

# the Competitive Edge

for Credit Unions

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## Business Combinations

### FASB ASC Topic 805

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#### Overview

Business combinations (mergers) have been a means for credit union growth and establishing long-term viability, plus enhancing member value, for the past several years. This strategic and tactical consideration is expected to continue due to the convincing evidence that larger credit unions possess higher economies of scale. These economies of scale translate to members in the form of better rates, lower fees, enhanced distribution channels and convenience.

The Financial Accounting Standards Board (FASB) took action in 2008 to improve the relevance, representational faithfulness, and comparability of financial information that a reporting company (credit union) provides in its financial reports about a business combination. Previously, credit unions were exempt, as a mutual thrift, from Accounting Standards Codification (ASC) 805.

#### Merger Trends

Since 2004, credit union mergers have continued, but at a decreasing rate, although the asset volume of mergers increased.

Predominant reason(s) expressed for friendly mergers is achieving economies of scale realized by larger credit unions. Credit unions with \$100 million in assets



and higher are able to operate more efficiently, ranging from 46 bps to 119 bps, when comparing credit unions of \$100 million in assets against the next two larger peer groups. Major financial efficiency allows them to enhance the member value proposition through lower interest rates on loans, higher interest rates on deposit products and lower fees for services.

Recent economic changes, including rising delinquency and loan losses (2007 loan loss provisions were less than 50 bps, 2008 - 2009 are exceeding 100 bps; in some states, 200 bps), rising costs of operations, and eroding net interest margins through 2009, placed a considerable strain on credit union capital.

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In addition, actions of the NCUA required to stabilize the corporate credit union network added to the economic burden.

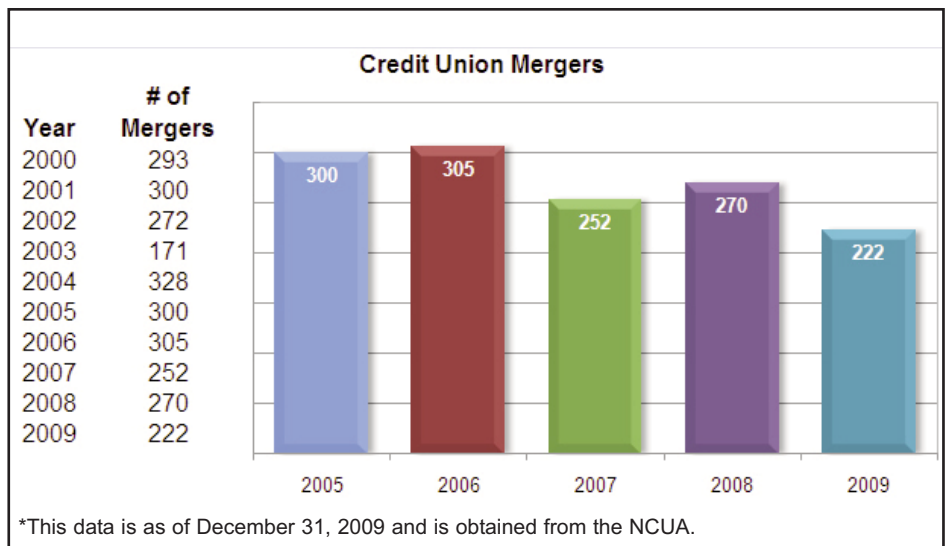
Maintaining adequate regulatory capital has become problematic for several credit unions, large and small. As a result, business combinations (mergers) are expected to increase significantly this year.

### Merger Accounting Changes

For most credit unions, mergers (with the exception of purchase and assumption transactions) have historically been accounted for under the pooling-of-interest accounting method. The pooling-of-interest method made it simple to combine the balance sheets of the two merging credit unions. The changes introduced by ASC 805 increased the complexity of the financial accounting for the acquiring credit union in a merger. The acquisition method (comparable to the purchase method prior to revisions of ASC 805) of accounting for business combinations for credit union mergers was effective for financial statement periods beginning after December 31, 2008 or, effectively, the 2009 calendar year.

Applying the acquisition method requires several steps with on- and off-balance sheet assets and liabilities analyzed at fair value. Those steps include:

- Identifying the acquiring credit union; which credit union will materially govern and manage the combined credit union
- Determination of the merger date; typically the date of merger of the two credit unions
- Recognition and measurement of identifiable assets, plus the liabilities to be assumed



- Recognition and measurement of core deposit intangibles, loan portfolios, investments, brands, goodwill and other values in the transaction

Guidance for identification of the acquiring organization is discussed in ASC 805 and key components which characterize control include:

- Voting control of the board of directors
- Managerial control of the organization
- Charter survivorship
- Asset sizes of the two credit unions

All of these factors need to be considered when determining which credit union will be the “acquirer” in a merger transaction; the surviving charter should not be the only criteria reviewed. Consider a larger federal credit union that is considering a combination with a smaller state-chartered credit union with the intention of assuming the state charter status. While the charter type of the smaller credit union will survive, if the board of directors of the larger federal credit union continues to control the majority of the board seats and/or the management team of the federal credit union will continue to operate (dominate management) the

post-merger credit union, a strong case supports the federal credit union as the acquirer despite the loss of the charter.

The determination of the acquisition date (credit unions refer to this as the “merger date”) is defined as the date the acquirer obtains or assumes control of the acquiree. This date is important since it is the trigger for the acquiring credit union to recognize and record, at fair value (acquisition method), all identifiable assets acquired and the liabilities assumed from the merger transaction.

The recognition and measurement of identifiable (both tangible and intangible) assets and liabilities assumed encompass some of the most significant changes in how a credit union will account for a business combination. One of the significant changes is as follows:

**Fair Value Measurements -** Under ASC 805, credit unions will be required to identify the fair values (Level 1, 2 and 3) (ASC 820, formerly FAS 157 and ASC 825, formerly FAS 159) of all identifiable assets acquired, liabilities assumed, and any non-controlling interest of the acquiree credit union.

Specifically, pay attention to any identifiable (core deposit intangible) intangible assets. Some of the most significant implications to the continuing credit union's balance sheet of the acquired credit union will include:

- Loan portfolios will be adjusted to fair value based on market valuations or with market level inputs
- Allowance for loan and lease losses of the acquired credit union will be reduced to zero, since all member loans will be fair-valued with an assumed loss factor inherent in the portfolio's fair value
- Core deposit intangibles may be recorded
- Fixed assets will be adjusted for fair value
- Investments will be reassessed at fair value
- Goodwill will be determined

Keep in mind the NCUA has changed its definition of regulatory net worth to include regulatory net capital of a merged credit union. Capital acquired in a merger may increase or decrease based on fair value adjustments.

As a result of these changes in the accounting for business combinations, credit unions will need to seek the assistance and guidance of professionals in the fields of business valuation and investment loan valuation, plus commercial property appraisers. These costs will be significant in many situations and should be recorded as period expenses as incurred (not amortized).

### Merger Accounting Changes

Credit unions identified as the "acquired" will be required to identify the fair value of assets and liabilities, including identifiable intangible assets. In most cases, there will be no consideration given to the acquiree credit union; goodwill is the difference

between the fair value of the assets received and the fair value of the liabilities assumed.

Fair values must be based on market participant assumptions rather than on credit union-specific assumptions which will increase the complexity of accounting for an acquisition, thereby potentially increasing the volatility of future operating metrics due to increased amortization, depreciation, or future impairment charges.

Goodwill recorded in a business combination is required to be reviewed for impairment (not amortized) on an annual basis. ASC Topic 350, Intangibles- Goodwill and Other, formerly FAS 142, is the accounting guidance that should be followed when assessing impairment. Calculating the goodwill of the merging credit union is a multi-step process that involves calculating the fair value of identifiable assets and liabilities (balance sheet valuation) and then calculating the fair value of the business enterprise (present value of future earnings.) The variance in these two calculations result in Goodwill (consideration in excess of fair value of assets and liabilities) or a Bargain Purchase (consideration less than the amounts of the fair value of net assets acquired which would result in a recognizable gain).

### Fair Value Components

In assessing the fair value adjustments necessary to the credit union financial statements being consolidated into the continuing credit union, the following areas should be evaluated thoroughly by management, internal audit, or a consulting team:

**Loan Valuation:** When valuing loans, the rate used to discount the future income stream is the rate that would be charged in the market for an equivalent loan at the time of the valuation, not the interest rate stated on the loan. For example, if the interest rate charged on a loan is 7%, but the current rate on a

similar loan, reflecting collateral, credit, and market risk, is 8%, the market value of the loan would be less than its book value, all other things being equal. This process must be completed for all loan types and can be obtained from market quotations (Level 1) or modeling with Level 2 or Level 3 inputs.

**ASC 840, Formerly FAS 91:** The costs to originate loans (e.g., HELOCs, first mortgages, indirect auto loans); once the loan types are valued, these deferred costs will be reduced to zero.

**Allowance for Loan Losses:** At date of acquisition, the acquired credit unions allowance for loan loss is reduced to zero as the allowance for loan loss should be embedded in each loan type's valuation analysis.

**Investments:** All investments are reassessed at fair value and obtained normally from current market value sources, like brokers or RIAs. Implications are that investments, if re-deposited at the acquisition date, may have a new basis after merging into the continuing credit union.

**Fixed Assets:** Any buildings and land will need to be appraised by a licensed commercial property appraiser. Methods used for updating fixed asset fair values include comparable transaction analysis, macro & micro-economic trends, depreciation method used and/or any appreciation or obsolescence.

**Core Deposit Intangibles:** Core deposits typically include non-maturity-based share accounts, such as regular shares, money markets, interest and non-interest bearing checking or draft accounts. The measure of core deposit value is to gauge the difference between the costs associated with the

core deposits and the costs of alternative funding at market rates. The costs for these core deposits include the interest paid, the maintenance costs, and an estimated annual decay of the deposits. An appropriate discount rate for calculating the present value would be a rate on a comparable risk investment such as a Treasury or FHLB rate. Core deposit intangible assets are required to be amortized over an appropriate period of time under generally accepted accounting

principles, tied to the average decay rate assumptions. Amortization periods vary across financial institutions and individual credit unions should consult with their CPAs to determine an appropriate amortization period. Since the core deposit intangible asset is an amortized intangible asset, annual review for impairment is typically not required.

**Operating Leases:** If a credit union is leasing any facilities, the leases should be analyzed against current market

rates for similar leases. Differences that exist between current lease terms and market lease terms should be recorded as an asset, if the market price of a similar lease is higher than the contractual terms of the credit union's lease, or a liability, if the market price for a similar lease is less than the contractual terms of the credit union's lease.

## OTTI: What It Is And Why You Should Care About It

Over the last year or so, the financial world has focused a great deal of attention on fair value accounting and the Financial Accounting Standards Board's (FASB's) guidance on the subject. Much of that guidance has been designed to reassure companies that they need not value financial assets at fire-sale prices when markets for those assets are inactive or illiquid.

Another important accounting issue, particularly for credit unions, is the treatment of other-than-temporary impairment (OTTI) for investments. In mid-2009, FASB issued guidance that changes the way these impairments are recorded for certain securities. OTTI can have a significant impact on credit union earnings and regulatory capital, so it's important to have policies and procedures in place to deal with OTTI and to document your assessments carefully.

### What is OTTI?

A debt or equity investment is impaired if its fair value is less than its amortized cost basis. If that happens, a credit union must determine whether the impairment is other than temporary. Factors to make this determination include:

- Length of time the security's fair value has been below its carrying amount

- The issuer's near-term prospects, and
- The credit union's intent and ability to hold the investment long enough to allow for any anticipated recovery in value.

Under previous rules, assets that experienced OTTI were written down to fair value, with a corresponding charge to earnings.

In a depressed market, for example, a debt security's fair value may decline even though there's little or no change in the underlying cash flows. Arguably, a requirement that the holder write down the security to fair value, even if it intends to hold it to maturity, doesn't fairly represent the underlying economics.

### How Does The New Guidance Work?

The new rules treat equity securities in essentially the same way as before, but they make significant changes to the treatment of debt securities classified as available-for-sale or held-to-maturity. If a credit union determines that a debt security is other-than-temporarily impaired, it must then determine whether it intends to sell the security or it's more likely than not that it will be required to sell the security before its anticipated recovery.

If the security is likely to be sold, the total amount of OTTI is written down and recognized in earnings. If it's not likely to be sold, however, only the credit component of OTTI - that is, the loss attributable to the issuer's inability or unwillingness to pay, is recognized in earnings. The noncredit component, which reflects losses caused by illiquidity, fluctuating interest rates or other factors, is recognized as other comprehensive income (OCI).

There's no prescribed method for estimating the credit component of OTTI, although FASB's guidance notes that one acceptable methodology is the same method used to account for the impairment of a loan. That method generally involves calculating the present value of expected future cash flows discounted at the effective interest rate.

### Minimize Impact

To minimize the impact of OTTI on earnings and regulatory capital, be sure that your credit union has policies and procedures in place for classifying securities, determining fair value, assessing securities for OTTI and measuring the credit and noncredit components.

# Reverse Mortgage

## Borrowing Against Your Home

Kenneth Trauthwein, MSF

A reverse mortgage is another viable loan product for many financial institutions. Lenders have an easier task qualifying applicants because income and credit history are not considered and have the opportunity to cross-sell additional financial products. A reverse mortgage can put money in your borrower's pocket and is a unique type of mortgage loan that allows your borrower to convert a portion of the equity in their home into cash without having to sell their home. In a traditional mortgage loan, the borrower makes monthly principal and interest payments to the lender. In a reverse mortgage, the borrower receives money from the lender and does not have to pay back the loan while living in the home. The loan is repaid when the borrower dies, the home is sold, or when the home is no longer the borrower's primary residence.

Reverse mortgage loans have several eligibility requirements. A borrower must be 62 years of age or older, own their home outright or have a low mortgage balance and live in the home. The loan proceeds can be used to finance home improvements, pay unexpected medical expenses, or supplement retirement income. Qualifying homes include single-family homes, 1-4 unit homes with one unit occupied by the borrower, condominiums and manufactured homes. The amount your borrower can obtain depends on age, the current interest rate, and the appraised value of your borrower's home or the Federal Housing Administration's (FHA's) mortgage limit. The mortgage limits differ by area.

There are three types of reverse mortgages. **Single-purpose reverse mortgages** are offered by some



government agencies and nonprofit organizations.

This type of reverse mortgage is not available everywhere and loan proceeds can only be used for a single purpose, such as home repairs or property taxes. **Proprietary reverse mortgages** are private loans that are backed by the companies that develop the loans. **Federally insured reverse mortgages** are known as Home Equity Conversion Mortgages (HECMs) and are the most popular. The U.S. Department of Housing and Urban Development (HUD) backs HECMs.

The HECM has many appealing loan features. Borrowers are able to choose from the following payment options:

- A term option with fixed monthly cash advances for a specific time period;
- A tenure option with fixed monthly cash advances for as long as your borrower lives in their home;
- A line of credit option lets your borrower draw down the loan

proceeds at any time in amounts the borrower chooses until the line of credit is used up; or

- A combination option with fixed monthly cash advances and a line of credit.

A HECM allows the borrower to retain title to the home without making monthly loan payments. A loan is repaid when the last surviving borrower dies, sells the home, or no longer lives in the home. Under the HECM program, your borrower can live in a nursing home or other medical facility for up to 12 consecutive months before the loan must be repaid. A borrower's heirs are still entitled to the property upon passing. The estate can be settled in normal manner when the property is passed on to the borrower's heirs. The heirs have one year, from the passing of the note holders, to settle. They can refinance out of a reverse mortgage or sell the property and keep the net sale proceeds after the reverse mortgage balance is paid in full. Other benefits include loan advances that are not taxable and Social Security and Medicare benefits are generally not affected.

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*(Reverse Mortgage - Continued from page 5)*

Public benefits can only influence eligibility if loan advances are counted as liquid assets due to monies being deposited into checking or savings accounts beyond the calendar month in which the advances are received. Most important of all, and the risk to the lender, is the borrower can never owe more than the value of the home at the time the borrower or his heirs sell the home. If the sale proceeds are not sufficient to pay off the loan, the lender absorbs the difference.

Getting a reverse mortgage does require counseling. An applicant is required to complete a counseling session with a HUD-approved counselor. A reverse mortgage can

use up all the equity in the home. The amount that is owed grows over time. Interest is charged on the outstanding balance and added to the amount that the borrower owes each month. Since the borrower retains title to the home, he is responsible for taxes and insurance. The loan may become due and payable if taxes are not paid or if homeowner's insurance is not maintained.

A reverse mortgage can be used to purchase a primary residence. If the borrower has cash on hand to pay the difference between the HECM proceeds and the sales price plus closing costs for the home that they are purchasing, a reverse mortgage can finance the purchase. There was a "Jumbo" reverse mortgage product but the current credit crunch halted this product. A "Jumbo" reverse

mortgage is for a home valued over the maximum limit and is generally offered as a proprietary reverse mortgage, which is not insured by the FHA.

This financial product requires extra time and personal financial counseling upfront. Reverse mortgages may be a viable option for some borrowers but not for all. Credit unions have the ability to gain insight into the financial products and services that best match the needs of their members. Appropriate cross-selling of traditional home equity products may provide a more practical and less costly alternative. Your members should consider all their options.