

## **Recession Brings Opportunity for Healthy CUs, but Beware of Bad Mergers**

By Peter Duffy

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Some healthy credit unions have called on Sandler O'Neill to discuss the opportunity to add scale through merging with a troubled CU. While this might make sense intuitively, we've actually seen many credit unions grow increasingly reticent to merge, given the true asset quality of the would-be merger partners. We hope the caution spreads to all potential buyers because there may be nothing more distracting and debilitating than a bad merger.

The healthy merger transactions we've been advising on have been on the bank side.

With credit unions, we continue to see the same obstacles that have always held back healthy mergers or mergers of equals, particularly the lack of accountability that gives some boards cover to reject otherwise good (for the members) combinations. CEOs who thought that the Great Recession would make healthy mergers easier have told me that little has changed.

Clearly, mergers should be part of most financial institution's strategic plan, and here are some thoughts as the planning season begins amid so much turmoil and uncertainty.

Since the 1980s, the roster of banks and credit unions has declined, from 32,000 to 16,000, as the consumer determined the most efficient lenders and simultaneously put 58% of U.S. deposits in the top 50 bank holding companies, according to FDIC and NCUA statistics.

The Great Recession further exposes the weaker players and will likely lead to an accelerated pace of consolidation.

Further, the imbalance of supply and demand (too many lenders), leaves the math of the consumer lending business model in extreme duress, if not broken. All lenders have seen their margins deteriorate to a level where, if not for fees, many would post flat to negative earnings. Net interest margins at both banks and credit unions are down 20% since 1995.

And now, fee income of all types is vulnerable to reduction through legislation.

For credit unions, the math is worse. Without fee income, credit unions would have recorded an ROA at 0 to 10 basis points over the last four years (banks 30 to 60 bps). If legislative proposals to reduce various fees are enacted, credit union income will become even less competitive. (This is based on NCUA-FDIC statistics for banks and credit unions with \$100 million to \$40 billion in assets).

The market is dealing with the oversupply of lenders by driving margins tighter, which has led to increased consolidation that we expect will continue. The consolidation within credit unions is much less efficient due to issues regarding accountability, social considerations and field of membership restrictions.

When good mergers happen, customers benefit with improved convenience and service offerings as the combination provides increased branching while the cost saves produce better efficiencies. The cost saves allow the new financial institution to pass along the benefits to the customer. In a commoditized business, there are other reasons to consider mergers (strategic mergers can add expertise in a product line, such as small business lending), but most are an opportunity to gain efficiencies through cost saves and potential for leveraging the brand into more households. We still don't see many healthy or mergers of equals occurring among credit unions.

Mergers involving a troubled financial institution are a different consideration. These tend to be higher risk due to a greater number of unknown variables in the troubled FI. If a troubled financial institution is being offered to a healthy one, sufficient capital should be provided by the regulator or the healthy institution could suffer inordinately. We continue to hear of loan losses two to three times greater than anticipated by the acquirer in troubled CU mergers.

Smart acquirers considering mergers have been well served in this environment to remember, "When in doubt, do without."

What's more, the daunting task of the sheer volume of troubled credit unions creates a manpower issue for the regulator, leaving the troubled CU on life support for an extended period of time. The unintended consequence of a wounded financial institution on extended life support is that the resolution becomes more expensive to the acquirer. In the case of forbearance, perhaps only after months of deterioration does the institution get shopped.

The troubled merger too often adds less scale than previously thought once the true level of bad assets is eventually known.

The real damage for troubled mergers comes with the resulting impact on capital. The acquiring credit union sees its capital ratio decline significantly and strategic plans become vulnerable to severe restrictions. You can see examples of this in the movement today. Finally, one must consider the distraction to staff and potential impact on morale brought on by a bad merger.

For healthy financial institutions, there is a silver lining to the financial crisis, and it's called opportunity. Healthy FIs will use their capital (or raise secondary capital) to make acquisitions at historically low levels. They are also in a position to exploit opportunities created by the consumer's sudden appetite for safe investments such as government-insured deposits.

In the Northwest, both credit unions and banks enjoyed a boom in deposit growth after WaMu collapsed. Today, Citibank is reorganizing its strategy and selling branches all across the U.S.

This trend will continue for the next two or three years, bringing with it an opportunity for substantial growth for healthy, well-capitalized financial institutions.

*Peter F. Duffy is associate director with Sandler O'Neill & Partners LP. He can be reached at 212-466-7871 or [pduffy@sandleroneill.com](mailto:pduffy@sandleroneill.com)*