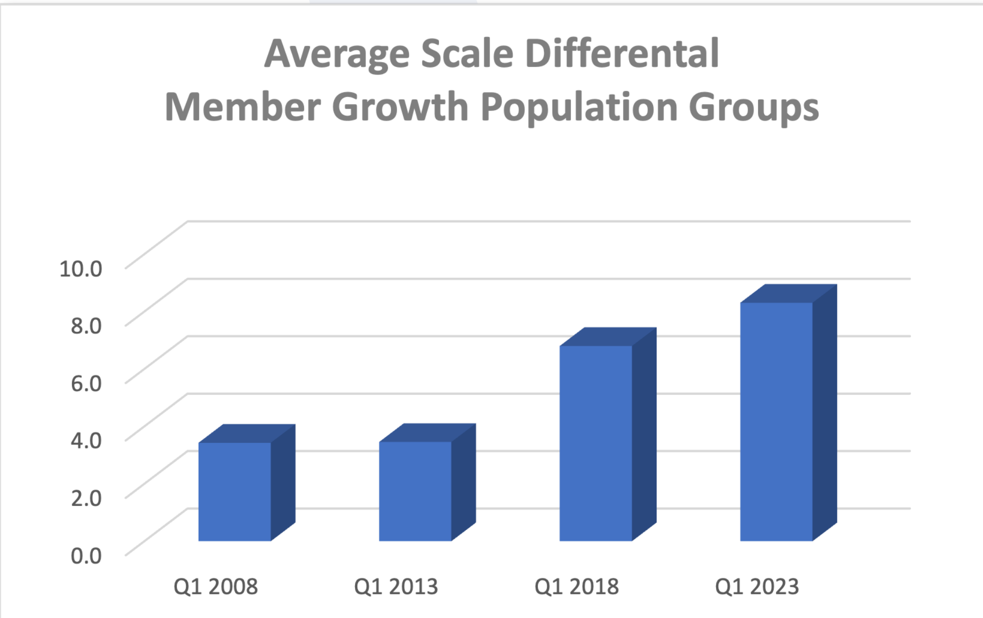
A Compendium for Merging Credit Unions

What is there to gain? What is at stake?

The pace of consolidation in the credit union industry has accelerated since 2020, as a confluence of factors continues to pressure small financial institutions. These factors include (1) increasing competition from nonbank financial institutions, (2) shifts in consumer preferences that demand maximum convenience and digital technology, and (3) difficulty succeeding an aging leadership.

A study of industry membership growth indicates that an element of scale is becoming a requisite quality for competitiveness in most markets. By Q1 2023, over half of the credit unions in the country had fewer members than five years ago. The average asset size of the 2,491 credit unions with negative member growth over that period was $103 million. By contrast, the average asset size of the 2,312 credit unions with positive member growth over the same period was $855 million, over eight times larger.

The size discrepancy between credit unions with negative and positive member growth has been increasing dramatically over the past two decades. For instance, over the 5-year period ending Q1 2008, about 43% of such credit unions experienced negative member growth with the average asset size of such credit union at about $63.5 million. Adjusted for inflation, the asset size equates to about $90 million in today's dollars. However, today's credit unions that achieved flat to positive member growth in the earlier period had an average asset size of $218 million, equating to about $318 million in today's dollars. The size differential among the same universe of credit unions with negative versus non-negative member growth in the earlier period was just less than a factor of 3.5 times.



Source: National Credit Union Administration. *5300 Call Reports.*

Given today's market conditions, balance sheet growth is quite expensive, with the average cost of funds in the credit union industry more than doubling in the last two quarters (from 0.58% at Q4 2022 to 1.32% at Q2 2023). To find more scale, credit unions will look for merger partners. Historically, the challenge for strategic mergers among credit unions has been the degree of one-way traffic, with most credit unions insisting on being the continuing credit union in any merger.

When we chart the size differential between the groups with negative and non-negative member growth over the successive five-year periods between Q1 2003 and Q1 2023, we observe a dramatic increase in the amount of scale required to achieve positive member growth.

Our thesis is simple:
The size and shape of today's market and the macroeconomic backdrop offer those credit unions that proceed strategically (1) much to gain as the merging credit union, (2) significant flexibility to protect their interests in a combination, and (3) ample opportunity to influence the combined credit union in the future by planning and negotiating shrewdly.

We suspect too, that this formula is not likely to hold in perpetuity.

What does a merging credit union have to gain from a merger transaction?

The merging credit union is a sought-after commodity within the industry. A merging credit union with reasonable financials, strong member relationships and/or a unique foothold in small target markets possesses considerable negotiating leverage when asserting itself proactively in a consolidating market. These credit unions will likely find multiple suitors willing to engage in flexible dealmaking to craft an arrangement in the interests of the merging credit union and its stakeholders.

There are many available benefits for members, employees and the communities of a merging credit union that may accrue from a well-orchestrated merger. A review of the potential benefits is summarized below:

Benefiting Members

There is much that may be gained for members of a merging credit union in a carefully planned combination. Members stand to benefit from a properly executed merger transaction in several potential ways.

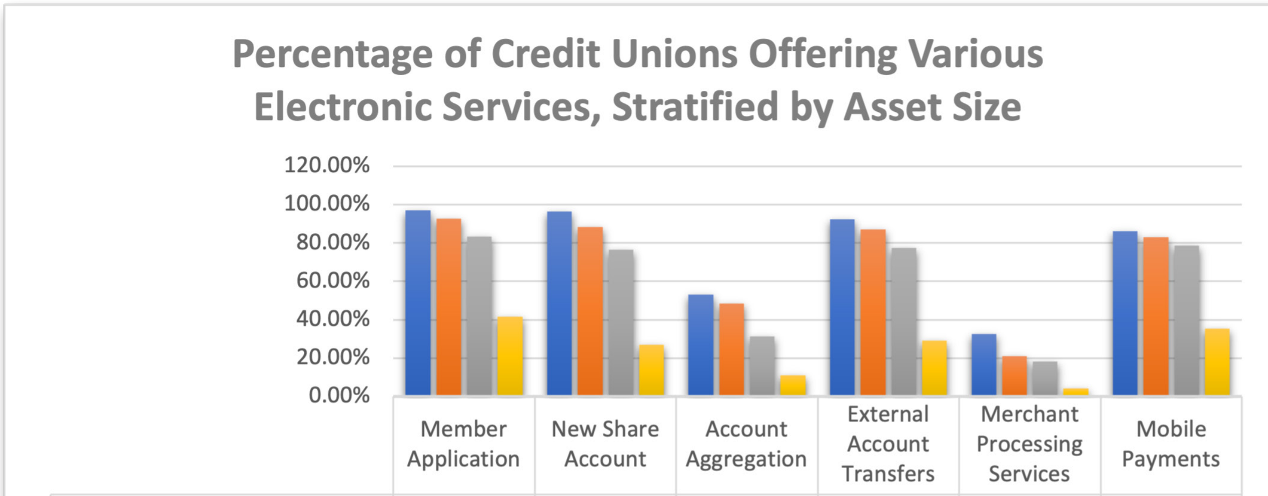
Infrastructure and Convenience:

Upon a successful merger, members are typically incorporated into a combined credit union with a more expansive network of branches and ATMs and an expanded geographical footprint.

The integration of the merging credit union's existing branches into the branch network of the combined entity is often a negotiated point. However, motivated merger partners in the context of strategic merger dealmaking are often willing to offer a substantial commitment with respect to the ongoing operation of the merging credit union's existing branches. Such terms may be critical to members' perception of the transaction. Of course, a merging credit union is far more likely to secure such commitments in a strategic merger, rather than a transaction born of necessity.

During the pandemic, consumers of every age demographic became more acquainted with the conveniences of today's digital banking technologies, as the disruption accelerated adoption of remote banking among the population. Consequently, the quality of the digital banking experience has emerged as a crucial factor for member satisfaction. It follows that one of the primary benefits that may be achieved through a merger involves enhancement of digital banking capabilities.

As a general rule, credit unions with more scale possess more technological capabilities and can deliver a wider array of electronic services. The NCUA tracks various categories of electronic services offered to members in quarterly reporting required of credit unions. According to such data, provision of the most progressive digital capabilities such as (1) electronic membership application and new share account processing, (2) account aggregation visibility, (3) external account transfers, (4) merchant processing services and (5) mobile payments all tend to favor larger credit unions. As illustrated in the chart below, the percentage of credit unions offering two various electronic services increases progressively with asset size.



	Member Application	New Share Account	Account Aggregation	External Account Transfers	Merchant Processing Services	Mobile Payments
Greater than $1 Billion	97.22%	96.53%	53.01%	92.59%	32.64%	86.34%
Between $500M and $1 Billion	92.78%	88.32%	48.45%	87.29%	20.96%	83.16%
Between $500M and $250M	83.42%	76.38%	31.16%	77.39%	18.09%	78.64%
Less than $250M	41.67%	26.92%	11.08%	29.05%	3.98%	35.17%

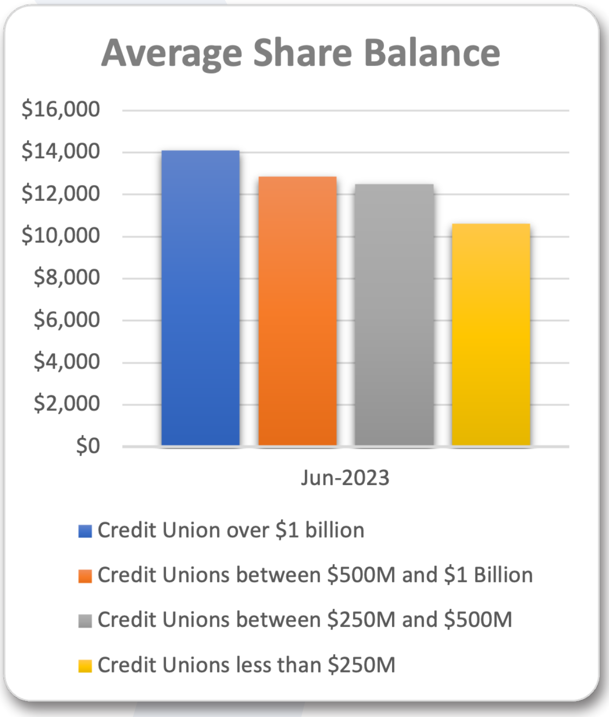
Source: National Credit Union Administration. 5300 Call Reports.

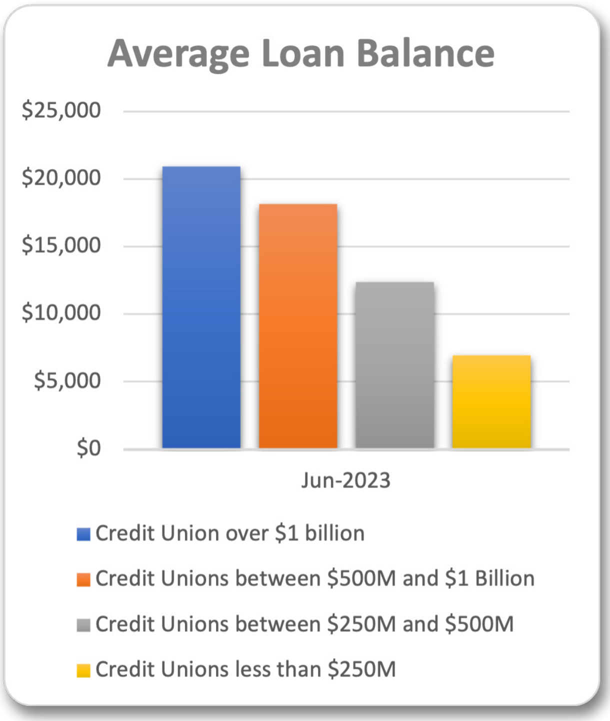
It makes sense that credit unions can more easily leverage their scale to employ the most state-of-the-art remote banking technologies. They are also in a better position to invest in offering members 24/7 customer service, a common feature of the highest quality banking service.

By combining with a merger partner to become part of a financial institution with more scale, members of the "acquired" credit union will often benefit from a more advanced panoply of digital capabilities and services.

Products and Services:

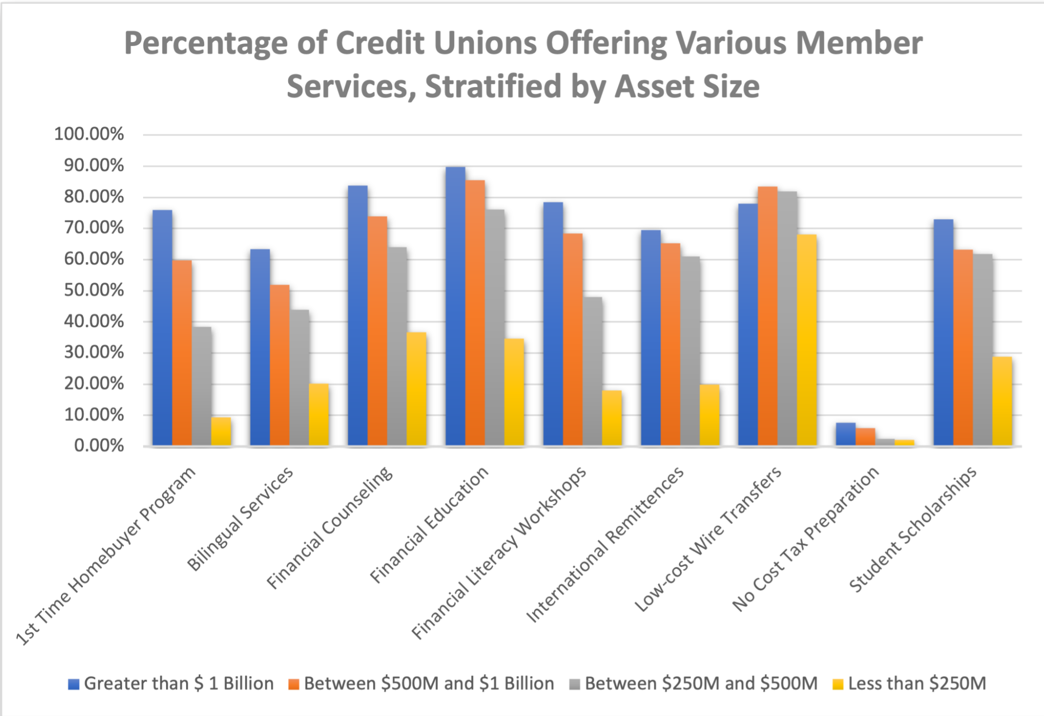
Members also stand to benefit from a successful merger transaction by receiving access to a broader set of products and services at the combined credit union. Because credit unions tend to offer a more expansive selection of products and services as they gain scale, they typically achieve a greater share of members' wallet as they grow. This reality is observable in the disparities in average deposit and loans balances across credit unions of different sizes.





Source: National Credit Union Administration. 5300 Call Reports.

The wider expanse of services at larger credit unions also extends to related financial and developmental services. According to NCUA data, provision of a variety of financial and development services such as (1) first time home buying assistance, (2) bilingual services, (3) financial counseling, education materials and literacy workshops, (4) international remittances, (5) low-cost wire transfers, (6) no cost tax preparation, and (7) student scholarships tend to favor credit unions with more scale. As illustrated in the chart on the following page, the percentage of credit unions offering such services increases with asset size. Many of these services are critical to low- and moderate-income members, as well as underserved communities.



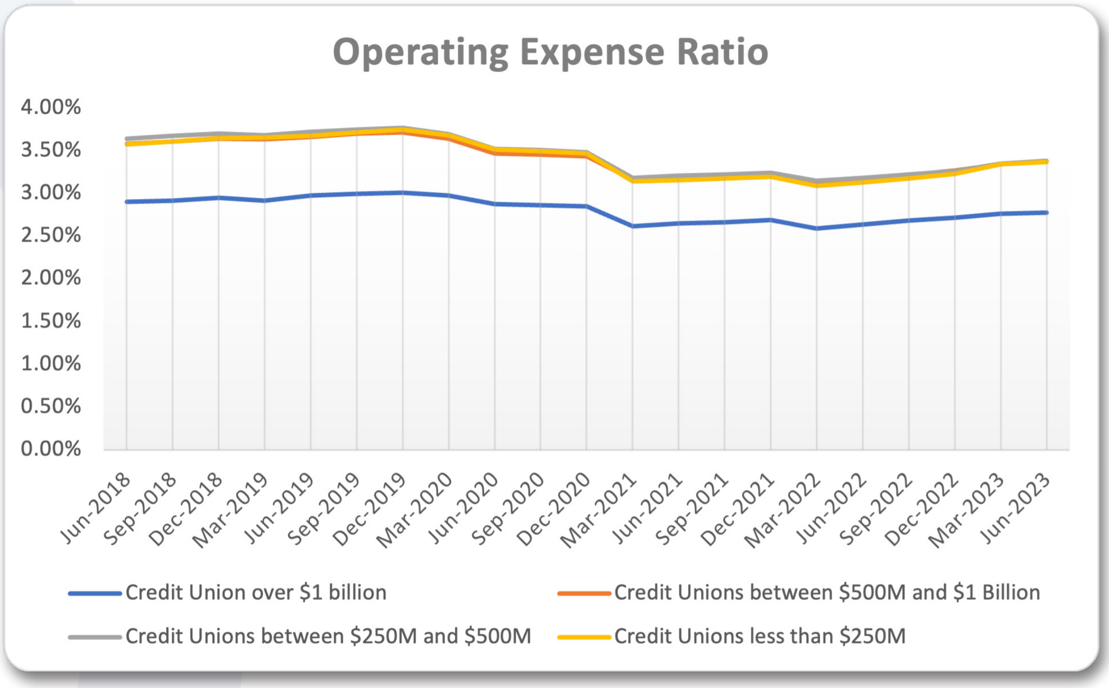
Source: National Credit Union Administration. *5300 Call Reports.*

Larger credit unions also tend to employ more advanced data technologies, resulting in better communications with members. Larger credit unions also tend to introduce more relevant products and services, resulting in deeper member relationships and a higher degree of member satisfaction.

By combining with a merger partner to become part of a more robust financial institution, members of an "acquired" credit union will often benefit from access to a more expansive menu of products and services and enjoy greater interaction resulting from relevant, data driven communications.

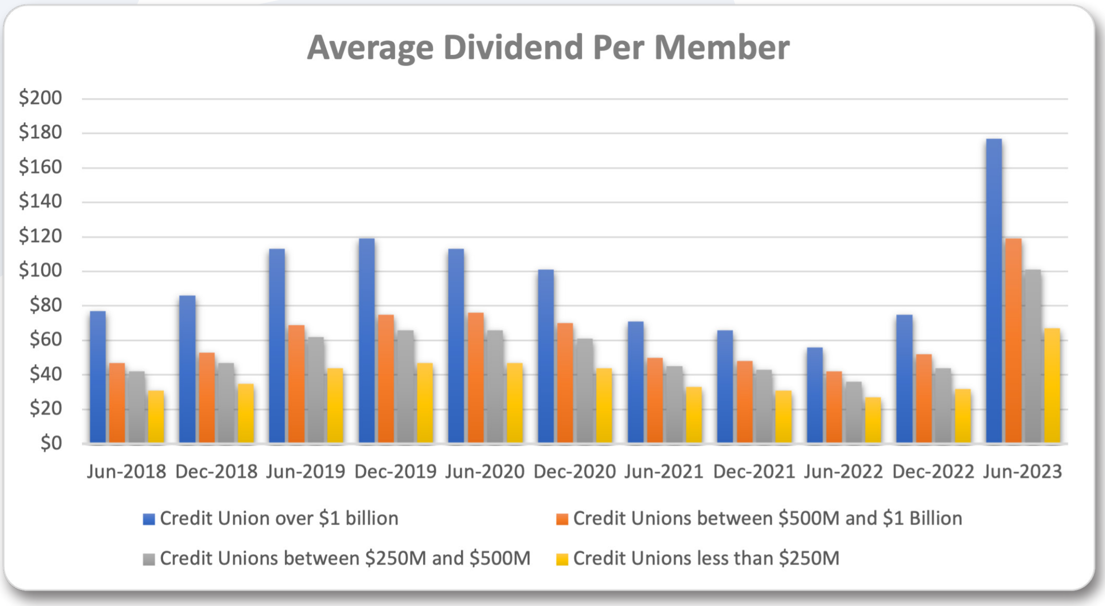
Economic Return to Member:

Economies of scale also allow larger credit unions to operate with more efficiency, despite investing more heavily in technology and services. This translates into lower Operating Expense Ratios and higher Returns on Assets.



Source: National Credit Union Administration. *5300 Call Reports.*

The Return on Assets advantage of larger credit unions tends to be a fraction of the advantage they enjoy in operating expense efficiency. For instance, at Q2 2023, credit unions with over $1 billion in assets reported an average ROA between 7 and 15 basis points higher than smaller peer groups, compared to an OpEx ratio advantage of 60 basis points. We surmise that a significant portion of the efficiency advantage is distributed to members in various forms of return to member. We find confirming evidence for our hypothesis in a comparison of average dividends paid to members across credit unions in different categories of asset size.



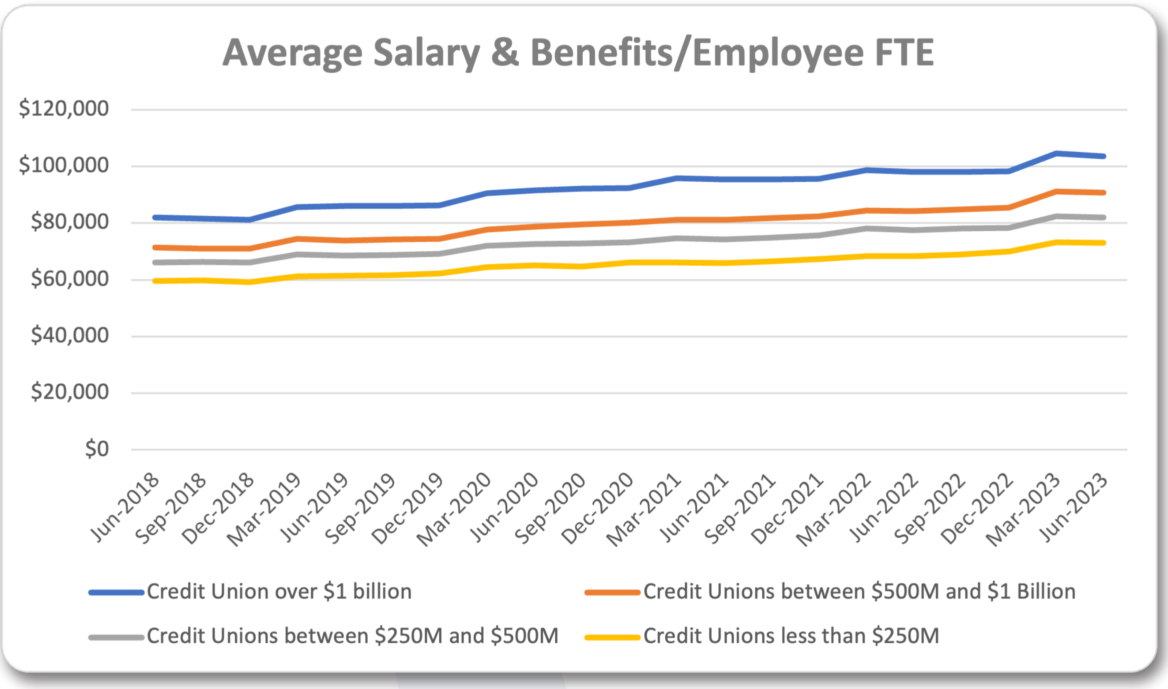
Source: National Credit Union Administration. *5300 Call Reports.*

Time and again, industry data support an intuitive conclusion:
The formation of credit unions with larger scale through strategic merger combinations offers several objective benefits for members.

This is especially true in respect of carefully selected, prudently executed, and fully negotiated merger transactions.

Benefiting Employees

The credit union's employees are the next cohort of merging credit union stakeholders that may gain substantially from a strategic merger. Here, the potential benefits are straightforward. First, the average compensation and benefits at larger credit unions tends to be more generous. This is easy to recognize in the data where greater economies of scale translate into more competitive employee compensation.



Source: National Credit Union Administration. *5300 Call Reports.*

Naturally, larger organizations also tend to offer high performing employees more opportunities for career advancement. There are simply more managerial roles and executive positions to offer. In a similar fashion, larger credit unions typically dedicate more resources to the training and professional development of staff in order to groom more employees for management and to instill firm culture across the organization. At bigger firms, opportunities for professional development can often include educational assistance for professional certifications and advanced degrees.

Of course, the integration of the merging credit union's employees is one of the most highly negotiated points of any merger transaction. Again, those merging credit unions asserting themselves proactively are more likely to secure the best terms for their employees, including (A) full integration into existing compensation and benefits structures, (B) protection from layoffs for a specified period, and (C) meaningful executive positions.

Benefiting Communities

The surrounding communities are also affected by any credit union merger. Credit unions typically cherish the role of a community financial institution, making meaningful contributions to community development in their local markets. These contributions may take the form of sponsorship for community events and venues, philanthropic support for local causes, in-school branches, financial education workshops, and partnerships with non-profit organizations and local governmental agencies on joint initiatives. We work with credit unions of all sizes that are admirably dedicated to such efforts. The Department of Treasury's CDFI Fund, for example, has certified over 500 credit unions as Community Development Financial Institutions.

A merging credit union will likely find that much can be gained in the community realm from a strategic merger. Larger credit unions often demonstrate as much commitment to community development as their smaller peers. In fact, many leverage their advantage in terms of scale and resources to hire teams of community development professionals to lead and organize community programs and initiatives. Larger credit unions often sponsor charitable foundations to professionally organize and scale philanthropic programs. The professional marketing operations of larger credit union may also effectively promote partnerships with non-profit organizations to boost the profiles of such organizations and inform target markets. In sum, the advantage of greater economies of scale can empower more expansive community development efforts.

To secure such benefits in a merger transaction, a merging credit union should carefully seek out merger partners that share a similar commitment to community development. The merging credit union can negotiate for explicit commitments to foster community development initiatives in the communities most relevant to it. These negotiations may also seek to insert leaders of the merging credit union in roles at the combined credit union that will direct and influence such efforts.

What is at stake for a merging credit union?

There are many potential benefits of a well-orchestrated merger transaction that may be achieved by a merging credit union as described above. Yet, our experience tells us that small and mid-size credit unions rarely proactively seek out such arrangements. More often, it is the onset of difficult conditions that compel a credit union to action, but such conditions also tend to compromise its negotiating leverage.

We surmise that Board members and leaders at such credit unions shy away from merger discussions for two primary factors:

1. hesitancy to relinquish control of the credit union to others who may not share the same commitment to their members, and
2. sentimental attachment to the legacy of the merging credit union.

These concerns may be addressed through careful selection of a merger partner and active negotiation of the merger transaction.

In the first instance, a merging credit union should proactively seek out and engage with those credit unions that show outward signs of shared culture. This may include similar membership affinity groups, geographical markets, commitments to community development, specialty loan products or other unique attributes. Initial discussion ought to craft a shared vision for the combined credit union that demonstrates the value of the merging credit union and its members in such a vision. The merging credit union may negotiate for arrangements whereby its representatives may influence the conduct of the combined credit union within its local market. Such arrangements may take the form of a task force or advisory committee, or even Board representation at the combined credit union. Lesser or regional membership committees may be formed to guide integration matters or important initiatives in the merging credit union's market. Such committees may be populated with representatives of the merging credit union. Local member committees can be an asset to the combined credit union by providing its executive leadership with guidance directly from the ground of newly acquired markets that might be otherwise less familiar to it.

"The key to successfully addressing these considerations is for the merging credit union to act from a position as a strong and desirable merger partner so it may engage in negotiations with optimal leverage."

In the second instance, various approaches may be adopted to preserve or incorporate the legacy of the merging credit union into the combined entity. The continuing credit union can preserve the branding of the merging credit union and celebrate its heritage by operating it as a division. This approach is becoming more common in recent years. In 2022, Credit Union 1 in Illinois entered the southeast market by announcing a merger with Emory Alliance CU in Georgia. The parties elected for Emory Alliance Credit Union to keep its name and operate as a Division of Credit Union 1 to maximize the partnership with Emory University and Emory Health Care Network, the second largest employer in the Atlanta Metropolitan area. A variation of this approach was implemented by Nuvision CU in California when it merged with Denali FCU, the third largest credit union in Alaska in 2018. Today, Nuvision does business in the Alaska market as "Nuvision Alaska" and an image of the Denali Mountain features prominently in Nuvision's local branding.

Merger parties may also agree to cooperate on a rebranding initiative related to the merger. Several merger transactions have been followed by a related rebranding of the combined credit union. For instance, two multi-billion-dollar credit unions in New York combined when CapCom FCU merged with SEFCU in August 2022. The combined entity rebranded itself as "Broadview FCU" to reflect its wide multi-SEG field of membership. Broadview's total membership exceeds 469,000 members, the second largest membership among credit unions in the Empire State. Global CU in Washington combined with a much larger credit union when it merged with AlaskaUSA FCU in August 2022. In April 2023, Alaska USA rebranded itself as Global Credit Union, adopting its merger partner's name to reflect the combined credit union's significant geographical and market span.

Where a merging credit union is willing to explore merger arrangements and engage in dealmaking, parties will often find that creative arrangements may be formulated to address various concerns and honor the legacy of the merging credit union. The willingness of parties to cooperate in such a way provides an early signal to the merits of the combination. Therefore, such concerns ought to form objectives for merger dealmaking, rather than reflexive antipathy for it.

Conclusion:

Whether maximizing the interests of its members, its employees, its communities, or its heritage, a merging credit union acting proactively has significant opportunity to form an arrangement that fits its needs. A strategic, proactive approach can incorporate mechanisms to help ensure the merging credit union's objectives for the combination. The key to successfully addressing these considerations is for the merging credit union to act from a position as a strong and desirable merger partner so it may engage in negotiations with optimal leverage.

Importantly, we also suspect it will be the initial wave of credit unions who adopt proactive postures in this regard who benefit most. While credit union mergers do not hinge on a price, the terms that may be achieved by a merging credit union are certainly impacted by the primary factors of market behavior. That is, supply and demand. As the industry consolidation heats up due to (1) market conditions, (2) competitive dynamics, and (3) retirement of aging leadership, we expect more credit unions to reach for merger partners. Those credit unions that delay a proactive posture until conditions force such position upon them will likely find themselves amongst a more crowded field, limiting their ability to translate interest in a merger into the most favorable outcome.

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