

Executive intelligence on credit union exams, enforcement and risk management

Failed-CU mergers come with high risks

Expert teams assembled early are essential

The NCUA's registry for failed CU mergers is imminent. After the agency finishes testing the registry – it's now in-process – it hopes to make the registry live with the September Call Report cycle, says NCUA spokesman, John McKechnie. The registry should make it easier for more CUs to get into the bidding process for failed CUs at a time when the ranks of CUs in CAMEL Code 3, 4 and 5 territory continue to swell.

All this adds up to more chances for CUs looking to target failing CUs as merger partners. Nevertheless, the bidding process comes with a steep learning curve. CUs without the experience or due diligence capabilities will find themselves at a serious disadvantage, experts say.


“There seems to be more opportunity for failed credit union mergers in the next couple of years,” says Chuck Holzman, managing partner with Holzman Corkery, PLLC, Southfield, Mich. “We’ll probably see a number of larger, healthier credit unions jumping at the opportunity to merge with an unhealthy credit union. But when credit unions do [seek to merge with a failing CU], they need to get a true handle on what the real liabilities are that they’re about to assume. Most CUs don’t have a good understanding of these liabilities.”

Not only do suitor CUs need to conduct careful, comprehensive analysis, they need to do so in a very short time frame. Assisted mergers for CUs in troubled-but-stable condition may have more leisurely

3 standards for failed-CU mergers

Any failed-CU merger should meet one of three conditions, says Chuck Holzman, managing partner with Holzman Corkery, PLLC. The merger should:

1. Open up a new marketplace that will benefit the CU in the future;
2. Provide the CU with a key strategic piece, like a new field of membership or fresh capital; or
3. Protect the CU from a competitor who may also want to merge with the target CU and move into the market.

If the merger doesn't fit any of these criteria, there's no reason to do it, Holzman adds. 

time frames, but more severe cases may come along with NCUA-imposed due diligence windows of only

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CUs no exception to regulatory call for liquidity stress testing

Management's 'active involvement' is critical

If your CU is only stress testing its interest rate risk, you're in danger of getting into trouble at your next exam. Examiners expect CUs to stress test for both liquidity risk and capital adequacy, too. Not doing so is an unsafe and unsound practice, regulators warn.

“Regulators now strenuously advocate more robust scenario planning than is currently being done,” notes

Orlando B. Hanselman, education programs director for Fiserv Risk & Compliance in Johnstown, Pa.

Conduct “stress tests regularly” for a variety of bank-specific and market-wide events across multiple time horizons, regulators advised in the March 22nd *Interagency Policy Statement on Funding and Liquidity Risk Management*. “Stress test outcomes should be used to identify and quantify sources

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two to three weeks.

“The biggest issue is typically the loan portfolio and the amount of time an institution has to get its hands around the problem loans,” says Bill Wilhelm, a consultant in the Indianapolis office of Crowe Horwath. “There are a limited number of seats [for CUs in on the bidding] and if there are number of [complex] loans in the portfolio, then it’s a track meet.”

The risk of misevaluating an acquisition can be high, says Robin Hoag, a CPA and director with Doeren Mayhew, Troy, Mich. If, for example, a CU targets a \$100 million CU with \$85 million in assets, that acquirer will have \$15 million in goodwill on Day One of the transaction. There are no guarantees for that goodwill. “If that business unit doesn’t produce future cash flows or a reasonable rate of return annually, that goodwill could become impaired,” Hoag says. “A CU [in this hypothetical situation] could end up with a write-down on the books.”

What expertise do CUs need?

According to Hoag, CUs looking at mergers with failed and relatively complex CUs will have to have the following types of expertise, either on-staff or with external advisors:

1. Valuation. CUs need someone who can assess the core deposit intangibles and the loan portfolio. Typically, CUs have staff members who can evaluate mortgages or secured and unsecured consumer loans. When it comes to failed CUs, that evaluation often needs to fit within a two to four-week window.
2. Credit and collateral risk. A CU will need to be able to “manage the data, value it and work with a valuation consultant to determine the credit and market risk involved,” Hoag says. Some CUs are more complicated than others, he adds. If the CU holds some commercial loans, the process will be considerably more complex.
3. Contracts and obligations. CUs will need to know what contracts and obligations its merger target has in place.

Not all of those will be recorded or easy to spot. Hoag recalls a case in which a CU merged with another, failed CU only to find out, well after the merger, that the target CU had an unrecorded post retirement health-care obligation. “That CU was on the hook for \$500,000 to \$800,000 liability,” Hoag says. “When it comes to this process, it’s what you don’t know you don’t know.”

4. Operations. Integrating two CUs can be complex. CUs should consider bringing an operations manager into the merger team.

How can CUs prepare for the bidding and merger process? Hoag suggests that CUs assemble a team with all the skills necessary to evaluate a failed CU quickly. Larger CUs may have this expertise already on staff. Smaller ones will need to bring in outside advisors, he says. And once the team is together, a good way to prepare is to conduct a mock bidding process. Pick a recent assisted merger or P&A and run through the process as if your CU were in on it, Hoag says.

A CU anxious to build rapid-fire merger skills could also target small CUs for mergers, suggests Holzman. A tiny CU merger comes with small stakes, Holzman says.

“Even a \$5 million credit union merger will take some time and effort,” he says. “But it may be worthwhile to do to gain some experience. If you make mistakes, they won’t be economically significant.”

Holzman mentions a client CU with \$500 million in assets that put significant resources towards a merger with a \$5 million CU. “I asked the CEO why he put in the effort to do the merger,” Holzman recalls. “He said that the merger had some value, from a lending perspective, but that it had also been five years since his last

In assisted mergers and P&As, the NCUA wants solid suitors, high bids

When sizing up suitors for assisted mergers or purchase and assumptions, the NCUA really only has two qualifications in mind, says Robin Hoag, a director with Doeren Mayhew, Troy, Mich. First, the agency wants to be reasonably sure a bidder can handle the merger – that it has adequate capital, the operational skills to handle the merger and the demonstrated ability to manage the risk contained within the failed CU. After that, he adds, it’s all about the size of the bids. The NCUA, as manager and

protector of the NCUSIF, wants the highest bid it can get for a CU in conservatorship. At the same time, it wants to dump the CU-in-conservatorship as quickly and cleanly as possible. The agency isn’t keen on keeping undefined liabilities on the books.

“They want to be done with it and move on,” says Hoag. “Typically, all transactions are done straight-up, caveat emptor. But still, the NCUA won’t allow a CU to acquire risk it doesn’t think the credit union can handle.” ▲

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merger and the team he had in place then wasn't with the CU anymore. He wanted to give his team the experience so that when the next big merger came around, they'd be ready."

What other issues should CUs look for in a failed-CU merger?

- **Watch out for hard-to-evaluate loan types.** A lot of CUs have filled their portfolios with HELOCs and second mortgages in recent years and a lot of those CUs have seen the equity in those loans evaporate, warns Rick Childs, a director of financial advisory services in the Indianapolis offices of Crowe Horwath. CUs targeting failed CUs may find portfolios stuffed with these loans. MBLs may be a thorny issue, too, he adds. "A number of credit unions have gotten involved in them and some may not be doing them well," he says. Also, if that CU keeps a large portfolio of MBLs, a merger might bring your CU's MBL portfolio up to and beyond the MBL cap.

- **Tap regulator expertise.** CUs may not think of the NCUA as a failed CU merger resource, but they should, says Crowe Horwath consultant Bill Wilhelm. "Use the personal relationships you have with the NCUA, both in Washington and with the region," he says. "Engage them in conversation before any transaction. Let them know you're on the list of bidders and tell them what you're considering. They are a valuable resource. They have subject matter experts in-house and they can help you understand the complexities of the process."

- **Get directors involved.** Technically, the board gives final approval to any merger, but in practice, boards can rely too heavily on management's input on a merger decision. Director involvement in merger decisions is not only a fiduciary responsibility, but it's also a necessary step in the

process. When boards refrain from vetting management's judgment, it often portends a bad transaction, says Childs. "Transactions go wrong when directors aren't actively involved," he says. What should directors do? Ask for clarification, Childs says. "If management says something that doesn't make sense, ask good questions," he says. "The more involved the board is, the better the transaction will be."

- **Focus on fit.** Some financial institutions can be so obsessed with finding bargain mergers or P&As that they neglect to evaluate a given opportunity's specific benefit to the CU, says Wilhelm. A failed CU merger or P&A needs to fit within a CU's strategic goals, or else that CU might be looking for trouble. "Financial institutions often go looking for failed institutions hunting for opportunities to make money," Wilhelm says. "But the key is, whatever you buy has to make a good strategic fit with your institution. If it doesn't, you're going to have more problems than you intended."

- **Find advisors with relevant experience and a national profile.** "Early in the process, credit unions should hire consultants who have experience with the legal and regulatory aspects of these kinds of mergers," says Holzman. "You want to make your evaluations early on. [You'll want to have these advisors in place] before spending a lot of time talking terms."

- CUs would also do well to choose legal and financial consultants who have experience dealing with the NCUA's regional and national office, adds Wilhelm. "You need someone skilled in these transactions and someone who can deal with the NCUA. [The skills needed for transactions like this] are beyond the ability of most local legal firms." 📍

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The Safety & Soundness Report, the independent eyes and ears of the credit-union movement, provides executive intelligence on CU exams, enforcement and risk management.

EDITORIAL:

Need us to investigate a topic? Want to express your opinion? Please call or e-mail us.

Editor:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@cusafety.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@ucg.com

SUBSCRIPTIONS:

Direct questions about newsletter delivery and account status to

Tel. 1-866-236-6228;
Fax 301-287-2945;
or send an **e-mail** to
Customer@cusafety.com.

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Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 100
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of potential liquidity strain and to analyze possible impacts on the institution's cash flows, liquidity position, profitability, and solvency," the statement says.

The regulators also emphasize that "management's active involvement" is critical to effective stress testing. Use the results of the tests to take "remedial or mitigating actions" to limit your CU's exposures, build up liquidity cushions, adjust your risk tolerance and shape your contingency planning, regulators say. (For more on liquidity contingency plans, see "Don't overlook liquidity risk," *The Safety & Soundness Report*, August 30, 2010.)

Too little liquidity isn't a major operational concern for CUs right now – in fact, many CUs are awash in liquidity – but the NCUA still cares about liquidity risk, says Hanselman. Bank regulators are demanding to see detailed contingency plans for liquidity from banks, complete with minimum primary liquidity ratios. The NCUA isn't pushing CUs quite so hard for that level of detail, but NCUA examiners are enforcing the interagency policy statement.

"Credit unions are under the same regulatory pressure to enhance liquidity risk management," says Hanselman. "Boards are absolutely being ordered to implement liquidity policies and address contingency plans. Regulators are making a similar mandated call for credit unions and that includes stress testing."

Small banks and credit unions are struggling to conduct stress tests because so many have outsourced their analysis of data and lack the resources to do the tests in-house, he adds.

Stress testing must start at the board and executive level, Hanselman urges. "Stress testing is a creative exercise. It starts at the board, executive and ALCO tables before the computer and the analysts are

even involved," he says. "Executive involvement before the model is run is imperative."

Hanselman predicts that examiners will demand to see comprehensive stress testing at CUs within the next 18 months, particularly in regards to interest rate risk and credit risk testing. Nevertheless, he adds, liquidity can't be neglected.

"Regulators want to see financial institution analysis of the full spectrum of risk scenarios, from the possible to the probable, as well as quantification of the related expected capital impact," he says. Regulators reminded CUs in its March guidance that "stress testing and contingency planning are closely intertwined."

Crafting Your Stress Test

So where to begin? Use your experience with interest rate scenarios to roll out a stress testing program for other CU risks, suggests Geoffrey Rubin, principal at Second Pillar Consulting in Glen Allen, Va., which has a business relationship with *The Safety & Soundness Report*.

"It is important that stress testing

programs include not just external events (rate shifts, credit loss increases, liquidity changes) but also management levers," Rubin notes. "How are those assumptions validated? Specific executives should be accountable."

What sorts of management levers should CUs include? In a stressed capital scenario, CUs should look at balance sheet structure and size, the product mix and embedded optionality, Hanselman suggests.

Since liquidity crises are so event-driven, CUs often use stress testing to assess and manage their liquidity risks, Rubin says. "The challenge is defining the performance of liquidity sources and uses in a stressed environment. How will credit lines draw down? How quickly can the origination pipeline be closed without hampering the long-term health of the CU? Strong liquidity management programs spend a great deal of effort establishing and refining liquidity stress scenarios."


One basic question every CU should be able to answer is: What are the historic drawdown rates on product specific credit line portfolios?

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Common stress testing mistakes

There are two common stress testing mistakes, says Geoffrey Rubin, principal at Second Pillar Consulting in Glen Allen, Va.

1. CUs spend too much time debating the "right" scenario, which distracts from the central purpose of stress testing – to assess the general resiliency and risk exposure of the balance sheet. Instead of just choosing one scenario, study a range of scenarios, he advises.

2. Don't use the outcome of any scenario as a hard and fast operating rule. If your worst case scenario suggests you need an additional \$100 million of liquidity, for instance, that doesn't mean you need to raise the money today. Rubin points out that regulators violated this principle when they stress tested the nation's 19 largest banks last year, calculating a worst-case capital scenario and then demanding capital infusions into the banks. 

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Then stress test those lines to estimate the risk impact when the draws fall or rise from the historic norms, advises Hanselman. For example, when you see home equity lines trend higher than the norm, “that’s an early warning sign of credit risk.”

When you develop your stress testing scenarios, incorporate both internal and external factors, Hanselman says. Your objective should be “unearthing hidden dangers” buried within your static ratios.

Worried about your concentrations? You can stress test your portfolio to gauge your potential losses. Try doubling your losses on certain portfolios to ensure that earnings and capital are sufficiently resilient, Rubin suggests.

“The first thing I tell all CUs is that the only true measure of capital adequacy is stress-tested capital,” Hanselman says. “To stress test your capital thoroughly implies that you must stress test all the risks embedded in your business model.” He notes that too much or too little capital can be “equally problematic.”

You need a skilled analyst and a robust computer model to accurately

stress test a variety of risk scenarios, Hanselman says. He advises CUs to stress test on a two-year forward horizon. In the case of credit risk, for example, understand your own history, especially regarding default probabilities, losses upon default and credit rating migrations. Make sure you look at outside trends as well, including such factors as, for example, a concentration in the real estate portfolio by zip code. Also, warns Hanselman, SEG-based CUs should be aware of concentration in employment. Some CUs serve a single SEG or one dominant SEG. Others may have a concentration in a single industry, such as those that serve only federal employees.

“Sponsored employee group credit unions need to be wary of where their employee concentrations are,” he says. “They should be stress testing that as well.”

Follow the 10-Step Process

Hanselman advises CUs to use a 10-step process when developing their stress tests:

- Create a scenario narrative.

- Perform a cause and effect analysis for each key performance factor. He also calls this the “what if” analysis: What happens, for example, if the local unemployment rate rises three points?

- Document your assumptions.

- Run the forecast model to quantify the scenario’s impact.

- Compare the scenario results to the base case budget. The difference between the two is your quantified risk.

- Strategically adjust controllable factors.

- Finalize the scenario forecast.

- Keep the scenario for future reference. “File, follow and learn” from previous stress tests, he says.

- Back test the scenario forecast to allow for modifications.

- Learn from experience and history.

Editor’s Note: Hanselman’s 10-step process was first published in Bank Asset Liability Management last year. ▲

CU tools: A failed-CU merger due diligence checklist

No CU wants to discover surprise liabilities after merging with a failed CU. Institutions that avoid those kinds of nasty surprises collect and analyze massive amounts of information prior to the transaction. What data should a bidding CU have on-hand? Here’s the due diligence document checklist used by Holzman Corkery, PLLC, a Michigan-based law firm with extensive experience advising CUs involved in failed-CU mergers.

Legal/Corporate

1. Certificates/articles of incorporation and amendments.
2. Bylaws/regulations and amendments.
3. Indentures or other agreements relating to the outstanding long term debt of the company or any subsidiary.
4. Copies of all material contracts or agreements, including but not limited to, data processing arrangements, leases, maintenance agreements, employee matters, service arrangements and non-

compete or non-solicit agreements.

5. List of all pending of threatened lawsuits, litigations, investigations or governmental proceedings against the company. For items more than \$200,000 a list of all pleadings.

6. Litigation letters sent to the company’s auditors in connection with the last 3 annual audits and any subsequent updates.

7. Papers relating to a threatened or pending investigation against the com-

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pany by a governmental agency.

8. Copies of all material consent decrees, judgments, orders or settlement agreements which either require or prohibit future activities.

9. Copies of all documentation pertaining to grievance proceedings, disputes, or labor litigation, discrimination, unfair labor practices or other labor related claims.

10. List of all real estate owned.

11. List OSHA, environmental, building code, zoning, etc., violations or alleged violations relating to real estate.

12. List all legal fees paid in the previous 2 years including a description of the services and the name and the telephone number of the contact partner.

13. Directors' and officers' insurance policy.

Asset Quality

1. All regularly prepared loan quality reports for senior management and/or the board.

2. Collateral, financial and policy exception reports.

3. Internal loan review reports and/or problem loan summaries for the last 12 months.

4. List of watch loans and definition of loan grade categories.

5. Internal "classified/criticized" loan list.

6. Aged delinquency reports by loan type (30, 60, 90 days past due).

7. Delinquency reports identifying trends over the last 12 months by product.

8. List of properties in the process of foreclosure.

9. List of all non accrual, restructured and 90 days or more past due for the latest month end.

10. List of all other assets owned.

11. List of all participations purchased and sold identifying any recourse agreements.

12. List of all loans to directors, executives and other insiders.

13. Report of charge offs and recoveries by loan type for the last two years.

14. List of Commercial and Residential ORE Owned including book value, date acquired, property description location, environmental problems, etc.

15. Quarterly allowance for loan loss analysis for the last two years.

16. Copy of CU's loan policy.

Audit

1. Corporate organization chart.

2. Board reports for the last 12 months.

3. Copies of the most recent exam from each regulator and the response for the last two years.

4. Copy of the management letter and the response to each for the last two years.

5. All reports issued by the security or loss prevention departments regarding major losses and control weaknesses for the last two years.

6. Internal audit reports issued during the last two years.

Data Processing Operations

1. Planned capital expenditures or new/released leases for equipment in the next 3 years.

2. Service bureau contracts.

3. Hardware/software inventory.

Facilities

1. List of all real estate holdings (branches, office buildings, specialty buildings, vacant space, land, and ORE property) indicating leased or owned.

2. Book value for both accounting and

tax purposes of land, buildings and leaseholdings.

3. Fixed assets, property description and lease amortization tables.

4. Copies of all leases.

Finance/Accounting

1. Year end ALM reports for the last two years.

2. ALM reports based on combined data of two organizations.

3. Detailed listing of investments with maturities.

4. Copy of most recent budget.

5. Fixed asset depreciation schedule.

Risk Management

1. Copy of bond insurance coverage including directors coverage.

2. Summary of insurance claim information.

3. Insurance claim information for the last three years.

4. Copies of any agreements providing for indemnification protection for any director or officer.

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