The Detail is in the Dashboard:

Embracing a Systematic Approach to Screen for Potential Credit Union Merger Partners

"Goals are good for setting a direction, but systems are best for making progress."

– James Clear

While many of our credit union clients have a goal to be active in credit union mergers, far fewer have developed a reliable system that monitors the market to bubble up potential opportunities as they arise. Fewer still have a methodology for understanding the non-financial factors necessary for a successful transaction. Because we see tremendous value in such an approach, this piece offers some insight into the methods we apply when we build dashboards for clients looking to identify potential merger targets.

In its 2023 Annual Report, the National Credit Union Administration (NCUA) rang the alarm bell for industry consolidation:

> "Small credit unions face challenges to their long-term viability for a variety of reasons, including lower returns on assets, declining membership, high loan delinquencies, increasing non-interest expenses, and a lack of succession planning for credit union boards and key personnel. If current consolidation trends persist, there will be fewer credit unions in operation and those that remain will be considerably larger and more complex."[1]

In a July 2023 Whitepaper, we too observed that strategic merger activity in the credit union industry appeared to be on the rise. At the time, we cautioned, however, that "[s]trategic mergers require complex dealmaking where parties propose, negotiate, and consummate a mutually beneficial combination."[2] Because credit union combinations are multi-faceted arrangements that must address the needs and objectives of various constituencies across both organizations, successful dealmaking can be elusive, as it requires a high degree of preparation, social intelligence and a significant span of creativity.

As potential continuing credit unions go about their search for combination partners, they are well served to keep in mind that the merging credit union is currently a sought-after commodity within the industry. Today, a merging credit union with reasonable financials, strong member relationships and/or a unique foothold in small target markets possesses considerable negotiating leverage when asserting itself proactively in a consolidating market.[3] Often, these credit unions will find multiple suitors willing to engage in flexible dealmaking to craft an arrangement in the interests of the merging credit union and its stakeholders.

[1] Annual Report 2023, National Credit Union Administration (Feb. 2024), at 198, available at https://ncua.gov/files/annual-reports/annual-report-2023.pdf

[2] See Strategic Mergers An Underutilized but Emerging Strategy for Credit Unions, Olden Lane, at 16, available at https://img1.wsimg.com/blobby/go/62764619-3fc7-4548-a964-a6eb47b231bb/Strategic-Mergers-July2023.pdf

[3] Id., at 10.

Nonetheless, merging with the right credit union can be a critical success factor for continuing credit unions seeking to expand or diversify. When identifying potential merger partners, it is essential to consider a wide range of factors, such as profitability, strategic and cultural fit, scalability, and regulatory environment. By doing so, a credit union can improve the likelihood of a successful outcome that might position its business for long-term growth and success.

Understanding the Financial Drivers

In working with clients, we typically consider several drivers to rank the universe of the potential credit union targets according to their desirability as a merger candidate. While we adjust the factors in our model, from time to time, to respond to business cycles, today we regularly consider the following factors in developing our preliminary dashboard:

1. Average Cost of Funds
2. 12-Month Member Growth
3. Return on Assets
4. Net Interest Margin
5. Delinquency Ratio
6. Net Charge Off Ratio
7. Efficiency Ratio (Excluding PLL)
8. Operating Expense Ratio
9. Net Worth Ratio

Our proprietary model considers the absolute levels of these factors, their trendlines, and their difference from peer groups, as appropriate. And we give a weighting to each factor as we consider the overall universe of potential targets, scaled down by both asset size (minimum and maximum) and geographic parameters (typically, by state(s)).

The **Average Cost of Funds** measure has been the highest weighted factor in our model for some time. In our view, it has been the largest driver of stress across the industry in the most recent period. In The Comprehensive Guide to Credit Union Performance Benchmarking, Callahan & Associates does a fine job explaining the importance of this measure:

> "A credit union's cost of funds is influenced externally by the overall rate environment and internally by the make-up of the deposit portfolio. . . When interpreting the cost of funds, it is easy to think about it as how much the credit union must pay in interest for every dollar of shares or borrowings it receives."[4]

The recent liquidity crunch for financial institutions has been like none in recent memory. After more than a decade of benign interest rates – which ended with the government shoveling stimulus monies directly onto the balance sheets of depositories – the industry had been conditioned for access to seemingly endless amounts of easy money. Chart 1, on the following page, highlights the anomalous share growth that characterized the pandemic period.

[4] The Comprehensive Guide to Credit Union Performance Benchmarking, Callahan & Associates, at 8.

Share Growth

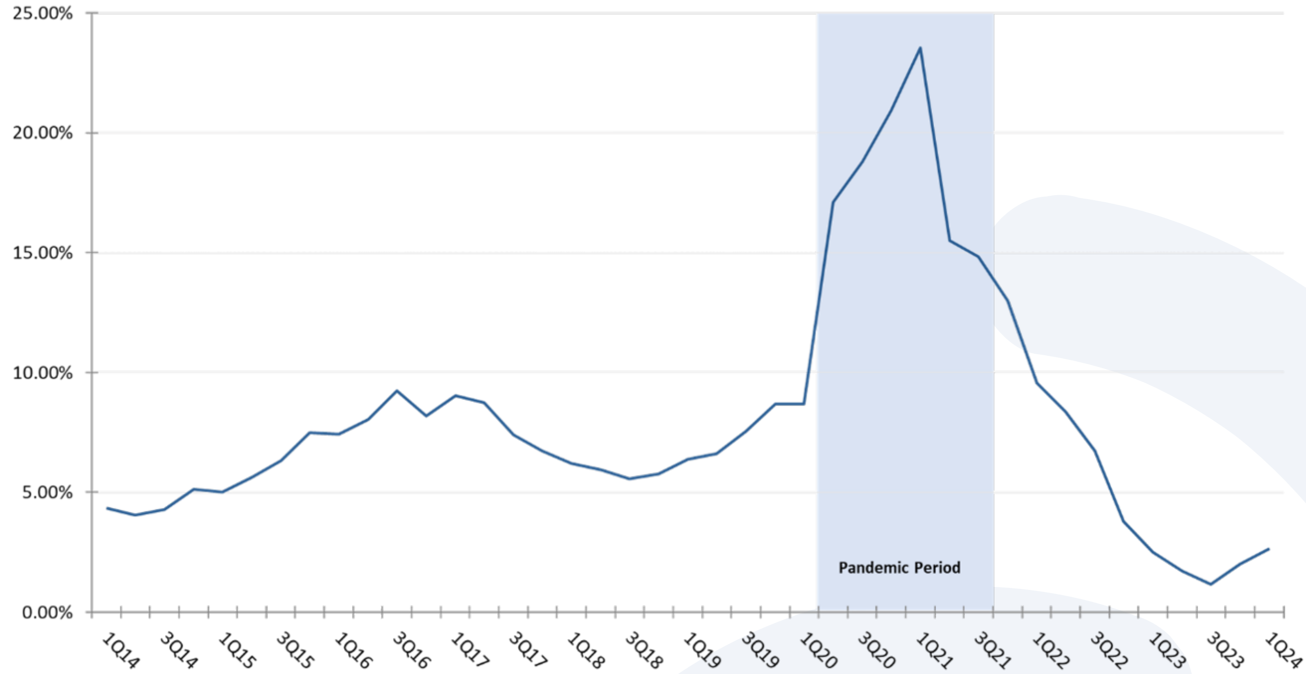

Chart 1

Of course, credit union share growth has been challenged since the pandemic, as government stimulus funds rolled off and interest rates spiked. To replace the deposits that exited in the period after the pandemic, credit unions have increasingly turned to higher cost sources of funding, including member share certificate specials, brokered deposits and borrowings from the Federal Home Loan Bank or corporate credit unions. This reliance on higher cost funding sources has spiked the Average Cost of Funds for the industry from 41 bps (Q2 2022) to 2.11% (Q2 2024). See Chart 2, below.

Average Cost of Funds

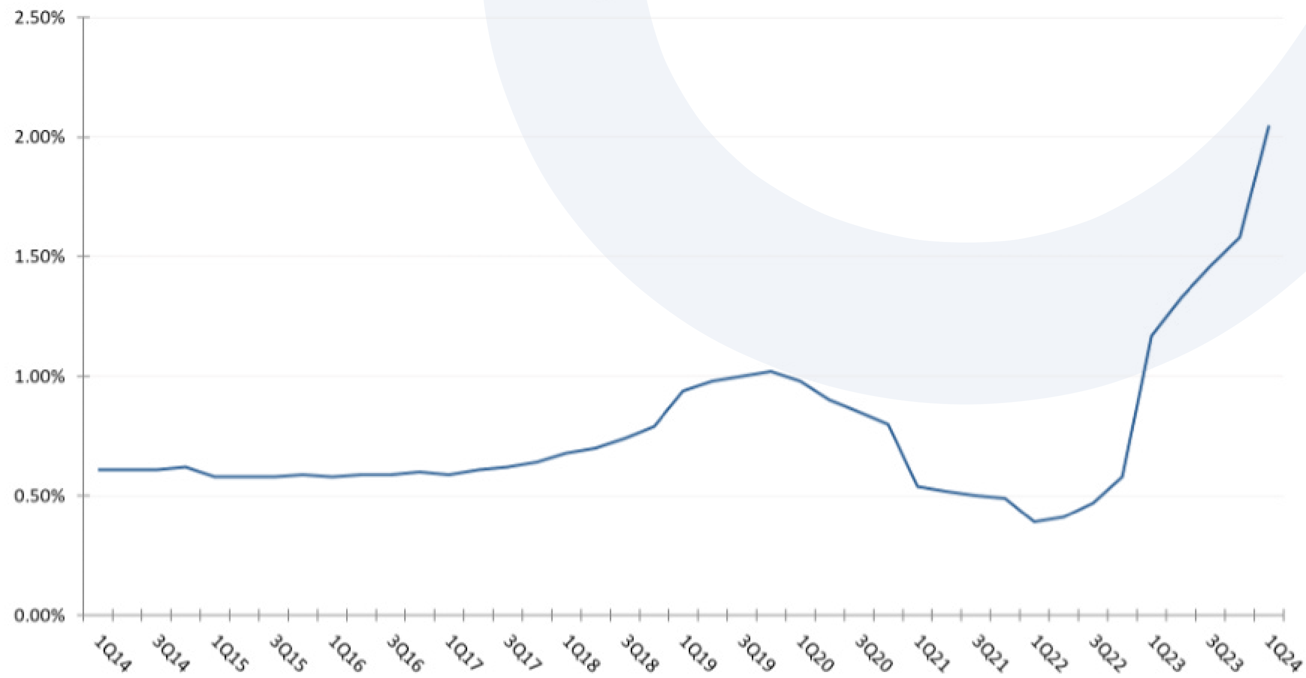

Chart 2

Appreciating the true effect of an increase in the cost of funds on a credit union's business can be tricky. First, the repricing of the asset side of the balance sheet typically predates the repricing of liabilities. Also, if a credit union is struggling with profitability and has not yet faced an increase in costs of funds, troubling times might be ahead.

In many ways, the **12-Month Member Growth** number is a proxy for management capability, as members are the lifeblood of any credit union. The number can be particularly telling in a difficult macroeconomic environment, as potential members are wooed by competitive rates. There are other nuances buried in this measure. For example, a potential target's field of membership should be carefully studied to appreciate whether it might have a limiting function in member gathering or retention. The suite of products and services as well as the competitive landscape should also be evaluated to appreciate the drivers behind a credit union's member growth challenges and opportunities.

The **Return on Assets (ROA)** measures credit union profitability. Negative earnings suggest challenges, often from high provisions for loan losses, increased operating expenses, or losses on investments. These signs can flag a credit union for closer scrutiny, especially if operational inefficiencies are evident. In deciphering a credit union's ROA picture, care should be given to understanding the absolute level as well as the trend. A credit union's ROA should also be understood by comparison to its geographic and asset level peer groups. Often a deeper analysis of the loan composition and the nature of the credit union's deposit gathering will reveal the story behind its historical profitability and its potential to generate reliable earnings into the future.

As Chart 3 below highlights, credit unions have struggled in recent quarters to maintain the level of their longer-term profitability. In fact, at 69 bps, the overall industry ROA in Q2 2024, was as low as any quarter in the last ten years, save the three quarters in the throes of the pandemic (Q1-Q3 2020).

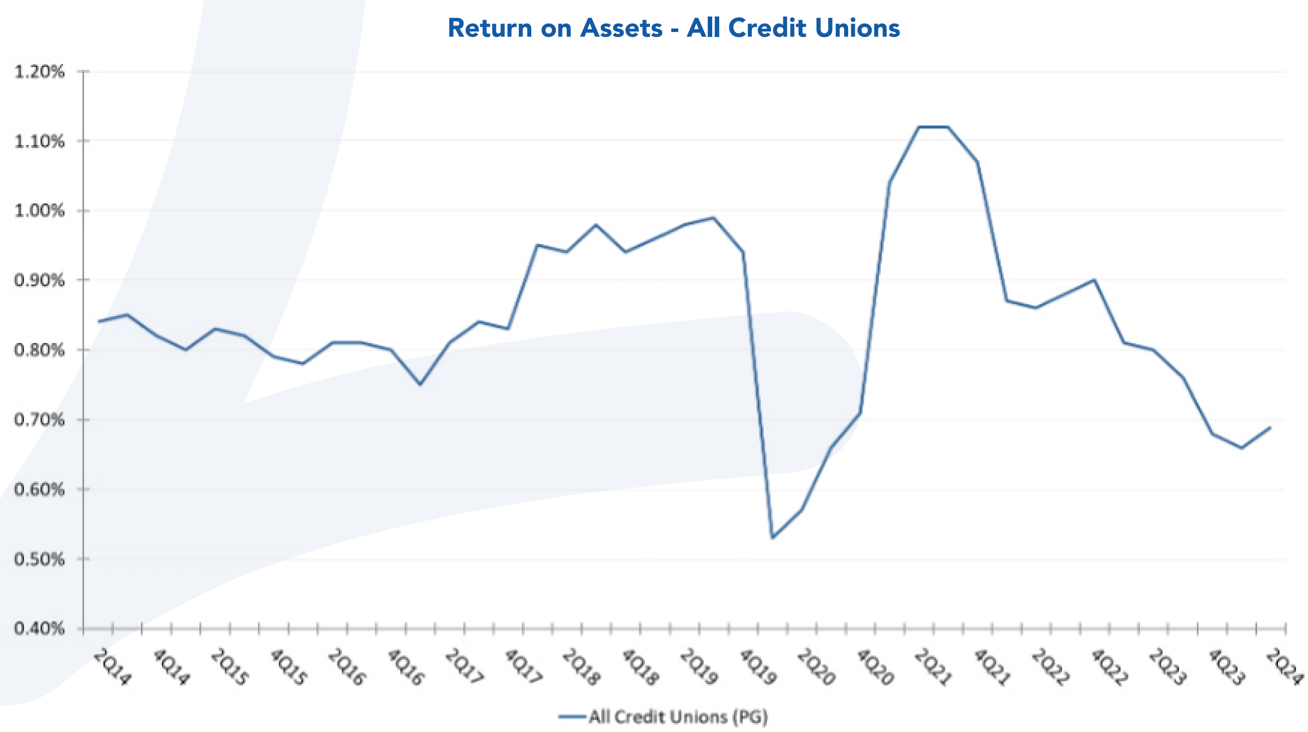

Chart 3

Both the **Delinquency Ratio** and **Net Charge Off Ratio** are vital for assessing asset quality. The delinquency ratio may increase during times of economic turbulence, as members struggle to pay back loans in a timely manner. As a general rule, we focus less on **Net Interest Margin (NIM)** because it is correlated with both a credit union's Average Cost of Funds and its earnings. However, a significantly higher NIM than peers or the national averages could indicate a riskier loan portfolio, which might be confirmed by higher Delinquency or Net Charge Off ratios.

The **Efficiency Ratio** and **Operating Expense (OpEx) Ratio** both provide insight into the operating efficiency of a credit union. The lower the efficiency ratio, the better. A high efficiency ratio means that the credit union is shedding a larger share of its income to overhead expenses. By contrast, a low efficiency ratio means that operating expenses represent a smaller percentage of income.[5] Operating expenses are a credit union's costs of doing business. Because employee compensation typically comprises about 50% of a credit union's operating expenses, it can prove difficult to put the genie back in the bottle if this ratio becomes elevated.[6] Overall, a high Efficiency Ratio and elevated Operating Expenses may indicate deficiencies in the business model, cost management and operational processes.

The **Net Worth Ratio** reflects a credit union's capital adequacy, indicating its ability to absorb potential losses and sustain operations during adverse economic conditions. Here, we are concerned with both the absolute level and trend of the ratio when we attempt to understand the likelihood that a credit union will fall below the well-capitalized level of 7%. As the Net Worth Ratio is often the trigger for aggressive NCUA action, it should be monitored closely.

Collectively, the metrics we review as part of our multi-factor model offer a comprehensive assessment of a credit union's financial health, managerial effectiveness, asset quality, and operational efficiency. By properly evaluating these factors, our team is able to properly advise clients as they look to whittle down the list of potential merger partners in a systematic way. An example of a recent heat map we have constructed is highlighted in Table 1, below. The dashboard examines a series of financial metrics (with appropriate weightings assigned to each factor) across a universe of credit unions sorted by asset size and geography.

Name	Score	Average Cost of Funds	Return on Assets	Net Interest Margin	Delinquency Ratio	Net Charge Off Ratio	Efficiency Ratio (Ex Provisions)	OpEx Ratio	Net Worth Ratio	12-Month Member Growth
Arizona Copper	8.56	0.15%	-2.77%	5.75%	2.96%	3.36%	102.25%	8.84%	3.88%	-2.48%
Credit Union 1	7.39	0.40%	-1.87%	3.98%	3.25%	-0.68%	122.25%	6.12%	8.97%	-4.47%
Credit Union 2	7.18	0.17%	-5.59%	4.32%	2.93%	3.02%	143.89%	11.63%	9.85%	5.85%
Credit Union 3	6.36	1.19%	0.05%	3.35%	0.43%	0.69%	90.27%	3.95%	6.88%	-11.77%
Credit Union 4	5.57	0.45%	0.10%	4.80%	1.01%	0.58%	94.68%	6.57%	10.40%	2.15%
Credit Union 5	5.40	1.11%	0.15%	3.24%	0.46%	0.51%	88.60%	4.39%	7.47%	3.40%
Credit Union 6	5.32	0.40%	0.28%	4.16%	0.73%	0.58%	91.51%	5.01%	12.82%	1.78%
Credit Union 7	5.14	0.23%	-0.40%	3.62%	0.00%	1.25%	89.53%	3.24%	15.35%	0.90%
Credit Union 8	5.09	0.61%	0.61%	3.17%	0.75%	0.37%	86.98%	4.02%	11.83%	-7.55%
Credit Union 9	4.72	1.09%	1.08%	3.30%	1.10%	0.48%	76.47%	4.23%	10.40%	-0.30%
Credit Union 10	4.71	0.42%	0.25%	4.09%	0.66%	0.81%	72.20%	3.11%	12.36%	-3.12%
Credit Union 11	4.66	0.72%	0.41%	3.65%	0.29%	0.58%	80.66%	4.30%	9.48%	-0.07%
Credit Union 12	4.20	0.95%	0.99%	3.96%	0.58%	0.23%	74.03%	3.74%	9.86%	-1.33%
Credit Union 13	3.88	0.67%	1.41%	5.23%	1.80%	1.06%	60.24%	3.59%	11.97%	-1.06%
Credit Union 14	3.66	0.15%	1.66%	3.97%	0.55%	0.30%	71.74%	3.52%	12.14%	1.61%
Credit Union 15	3.44	0.68%	1.56%	4.14%	0.27%	0.77%	66.00%	4.14%	10.57%	1.19%

Table 1

Over time, the continuous monitoring of a broader credit union basket will reveal those candidates most likely to seek a merger based on the observed changes in their financial situation. Time and again, our heat maps reveal credit unions that have, in fact, just announced a merger.

Understanding the Non-Financial Drivers

Identifying and sorting potential targets based on financial factors is only the beginning of an effective merger strategy. After an initial dashboard of credit unions is considered based on financial factors, we look to additional attributes. For example, we regularly study the composition of a credit union's c-suite and its board of directors to understand where the leaders are in their tenure. We will also overlay a credit union's field of membership on a map

[5] See generally 15 Key Ratios Your Board Should Know, Callahan & Associates.
[6] Id.

to (1) understand its reach into counties, blocks or census tracts that qualify for low-income designated credit unions (LICU) status or Community Development Financial Institution (CDFI) status and (2) rationalize it with the existing branch network of the continuing credit union. Finally, we will monitor the websites and social media postings of potential merging credit unions to determine member satisfaction, ascertain mission and cultural alignment, understand how vibrant the underlying business is, or to determine whether products are being mispriced.

We construct a second dashboard that runs through a series of potential what-ifs to understand the effects of various levels of a member dividend on a potential transaction.

Conclusion

Identifying the proper list of potential credit union merger partners is painstaking work that requires a careful and systematic process with constant revision and improvement. The cost of admission for a credit union searching for partners is a granular understanding of its own business model and a willingness to apply a rigorous set of review criteria to the universe of available partners. Doing the legwork to understand the strengths, weaknesses and complements of the other credit unions will go a long way to ensuring that the process for screening potential combination partners is done with the right rigor to improve the likelihood of success.

Of course, identifying a viable list of potential merger targets is only the first step to a successful merger strategy.

When it comes to approaching potential combination partners, forming a vision that appreciates the mutual benefits of a combination or crafting deals that align the interests of all stakeholders, the need for a systematic approach only

oldenlane.com
100 Somerset Corporate Blvd
Bridgewater Township, NJ 08807

info@oldenlane.com