White Paper

What Credit Unions Need to Know About Bank Acquisitions

Part 2: Proceeding with the Deal

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Introduction

In Part 1 of this three-part white paper, we described key factors that may compel a credit union to explore acquiring a bank, including increasing its commercial business, expanding its geographic footprint, increasing deposits, facilitating growth, and acquiring key talent. We also laid out criteria that credit unions should consider in identifying a potential acquisition partner, such as the location and size of the bank, the quality of the staff who have built relationships with the bank's customers, and the financial viability of the institution under consideration.

Once the credit union has established the criteria for a bank acquisition, the next step is to create a flow of acquisition opportunities. Building a working relationship with outside advisors and attorneys that specialize in bank acquisitions will enable your credit union to obtain a steady flow of opportunities to evaluate.

Your advisor or attorney may uncover opportunities due to their broad network of relationships with banks and other advisors and attorneys representing selling banks. Advisors may also do direct outreach to banks that are on your target list in order to determine whether the bank is open to selling and at what price.

Part 2 of this white paper describes the process involved in proceeding with an acquisition once a viable target has been identified. There are variations in how the process may proceed.

Credit unions may be contacted directly by an advisor for a selling bank, or they may facilitate their own outreach. The bank acquisition opportunity may be a negotiated transaction or auction process. In either case, the credit union, in conjunction with the advisor and attorney, will set in motion a process to construct a deal that is acceptable to both parties.

Your advisor will develop a merger pricing analysis based on available information. Typically, such an analysis will contain:

- Market overview, with competition, branch locations and demographics
- Financial projections for bank and credit union
- Cost reduction opportunities
- Fair value estimate of the bank balance sheet
- Consolidated financials of the bank and credit union with an assessment of the combined net worth
- Price analysis using discounted cash flow, market value of comparable publicly traded banks including a control premium, and comparable bank transactions
- Double taxation assessment
- Payback and return of investment evaluation

Often the credit union will want to conduct multiple scenarios to account for different risks or opportunities. The analysis provides the pricing parameters for a letter of intent to acquire the target bank. The letter of intent is a nonbinding agreement with certain exceptions for confidentiality and exclusivity. The key terms of the LOI include price and consideration, corporate structure, transaction structure, minimum equity requirements, and executive retention.

Upon executing the LOI, the parties enter into due diligence and drafting of the definitive agreements. Due diligence is focused on understanding the potential risks and opportunities in the transaction and assessing the assumptions used for the merger analysis. The due diligence period is typically four to eight weeks. A deep dive of the loan portfolio is conducted, including quality and pricing. Deposit and loan concentrations are assessed along with likelihood of retaining the customer relationships.

Additionally, the credit union evaluates its ability to retain key employees. Regulatory, contract and compliance issues are reviewed, including field of membership opportunities and memberizing the bank customers. A fair value analysis is conducted based on the bank's general ledger and the findings from the due diligence. The updated projections are subsequently used for the definitive agreement and the regulatory application.

Concurrent with the due diligence, the attorneys for the bank and credit union are working on drafting and negotiating the definitive agreement. The credit union may at this stage consider making adjustments to their purchase price based on the findings from the due diligence. The definitive agreement will need approval by the board of directors for both the credit union and the bank.

Upon approval of the definitive agreement, the transaction is publicly announced. At this time, the credit union will typically also have a meeting and communication with the staff of the bank to discuss the transaction. Shortly thereafter, the credit union and bank will submit the regulatory applications for a merger or purchase and assumption of the bank.

Each of the steps outlined here is described in greater detail in this white paper. While the material presented here is meant to serve as a resource for what to expect when pursuing a bank acquisition, it's important to keep in mind that each transaction is different and carries with it its own unique circumstances and considerations. Working with advisors and attorneys who understand the process is essential to ensuring that any transaction undertaken proceeds to a conclusion that is beneficial to all parties.

Part Two of a Three-Part Series

Given the growing importance of this acquisition strategy, we have invited credit union leaders, bank executives, financial industry attorneys, merger and acquisition experts, and others to share their perspectives on credit union acquisitions of banks. We've compiled their insights and knowledge into a three-part white paper.

- Part 1: How to Get Started
- Part 2: Proceeding with the Deal
- Part 3: Post-Merger Integration

Here, in Part 2, we take you through what is involved in proceeding with the deal. Taken as a whole, this white paper series presents a compelling case for credit unions to consider banks as an integral part of their merger and acquisition strategy.

Synopsis of Five Credit Union Acquirers

For this white paper, we have interviewed C-suite executives, board members and former bank officials affiliated with five credit unions that have pursued one or more bank acquisitions as part of their M&A strategy. Below is a synopsis of those credit unions and the banks they acquired.

ADVIA CREDIT UNION: Advia, just over $3 billion in assets, has completed four bank acquisitions within the past decade. The Kalamazoo, Michigan-based credit union acquired a small community bank (about $88 million in assets) in 2016. This acquisition was followed by three more: $227 million People's Bank in Wisconsin in 2017, $170 million Golden Eagle Community Bank in Illinois in 2019, and $277 million NorthSide Community Bank in Illinois in 2024. The institution has completed several credit union mergers over the years as well.

DORT FINANCIAL CREDIT UNION: Dort Financial's acquisition of Flagler Bank in late 2023 allowed the Grand Blanc, Michigan-based credit union to expand into the Florida market, specifically four counties surrounding West Palm Beach. The acquisition of the $500 million bank grew Dort Financial's asset size to $2.3 billion and allowed the credit union to build its commercial offerings while providing Flagler's former customers (now Dort Financial members) with an expanded range of consumer products and services. The Florida locations will be operated as Flagler Credit Union, a Division of Dort Financial.

GREENSTATE CREDIT UNION: GreenState, headquartered in Liberty, Iowa, has acquired three banks within five years—$500 million First American Bank in Des Moines; $743 million Oxford Bank & Trust, located in suburban Chicago; and $300 million Midwest Community Bank, with locations in Freeport and Rockford, Illinois. The first acquisition allowed GreenState to round out its footprint in Des Moines, while the subsequent acquisitions gave the credit union entrée into new geographic markets. Taken together, the three acquisitions added nearly $1.6 billion to GreenState's total asset size of $11 billion.

HARBORSTONE CREDIT UNION: Harborstone, based in Lakewood, Washington, has initiated two bank acquisitions in the past two years. In May 2024, the credit union completed the acquisition of $160 million First Sound Bank, which is the second bank acquisition by a credit union in the State of Washington. The acquisition has fortified Harborstone's position in downtown Seattle. In spring 2024, the credit union announced a deal to also acquire $600 million SaviBank, which will help Harborstone expand its footprint to the northern part of the state. With these acquisitions coupled with organic growth, the credit union's asset size has reached $2.7 billion.

SOUND CREDIT UNION: In 2019, $3 billion Sound Credit Union completed the first bank acquisition in the State of Washington with the purchase of $200 million Bank of Washington. The Tacoma-based credit union subsequently purchased a branch from First Interstate Bank, involving the purchase of the building and the deposit relationships for that location. In November 2024, Sound Credit Union was in the process of buying Washington Business Bank, which has a little over $100 million in assets.

Section 1: Putting the Deal Together

Part 1 of this white paper discussed the rationale for credit unions to include bank acquisitions as part of their M&A strategy and gave advice on how to identify potential acquisition targets that align with organizational goals and financial capacity. Once a viable candidate has been identified, it's important that the credit union conduct a high-level assessment of the bank to ensure that it is financially viable and suitable for acquisition.

During the assessment, the credit union will learn important information about the bank's products and services, customer base, geographic footprint and market share while also ensuring that its assets, liabilities and business model will ultimately make it a beneficial purchase for the credit union. It's like checking under the hood to ensure that nothing is visibly wrong, with the understanding that if you do proceed with the deal that you'll conduct a more thorough due diligence that will either confirm your initial assessment or identify problem areas that must be addressed—and if the problems can't be addressed satisfactorily, you'll be able to halt the deal or renegotiate the price before moving forward.

If they haven't already, this is the stage at which credit unions should bring in outside experts such as financial advisors, legal representation, valuation professionals and others who specialize in mergers and acquisitions to guide them through the process. These experts will offer valuable advice on when and how to contact the acquisition target, how to proceed in the bidding and negotiation process, setting the price, and entering into a letter of intent.

The Bidding and Negotiation Process

At this point, the credit union will likely be ready to enter into a process of negotiating and perhaps bidding against other potential buyers to acquire their desired acquisition partner. In some cases, the process is formal, while in other cases, it is not.

"There are banks that will put themselves up for sale and reach out to 30-plus potential buyers with explicit bidding instructions and deadlines. This is the formal sale process," says Jeff Cardone, attorney/partner with Luse Gorman, Washington, D.C. "Alternatively, many banks informally consider a sale by strategically reaching out directly or indirectly to a more limited number of potential buyers. Credit unions are generally brought into the mix if the selling bank desires cash consideration."

In an informal process, a law firm or advisory firm might set up a meeting between the bank and credit union CEO. "I liken it back to the analogy of selling your house (see Part 1)," Cardone says. "You might not be thinking about selling, but if somebody comes to you with an attractive offer, you might say, 'Yes, I'd be willing to sell it for that price.' The benefit of an informal versus a formal process, from the bank's perspective, is that the sale process is more confidential. So, if a deal doesn't come to fruition, there won't be many institutions and their advisors who know about it."

A negotiation process may ensue that will involve discussions about matters relevant to the acquisition. Often, the negotiations revolve around price. However, there are also likely to be discussions around other issues, such as retaining personnel through employment agreements, stay bonuses and other incentives.

In the negotiation process, credit unions should determine what they are willing to pay based on valuation models and other benchmarks for similar bank transactions. Keep in mind that as a credit union pursuing a bank, you may need to pay more to outbid other banks that are likewise pursuing your target.

Banks often expect credit unions to pay a premium. In some respects, this is justified since it will offset the risk the bank may experience because of the regulatory process encountered in these transactions. In addition, these banks realize that their shareholders may face a double taxation issue, with taxes assessed at the corporate level and at the individual shareholder level. This primarily occurs in the case of C corporations versus S corporations; since most banks are C corporations, this likely will be an issue in the majority of bank acquisitions. (*Read more on this topic in the Purchase Accounting and Taxation Issues section later in this white paper.*)

Setting the Price

There are various methods involved in determining an appropriate price for a bank acquisition. Cardone reports that there are two primary methods considered by credit unions. One of them is price-to-tangible-book value, while the other is the earn-back period. “With improved economic conditions and political stability, the median price-to-tangible-book value for bank mergers is approximately 1.4x, which means in actual dollars if the selling bank’s tangible book value is $10 million, the median purchase price would be about $14 million,” he says.

Banks that are better performers—i.e., better earners—tend to get higher price-to-tangible-book value multiples, Cardone adds. This is not always related to asset size. “There are some larger institutions that have smaller multiples because they do not have the earnings to support a significant premium to their tangible book value.”

Cardone observes that the earn-back period is a more meaningful analysis for credit unions than price-to-tangible-book value. “Regarding the earn-back period, the credit union is evaluating the number of years it takes to recoup the premium being paid above the bank’s tangible book value based on the incremental earnings of the selling bank. The greater the incremental earnings of the bank, the shorter the earn-back period.

"Going back to my example, if the bank has a tangible book value of $10 million and the credit union is paying $14 million, that's a $4 million premium," he explains. "When a credit union adds the earning stream of the selling bank to its income statement, it needs to evaluate the number of months it would take to earn back the $4 million premium."

Cardone adds that when assessing the amount of earnings, the credit union should consider the impact of cost savings, purchase accounting adjustments and the potential runoff of customers. "For many credit unions, five years is an acceptable earn-back period, although many credit unions determine that for the right deal and/or a more competitive process, a longer earn-back period is acceptable or alternatively that a shorter earn-back period is more appropriate in determining the purchase price."

Michael Bell, a partner and chair of the Financial Institutions Practice Group at Honigman, LLP, an AM Law 150 firm headquartered in Detroit, views the breakeven point as an important way to gauge the price. "One hundred percent of the transactions we're in, we will model the internal rate of return and the payback," he says. "There's a golden timeframe of three to five years. If you model this out and find yourself getting a three- to five-year payback, that's a strong deal. Some deals beat three years, which is amazing. Every now and then, we'll do transactions in a five- to seven-year timeframe if the strategy calls for it, but most aim for the golden window of three to five years."

Financial consultant Wilary Winn LLC, Oakdale, Minnesota, works with its clients in helping prospective acquirers with purchase accounting of a bank acquisition. "There's a GAAP requirement that you determine the fair value of the bank as of the expected legal date of purchase," says Douglas M. Winn, the company's president and co-founder. "This entails determining the fair value of the equity, the fair value of the liabilities assumed, and the fair value of the assets required, all in accordance with FASB ASC 850."

When doing a preliminary evaluation, Winn adds that it's important to look at such factors as: What is the effect on capital? What is the likely goodwill? What's the likely core deposit intangible? Is it going to be accretive or dilutive to earnings? An analysis is key to ensuring the price of tangible equity. "Put in a shorthand way, it's a way of determining, 'Are you paying the right price?'" Winn explains.

When Michigan-based Dort Financial Credit Union acquired Florida-based Flagler Bank, the cost was in line with expectations. "For us, the cost of the acquisition made sense—we thought it was a fair price," says CEO Brian Waldron. "Going through due diligence, we looked at how long it would take us to earn a premium payback, and the timeframe was very quick because it was such a well-run institution. We utilized our advisors—Glenn Christensen at the CEO Advisory Group and our attorney, in particular, Jeff Cardone, partner at Luse Gorman—to discuss and walk us through the transaction and how it would pay back. We were blessed to have the capital to make the deal work."

Don Clark, CEO of Sound Credit Union, based in Tacoma, Washington, stresses that credit unions need to meet the monetary requirements of any acquisition they undertake. “It’s a purchase, so there will be an impact on your capital,” says Clark, whose credit union has undertaken two bank acquisitions. “You have to have a sufficient capital level so that when you model out and do a pro forma that your capital numbers are strong and not compromised.”

Entering into a Letter of Intent

If the credit union and bank come to an agreement about price and other conditions, they may decide to enter into a letter of intent (LOI). “A letter of intent is an indication of interest, which is nonbinding, except in certain limited parts such as confidentiality,” notes Richard Garabedian, a banking and merger and acquisition attorney with Fenimore Kay Harrison in Washington, D.C. “The LOI sets forth the general terms and conditions that would govern combining the institutions and sets the stage for due diligence by the parties.”

Typically, a LOI will include the following elements:

- Statement that the agreement is nonbinding
- Proposed purchase price
- Description of the assets being acquired (as some may be excluded)
- Deadline for signing the agreement
- Proposed timeline for key acquisition milestones, including the closing date
- Confidentiality clause
- Exclusivity clause (for a certain limited period of time)
- Description of the due diligence process

“If the price that the credit union is willing to pay and other fundamental aspects of the transaction as set forth in the LOI are acceptable to both parties, they should then be able to proceed to due diligence and draft a definitive agreement,” Garabedian says.

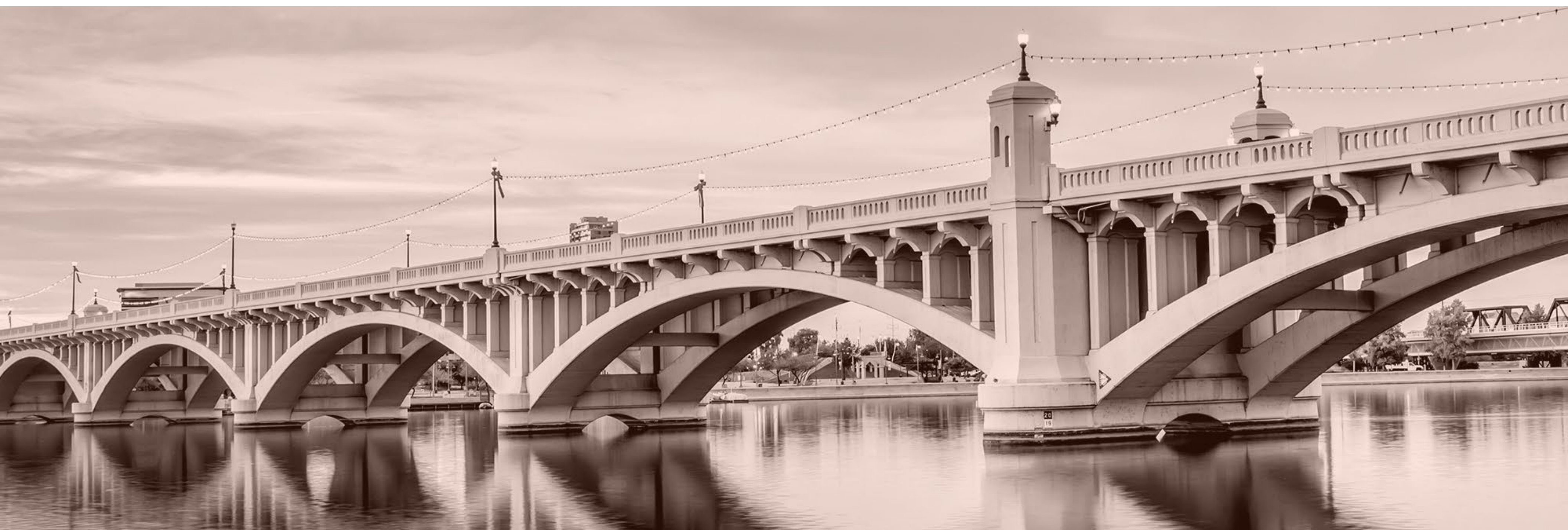
Section 2: Due Diligence Process

Due diligence is the part of the acquisition process that allows the buyer to thoroughly assess the financial soundness of the entity it is acquiring. During this process, the bank will provide the acquiring credit union with access to its data for a complete and thorough review. Based on this process, the credit union will gain a comprehensive picture of the bank's assets and liabilities, the quality of its loan portfolio, and any potential holdings that could be problematic or present a red flag to regulators.

"Due diligence findings could have an adverse effect on the initial purchase price of the transaction," Cardone says. "For example, if the bank has significant transaction expenses, purchase accounting marks to its assets and/or asset quality issues, it is important that these findings are reflected in the credit union's purchase price model."

GreenState Credit Union, headquartered in North Liberty, Iowa, has done three acquisitions within five years. COO Kathy Courtney saw firsthand how critical the due diligence process is to ensuring a viable deal. It was through due diligence that the credit union learned that the banks would have to divest themselves of some of their holdings before the deal would go through.

"With each of these deals, you have two levels of due diligence," Courtney reports. "You have the initial due diligence prior to the letter of intent, which is nonbinding, and then you get into deeper due diligence."



What to Watch For

Erich Bumgardner, founder and managing member at Credit Dynamics & Design LLC in Raleigh, North Carolina, has worked on many acquisitions in the financial services market, with his work ranging from optimizing the logistics to performing the due diligence. Bumgardner cites several factors to watch for during the due diligence processes:

Incomplete and confusing data on the portfolio. Bumgardner identifies this as the number one challenge. “Banks have different operating systems, and some are better than others,” he says. “They can get the data you need, but sometimes, it’s not very organized or complete. You need good data to pick a representative sample of loans to review, and we endeavor to select a large enough sample to develop a good view of the nature of the loans and the risk.”

Artificially compressed timeframes. “Due diligence, by definition, has a compressed timeframe,” Bumgardner explains. “And I get cautious when the timeline seems tight for purposes unrelated to the loans themselves.”

What constitutes an artificially compressed timeframe is dependent upon the circumstances. “If you’ve got a few days to a week to review an extensive portfolio and come up with an answer, that seems unreasonable,” Bumgardner says. “Usually, it takes several weeks to get things set up and completed. Not that it can’t be done more quickly if that’s the reality of the situation versus if something is rushed so that you don’t have a deep dive.”

Reserves. “The reserves are the window into what’s going on in the portfolio,” Bumgardner says. “We want to see that there are rigorous ratings tied to the reserves that are updated periodically. Not all pass loans behave the same in a downturn, so looking at the gradation and migration there is critical. It’s a little different in the residential and retail world regarding how you come up with your reserves (in comparison to) commercial real estate, particularly in today’s uncertain times. A robust early warning risk management system is necessary to ensure adequate reserves.”

Sometimes, CECL reserves can be driven by high-level trailing macro-data, Bumgardner says, which again can be backward-looking. “High-level macro-data is helpful in the models, but we like and trust models that are driven by current facts and circumstances around the loans themselves,” he observes. “Businesses with strong financial conditions tend to survive economic adversity better than those without. And that goes back to models that can be over-reliant on historical run rates through good times. A red flag could be low reserves heading into a down cycle. Another area for inspection is the time component of reserves, not just the previous embedded loss standard. Many loans will have maturities from three to seven years. In CECL, you expect to hold losses for that period, so these reserves should be higher than before.”

Bumgardner acknowledges that when people look at portfolios, they often think of them as all good or all bad. However, he points out, "In general, no portfolio's going to be perfect, and you're going to have losses. That's just the nature of credit. It's a question of whether you have adequately understood what those losses could be and whether you have priced the loans accordingly."

How the bank reserves against these potential losses is the issue, Bumgardner adds. "That's a key output of what we do. Relative to that, past dues and charge-offs can lag the cycle. Currently, it feels like we may be in an economic cycle danger zone where people are concerned about the potential of future losses. Although we're not experiencing a deluge of past dues and charge-offs that would, on the surface, drive lower valuations and quality, we do want to take a through-the-cycle view of these things and accordingly consider additional negative possible future outcomes."

Underinvestment in technology and systems. Bumgardner notes this particularly arises with smaller banks. "If you buy a financial institution, you bear the burden of upgrading the technology and the systems if you're going to be a high-performing institution," he cautions. "So, that is a consideration in evaluating what you're looking at, what you want, and the operational cost after conversion. Your regulators will likely be more demanding of you as an acquirer, and they will expect a high standard."

Insufficient staff to manage the portfolio and keep up with the financial statements and covenants. "That lack of management will play out," Bumgardner says. "It looks good from a profitability standpoint in the short run if you cut those expenses, but it comes back to haunt you in long-range performance and quality."

Loose standards. "We like to see institutions with good policies consistently applied. Further, we look for good independent loan reviews, which provide an institution an objective assessment of the loans and processes, that there's good interaction with their loan review firm and that they're reacting to issues identified and correcting them accordingly," Bumgardner says. "Updated information in the files, such as updated financial statements and adequate analysis, is needed to determine that there is still good support for ability to repay."

These are loans, not government bonds, Bumgardner points out. "It's still about knowing the current situation of that borrower's ability to repay, the risk embedded in it, and, therefore, the expected loss and cost of servicing that you'll assume."

Generally, the due diligence process in evaluating a loan portfolio is not much different if an acquisition involves two banks, two credit unions, or a credit union and bank, Bumgardner says. "It's the same best practice analysis. Typically, you'll find community banks with more complex loan structures, business loans, and commercial real estate loans. We see less of that in some credit unions, so in that sense, it'll be different kinds of loans you're looking at. But beyond that, I would think the focus is 'best practices' that you're looking for, and that would depend on what kind of loans the institution has."

Analyzing Credit/Loan Quality

One of the most important things to consider in the due diligence process is the quality of the loan portfolio. “Generally, banks engage in certain lines of businesses, such as commercial lending, that is not an area of expertise for the acquiring credit unions,” says Cardone, citing C&I and agriculture lending as two examples. Because credit unions may be unfamiliar with these types of loans, including the uniqueness of their collateral and underwriting standards, it may take extra time to go through the portfolio to identify any potential weaknesses or red flags. If there are weaknesses found in the portfolio, it should be considered in determining the purchase price that the credit union will pay for the bank.

Credit often is a good indicator about the quality of the overall deal under consideration. “Credit is the elephant in the room in terms of risk,” says David Ruffin, principal of IntelliCredit, based in Raleigh, North Carolina. “Whenever one institution, whether they be a credit union or bank, is looking at acquiring another institution, it’s requisite that they understand the credit risk that they’re potentially taking on.”

Ruffin has been in the banking industry for 50 years, including over 30 years in M&A work. In 2019, he founded IntelliCredit, a division of QwickRate, to analyze credit risk for community financial institutions. One of the key roles the company plays when working

on a merger or acquisition is not only to look at the credit risk profile but also to look at the credit cultures of the two institutions.

"If you have markedly diverse cultures and ways to approach lending, that in of itself is going to be a massive obstacle to a cleaner merging of the two," Ruffin says. "I've worked in the past with two banks that had excellent credit but backed away from a merger because their cultures were markedly different."

Ruffin describes how two cultures can be different on the subject of credit. "Some banks have very tightly controlled processes for loan authority, whereas others are more widely dispersed and have a lot of authority out in the field," he says. "That's a perfect example of a major cultural shift if you try to put those two together. So, we try to rely upon and quantify not only credit risk, but also cultural impediments to an ultimately successful acquisition or a merger."

One of the biggest differences between credit unions and commercial banks is that, by definition, the latter is more focused on commercial lending. "Most credit unions have a much broader base of consumer purpose lending, though most sophisticated credit unions have expanded their commercial lending offerings by acquiring bank talent to help form and get their commercial lending up to speed," Ruffin says. "If the credit union doesn't understand commercial lending and how it differs from consumer lending, it would be difficult for them to culturally absorb a commercial bank because they really are two different mindsets."

Ruffin has observed another fundamental difference between banks and credit unions, which is the size of their loan reviews. "The most fundamental problem I have with credit unions is they have a mindset that fairly small sample loan reviews are adequate," he says. "Most commercial banks don't see it that way. They think that a much more robust loan review or post-booking credit assessment, far beyond what shows up on a past-due report, is needed. The best advice I have for credit unions is stiffen up and improve their risk management—not just at underwriting but also post-booking."

When IntelliCredit works on deals of credit unions acquiring banks, the review is quite thorough. "We look at the entirety, soup-to-nuts, around how the credit analysis is done and how the loans are approved," Ruffin explains.

Ruffin identifies several things to look for during the credit review, including:

Consumer loan exposure. "One area that seems to clearly have emerged as a major red flag for U.S. borrowers' credit concerns are consumer loans," Ruffin says. "By definition, credit unions have more exposure to consumer loans than commercial banks do. Therefore, it would be incumbent to ask, 'What is your exposure to consumer lending going forward?'"

Loans secured by large letters of credit. "Sometimes that's not looked at," Ruffin observes. "We have seen whole deals blown apart because of flawed letters of credit that could not be honored."

Too many indirect loans. Ruffin notes that sometimes those loans will have a higher risk profile than the acquiring institution is willing to take on. He recalls a deal between two banks where the indirect lending for recreational boat loans was pretty high. It wasn't enough to scuttle the deal, but the acquiring institution quickly sold off the indirect loans after closing.

Concerns about the holding company. Ruffin explains that credit unions have to be watchful of certain aspects of the bank, such as the condition of the holding company. "In the case of commercial banks, most of them now are part of a holding company, and sometimes they can hide some problems, frankly, by kicking weak debt up into the holding company," he says. "You'd hope that whoever's doing the investment banking advisory to the credit unions would open all of that up for scrutiny. But in some cases. it hasn't been understood. If it's credit, we'll follow the line all the way up to a holding company, if indeed we find they've been kicking the loans up to the holding company, to get them off the nonperforming loan list."

Addressing the Key Issues

In doing the credit analysis component, Bumgardner stresses that it's important to distill the process down to the key risk issues. "You look at the most currently available financial statement and determine the debt service coverage ratio or capacity to repay and any other financial trends and considerations, like leverage and liquidity," he says. "Then you look at the other side of the coin, the collateral, and determine if it came to default, whether the collateral could support the loan, and what that is based on. Whether you've got updated statements or you've got an appraisal, it is vital that you understand the basis of the valuation. For many community institutions, this includes consideration of the guarantors' support—that guarantors have a solid personal financial condition, good liquidity, good outside net worth, and provide other sources of cash flow."

Credit Dynamics & Design LLC usually re-risk rates the portfolio based on a through-the-cycle approach to better estimate the risk cost in these loans. "We look at the structures," Bumgardner says. "We want to make sure that terms are reasonable and consistent, such as they're not doing excessive amortizations and commercial real estate loans. In addition, we want to pay attention to the borrower's equity in the loan transaction, the sources and uses of the proceeds, and the historical patterns."

Additionally, when credit unions are looking at the loan quality of a bank it wishes to acquire, Bumgardner has this advice: "First, make sure that it's the market you want and that the loan mix in that portfolio meets your concentration and growth goals. If you're looking at a particular market and the bank has a concentration of a particular type of loans, do you want to increase your concentration there, and are you comfortable with that? So, it's not just the marketplace but the types of loans, your internal concentration and growth goals."

As an example, Bumgardner cautions to watch out for out-of-market loans. "I've seen this a lot," he says. "You'll go in and have a portfolio in a market you like, but it may be full of out-of-market loans or participations that don't provide relationships that contribute to growing the financial institution. If you want to grow that way, you can buy your own participations."

Another thing to watch out for, according to Bumgardner, is a rapidly growing portfolio. There could be a perfectly satisfactory reason for the growth, such as the bank implementing a more effective strategy and building a larger base of good customers. Conversely, he observes, "It could be that they've sacrificed quality for growth to drive up their metrics in the short run."

Ruffin stresses to keep in mind that the due diligence process is being done for the benefit of both parties. While the bank will cease to exist after the acquisition, they still want to do right by their shareholders, employees, and customers, so they will want to ensure that the acquirer is a quality institution, regardless of whether it's a bank or a credit union.

"A bank looking at a potential credit union acquirer not only has to satisfy a regulator, but they have to satisfy that investment class that controls in some cases a good bit of their stock," Ruffin explains. "They have to be able to go to those people and say, 'This potential acquisition looks reasonable to us.' Even if you're being acquired, you have to satisfy these investors that this is worthy of our selling to this credit union."

Using Third Parties and Technology

Many credit unions work with third parties to accomplish the due diligence. It provides an added layer of assurance to work with experienced professionals who have already been through the process. This is typically utilized for valuation, loan reviews, property appraisals, etc., to supplement the due diligence you are already doing internally.

“I would recommend finding someone who has been there, done that,” says Courtney of GreenState CU. “It supplements your resources, but it also shows your regulators, ‘A third party looked at this. They have no vested interest in what the outcome is going to be, and they specialize in this exact type of work.’

“You also need to schedule time for the core conversion well in advance with both the bank and credit union core providers,” Courtney adds. “Their schedules book up quickly, particularly when there is more M&A activity occurring across the market.”

Advia Credit Union, based in Kalamazoo, Michigan, has moved forward with four acquisitions. During the due diligence process, President/CEO Jeff Fielder reports that the credit union works with an outside expert to do a detailed valuation of the bank, looking at discounted cash flows and how quickly the credit union will earn back the dilution of its net worth. The breakeven point that Advia is aiming for is about five years. Tangible book value is another consideration that the credit union takes into account.

Bumgardner affirms that it’s typically a best practice for a credit union to use an outside expert to conduct the credit portfolio due diligence analysis rather than doing it internally. “If they’re big enough and the acquisition is small enough, it may make sense for them to do it themselves,” he acknowledges. “However, the cons are that it distracts the employees, it takes a lot of focus, and it’ll take them out of their existing jobs for a couple of weeks. So, that creates stress on them.”

Another advantage is that the outside expert is proficient in the process. “With practice, you develop the ability to get in and out of files more quickly and to focus on what you’re looking for in a compressed timeframe,” Bumgardner says. “Having that experience helps. Another consideration, I believe, is having the public cover of an ordinary loan review firm in the normal course of business that a third party can provide.”

The pros of doing the diligence yourself, or in some way participating in it, include your first-hand insight into the portfolio and the people, Bumgardner adds. Of course, there are some cost-saving options as well. “We like the team approach, where people at the institution can work with us under our umbrella,” Bumgardner says. “We can provide them with data, and they can participate in the diligence without being in front of it.”

When working on an acquisition, IntelliCredit may be representing the acquirer, the acquiree—or sometimes both. Representing both sides is not a normal occurrence, Ruffin concedes, “but I’ve been occasionally asked to do that because, frankly, people trust our judgment. And it’s better to get an apples-to-apples comparison looking at both sides. I think it’s a matter of trying to be intellectually honest with both parties at the table.”

Ruffin acknowledges that there’s a general presumption that each party needs its own set of experts to advise them. “In some cases, during the best of times, some people wouldn’t even engage us to do a credit because they would trust their loan review company,” he observes. “If times were good, they might say, ‘We don’t need to incur another several thousand dollars to do a separate loan review.’ And sometimes investment bankers have said, ‘We don’t need another due diligence on credit because you’re performing cleanly.’”

However, Ruffin cautions that more volatile economic conditions may make it a bad idea to depend on just a loan review or even an examination report. “Remember, even the Federal Reserve acknowledged they were deemed asleep at the switch during the massive SVB failure and the Signature Bank failure,” he says. “That was an acknowledgement that the regulators did not see it coming.”

In addition to using third parties, technology has proven to be an important tool in facilitating the due diligence process. “It’s a lot easier nowadays because acquirers or sellers typically use what is called a data room,” Garabedian explains. “So, instead of having the acquiring party come into the offices of the target—causing employees to wonder, ‘Hey, who are all these people coming in here with briefcases?’—the target or the buyer upload their documents into the data room, using the proper authority and passwords, of course, and the parties can find the documents right there electronically.” There is a cost to it, Garabedian concedes. “But it’s pretty de minimus.”

Ruffin concurs that electronic data rooms are great tools for doing due diligence and credit reviews. “The great gift technology has given M&A, unlike even 15 years ago where very few loan files were imaged, is you can do this review far less obtrusively,” he says. “You don’t have to bring in a horde of people into the bank over weekends or risk having day-to-day employees suspect they’re now getting ready to be acquired. A lot of that can be done far more discreetly.”

Purchase Accounting and Taxation Issues

The purchase accounting and taxation issues of a bank acquisition can get quite complicated. “On the tax side, you need to figure out if the target bank is a C corp or an S corp,” says Winn. “If it’s a C corp, there’s double taxation. The C corp pays income tax, and then the shareholders of the C corp pay income tax. So, you have to make sure that that’s contemplated. If it’s an S corp, it’s a lot cleaner where the proceeds basically are taxed. An S corp’s tax is a partnership, meaning that only the selling members, or selling shareholders, are taxed. There’s no double taxation.”

Cole Schulte, a director at Wilary Winn LLC who heads up the company’s fair value business, summarizes the purchase accounting requirements: “When a credit union’s considering buying a bank, typically there’s going to an evaluation done to determine what the impact is going to be when you abide by purchase accounting standards, which would be setting the institution being acquired to fair value. When thinking about key considerations of a preliminary evaluation, the main items to consider would be the combined institution capital. So, with the institution being set to fair value, it’s important to ensure that the consolidated credit union would still have well-capitalized capital—north of 7%— to pay out the equity needed for the institution being acquired. That’s one of the main things that the National Credit Union Association is going to be looking for in the merger application to ensure that the credit union has enough capital to complete the deal.”

Another key consideration is total intangibles arising from the merger, which is the sum of total goodwill and total other intangible assets. If those assets are greater than 2% of total assets, Winn notes, NCUA regulations preclude complex credit unions (those with assets of $500 million or greater) from using the Community or Complex Credit Union Leverage Ratio (CCULR) method, also called the net worth method. As the NCUA describes, the CCULR framework is an option for complex credit unions to meet their risk-based net worth requirement without calculating a Risk-Based Capital (RBC) ratio. The total goodwill and other intangible assets limit of 2% of total assets is one of several criteria that the credit union must meet to use the CCULR method (***see box, page 23***). If the acquirer does not qualify for the CCULR method, it must use the RBC method. Under the RBC calculation, goodwill and other tangibles are deducted from net worth.

New risk-based capital rules have changed the game for credit unions looking to acquire banks. It was just a decade ago—in 2015—that the NCUA Board approved the risk-based capital rule to fulfill the Federal Credit Union Act’s requirement for NCUA to design a risk-based system consistent with and comparable to the federal banking agencies’ systems while taking the cooperative character of credit unions into account.

"The overarching intent is to reduce the likelihood of a relatively small number of high-risk outliers exhausting their capital and causing systemic losses, which, all federally insured credit unions would have to pay through the National Credit Union Share Insurance Fund," the NCUA stated in describing the rule. In 2018, the rule was revised so that it only applied to complex credit unions with $500 million or more in assets (it previously applied to credit unions with $100 million or more in assets).

Given this new rule, Schulte stresses that it's important for credit unions to be aware of the level of goodwill being acquired when purchasing a bank. "Complex credit unions will want to consider the 2% limit as well as the risk-based capital deductions," he says. "Historically, it hasn't been as important in the credit union industry to consider the amount of goodwill as it has been in the banking industry. But with the new risk-based capital rules, it's much more important to understand the level of goodwill, especially since it has coincided with the credit union-buying-bank movement over the last five to seven years."

Complex Credit Union Leverage Ratio (CCULR) Criteria

Complex credit unions (those with assets greater than $500 million) may use the CCULR framework to meet their risk-based net worth requirement without calculating an RBC ratio if they meet the following four qualifying criteria (as of the measurement date):

- CCULR (net worth ratio) of 9% or greater (initial opt-in)
- Total off-balance sheet exposures of 25% or less of total assets
- Sum of total trading assets and total trading liabilities of 5% or less of total assets
- Sum of total goodwill and total other intangible assets of 2% or less of total assets

Source: NCUA

Section 3: Putting Together a Definitive Agreement

If the due diligence process ascertains that there are no red flags or issues that need to be addressed, the parties may proceed to a definitive acquisition agreement. Many of the elements that were contained within the letter of intent will also be contained in the acquisition agreement, albeit with more details and precision. However, in this case, the agreement is a binding contract that will guide the acquisition process.

The acquiring credit union, in conjunction with legal counsel, will draft the agreement. The bank will review the document with the opportunity to make revisions, before the agreement is finalized for signature.

In addition to purchase price and other financial terms and conditions, the document may cover such issues as employment and severance agreements. This is critical for credit unions that are counting on key staff remaining with combined organization, especially in the case of commercial lending experts whose expertise and existing relationships will be vital to maintaining and growing the commercial side of the business. The agreement also will note that the transaction is subject to regulatory approval.

Regulatory Issues

After a credit union and bank enter into a definitive agreement, the transaction still must receive the approval of the appropriate regulators. These acquisitions have the potential to take longer than a merger between two credit unions because of the more complex regulatory requirements and the involvement of multiple regulatory bodies.

“Credit union/bank transactions are more complicated than bank-to-bank or credit-union-to-credit-union mergers from both a deal structure and regulatory approval process standpoint,” Cardone acknowledges. “However, because there is now a general playbook for successfully completing these deals, credit unions and banks are more open to such a partnership.”

When credit unions merge with credit unions, the transaction requires approval by the NCUA. When a credit union acquires a bank, the transaction still requires approval from the NCUA, but bank regulatory bodies—typically the Federal Insurance Deposit Corp. (FDIC) or the Office of the Comptroller of the Currency (OCC)—also must issue their approval.

“If it’s an FDIC-insured bank—which means it’s state-chartered—you need FDIC approval,” Winn reports. “If it’s a nationally chartered bank, you need OCC and FDIC approval. If the bank is owned by a whole bank holding company, that’s regulated by the Federal Reserve, and you need Federal Reserve approval.”

State-chartered banks and credit unions also need approval from their state regulators. With additional regulators involved, Winn points out, it can substantially lengthen the time period for the transaction to be completed.

The timeline for regulatory approval for a bank acquisition by a credit union can vary widely, depending upon the complexity of the deal, the state in which it occurs and other circumstances. Some experts indicate that regulatory approval for M&A deals between two banks or two credit unions will typically take three to six months, whereas a credit union acquiring a bank may find the process taking six to nine months or even longer. However, Bell says the deal doesn’t have to get too complex if the credit union has good advisors to help them. And it doesn’t have to take longer than a transaction involving two credit unions.

“If you work with experienced advisors, this process has been done so much that it’s navigable and there are ways to make it not onerous,” he says. “There’s a strategy with the approach of the regulators that has them work quicker and more efficiently. We’ve put that into place time after time after time, such that I think today, a bank-to-credit-union transaction can be done as quickly or even quicker than a bank-to-bank transaction. The process can be broken down into key segments, and it can be managed efficiently such that many credit unions that I work with have done this three, four or five times now, because they've got the process so dialed in."

At Dort Financial, Waldron reports that the regulatory process for acquiring an out-of-state bank was somewhat lengthier and more complicated than it would have been for an in-state merger between two credit unions. Four regulators had a role in the process: the NCUA, the FDIC, the Michigan Department of Insurance and Financial Services, and the state of Florida.

"There were a lot of moving parts," Waldron says. "And while there were some perceived delays, they were primarily due to staffing and trying to get everything aligned. When you have to coordinate four different approvals to get a large transaction like this completed—one of the largest bank acquisitions completed in 2023—it's going to take some time."

The transaction ultimately went through, and Waldron gives kudos to all the regulatory agencies for coordinating their resources to provide the necessary approvals. "They provided transparency through the entire transaction and did a great job coming together to approve the transaction," he says.

Because of the lengthy time involved in the regulatory process, those who have been through it says that it's important to be patient. "The regulator piece is the longest piece," says Geoff Bullock, president/CEO of Harborstone Credit Union, based in Lakewood, Washington, which has moved forward with two bank acquisitions in the past two years. "It's probably the piece that gives us all the most indigestion because it takes so long, but we have a very competent state DFI that does an excellent job. I'm not worried about them being erratic in their decision-making. I've always seen them be fair and reasonable."

Fielder agrees that working with multiple regulators can make a bank acquisition more time-consuming for a credit union. "Some transactions take longer than others, but for the most part, I found working with the regulators to be a positive experience," he reports. "We have found that the states of Michigan, Illinois and Wisconsin work really well together. There seems to be a good relationship between those regulatory bodies and the regulators themselves."

At Sound Credit Union, Clark stresses the importance of ensuring upfront that the deal is strong enough to minimize any potential problems in achieving regulatory approval. "The regulators will be looking at what's going to happen to the credit union that's acquiring a bank," he says. "What financial position are they going to be in? Can they do the transaction and still be financially strong? Will they still be able to grow? As a credit union, you have to be able to check all those boxes."

Not Ready for a Bank Acquisition? Consider a Bank Branch Acquisition

Credit union looking at acquisitions in the banking world have another option besides purchasing the entire bank—and that is to acquire one or more of a bank's branches.

"Those types of transactions are very common," says attorney Michael Bell. "Last year, we did more branch deals than anybody else in the country. They're great transactions. You're not assuming the entire operation, so you can often skinny down the loan book to what you want it to be."

When you do branch transactions, you not only get the physical branch but also the deposits, the loans, and usually the branch employees will become employees of the credit union. "Typically, what occurs is the bank is leaving the marketplace," Bell explains. "They're putting their balance to work somewhere else. We essentially step in and buy their business in the marketplace in a more surgical fashion than an entire bank deal."

These deals often go much faster, Bell adds, only taking three to five months versus the six to eight months of a full bank acquisition.

"It's a bit easier for a credit union to buy bank branches than it is to buy an entire bank," affirms Douglas M. Winn of Wilary Winn LLC. "The typical transaction for a bank is a purchase of assets and assumption of liabilities, so it takes a lot of legal work to paper the transaction."

In addition to completing two full bank acquisitions, Sound Credit Union purchased a branch from First Interstate Bank, thus gaining a location in Lynnwood, Washington. "The bank was not interested in maintaining a presence in the city, and we were looking to expand our contact center into that market to diversify geographically," CEO Don Clark explains. "We wanted to have two contact centers, so in case something happened in one market, we'd have places for people to go in another market."

One of the advantages of this transaction was being able to acquire the physical location of the branch. "They had a nice-sized building that would fit a second contact call center plus a branch," Clark reports. "We needed to move our branch from where it was in that same area. They were looking to sell, so it worked out so that we bought the building, and we bought the deposit relationships from the bank for that that one branch."

Section 4: Some Issues That Can Thwart the Deal

There are some issues that may arise to thwart or complicate a credit union's proposed acquisition of a bank. "One of the biggest issues is the legal authority for a state-chartered bank to combine with a credit union," Garabedian says. "There have been cases where the state regulator has said there is no authority. I have had transactions where we talked to the regulator quite intently to make sure there was legal authority for the state-chartered bank to merge with a credit union. And if the authority wasn't there, we walked away from it."

In rare instances, Garabedian observes, "there have been mergers that were shut down by a state regulator following the execution of a merger agreement because there was no authority for the bank to sell its assets or merge with the credit union. When I saw these reports, I was always surprised that the issue wasn't resolved before the parties spent all the time and money negotiating an agreement and even filing an application. It would appear to me that people didn't do their homework." (***See sidebar, "Atmosphere for Bank Acquisitions Varies by State," p. 30***)

Credit unions also should be aware of the difficulties they would encounter if they were looking to acquire a bank that holds a large number of municipal deposits. "In certain states, these deposits have to be held in FDIC-insured institutions," Winn says. "So, on day one, the credit union can't have those deposits. The depositor would have to go to a different bank."

Garabedian likewise stresses the need to be aware of those states that do not permit municipal deposits to be held by a non-FDIC-insured institution. “In that case, the parties have to make some other arrangement because the ‘munis’ won’t be able to go over to the credit union,” he says. “If there’s a large enough pot of them, it might kill the whole transaction. You’re not going to run into that when it’s a bank acquiring another bank because the banks are both FDIC-insured, and the statutes are typically very specific in saying FDIC instead of just federally insured. It doesn’t matter if the credit union is state-chartered or federally chartered. If the state says they must be FDIC-insured, as compared to federally insured, it takes the credit union out of the equation.”

Another complication for the bank acquisition could occur in a purchase and assumption when a credit union does not want to retain all the assets. “It could be loans that are not permitted under the credit union’s charter, or there could be some other quirk with the loans,” Garabedian says. “It could be any asset where the credit union says, ‘We don’t really want these or we can’t legally hold them,’ so you could push them to the holding company, if there is one, where they would be up for potential sale and the proceeds distributed to the shareholders.”

There are ways to eliminate or dispose of nonconforming or nonacceptable assets, Garabedian adds. “You’re basically talking about eliminating those assets from the purchase and assumption transaction because the only thing that’s left is the holding company that doesn’t hold the bank anymore—it actually holds the charter, and the charter is dissolved. If there is no holding company, these assets could be disposed of after the transaction occurs and the proceeds distributed to the shareholders of the bank.”

Advia Credit Union hasn’t proceeded with every bank acquisition that comes its way. The institution considers various quantitative and qualitative factors when looking at a potential bank acquisition target. “We look at the demographics of the community and how well we believe our products and services will resonate within that market,” Fielder says. “We look at competitors in the space. We also look at our existing membership base within that area. Before we found NorthSide Community Bank, we looked at probably three other institutions. We say no to more potential deals than we say yes to.”

There are various reasons that Advia might decline to proceed with a deal, Fielder says. Perhaps the bank has a high number of brokered relationships or inorganic relationships (examples being participation loans and indirect loans). If the differences in credit union philosophy are too extreme, that also may be a reason to walk away. “If the credit philosophy is not aligned, that’s a greater risk on the balance sheet than that we’d like to take on,” Fielder says.

If something potentially could derail the deal, Fielder says it’s best to identify that before the deal gets too far along. “In each case, we always meet with the management of the bank and get to know that senior leadership,” he reports. “If you move into due diligence, you’ve already learned a lot about the bank. So, if there is a reason not to proceed with the deal, I think you can identify that early on.”

Atmosphere for Bank Acquisitions Varies by State

Be aware that not all states provide the same opportunities for credit unions. One of the most robust states for bank acquisitions by credit unions is Washington, as evidenced by this white paper in which both Sound Credit Union and Harborstone Credit Union have completed or are in the process of completing multiple bank deals. As S&P Capital IQ reported in April 2024, three of the first four acquisitions announced in the state in 2024 have been banks being acquired by credit unions.

There are some states that don't permit such transactions at all, or at the very least are making it difficult for credit unions to purchase banks. As S&P Global Market Intelligence reported in 2022, Mississippi passed legislation banning these types of transactions. And in a blog post that same year, Wilary Winn LLC reported that regulators in several states, including Minnesota, Nebraska and Tennessee had blocked credit union/bank acquisitions, with several additional states expressing opposition to the deals.

Some states, however, may be paving the way for these transactions to take place. This year, Colorado is considering legislation that would allow credit unions to purchase the assets of state banks. The expectation is that acceptance of these deals will continue to expand into new state jurisdictions.

CEO Brian Waldron of Michigan-based Dort Financial is of the opinion that credit unions should be allowed to acquire banks, regardless of their state location. "When you look at the way a community bank operates and a credit union operates, they are very similar," he says. "They both serve their communities. A bank should certainly have a say in whom they can sell to. If the right suitor comes along and their synergies align, a credit union should be afforded the same opportunity as a bank."

Conclusion

Proceeding with a bank acquisition requires meticulous attention to detail at every stage. From the initial investigation into the acquisition target to signing of the definitive agreement, it's vital that the credit union allocate sufficient resources—both internal and external—to ensuring the soundness of the pending transaction and facilitating a successful regulatory review.

During due diligence, a comprehensive evaluation of credit and loan quality, along with a thorough analysis of the bank's assets and liabilities, will be necessary to uncover any issues that require resolution or to identify potential red flags that would be reason to abort the deal. Early in the process, be aware of what is permissible in your state, as lack of understanding could derail a deal to which you've devoted time and effort.

Once the transaction enters the regulatory stage, there is a need for patience. Bank deals can take longer because of the multiple regulatory bodies involved. However, being proactive by identifying and addressing potential snags can significantly streamline the process and lead to a smoother, more time-efficient approval.

In Part 3 of this multipart white paper, we will discuss post-merger considerations of a bank acquisition. Understanding the impact the acquisition will have on the transitioning bank customers and employees, as well as the culture of the combined acquisition, will help you navigate the transition more successfully.

LESSONS LEARNED

Ed Sterling, Dort Financial Credit Union (formerly CEO of Flagler Bank)

"The big lesson for both an acquirer and seller is to prepare both entities well in advance for such a transaction. Dort benefitted by preparing for an acquisition by securing ample liquidity and ensuring that their capital was in a strong position to absorb the bank's assets and liabilities. As for regulatory considerations, it is the utmost importance to engage with experienced professionals to assist in the transaction."

Jeff Fielder, Advia Credit Union

"It's important to have a team that can navigate the complexities of the transaction and a board that's willing and supportive of taking the risk. If it's too restrictive based on asset size or from a net worth perspective, there are ways to raise subordinated debt to support a transaction, and obviously you need to have your regulators' support. The feasibility of the deal depends on the size of the bank. There are ways to address that as well. In the case of a smaller credit union, you could potentially acquire a very small bank."

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