

Banking on growth: FDIC-assisted assets may be an opportunity for midsized institutions



Mid-market and community bankers, like the rest of the financial services industry, are struggling to regain their equilibrium after the financial crisis and economic downturn. More than 100 banks with \$25 billion or less in assets have been taken over by the Federal Deposit Insurance Corporation (FDIC) in 2009.¹ At the same time, midsized banks that have managed to stay comparatively healthy are operating under intensifying regulatory and reporting requirements, adding to costs.

Institutions that are weathering the crisis face a looming question: We are surviving today, but how do we grow for tomorrow? Commercial lending, the backbone of many institutions, remains stunted. Mega institutions have swooped up retail and credit card accounts. Residential mortgages carry heavy interest rate and credit risk.

The answer for some may be focusing more attention on the potential of acquisition and merger opportunities stemming from the recent travails of the banking sector. The more than 400 banks on the FDIC's distressed watch list,² combined with those the FDIC already has had to take over, suggest an ample supply of possible M&A targets. Healthy midsized banks have the rare opportunity to tap such opportunities to potentially gain long-term strategic advantage.

As a result, some banks may soon elect to enter more aggressively into nongovernment-related (i.e., private sector) transactions as stability continues to return to the financial markets. However, most acquirers view FDIC-assisted transactions as a safer means to expand their franchises. In either instance, potential buyers should consider proceeding cautiously amid the considerable risks of acquiring a troubled or failed institution.

FDIC sales that include a loss-sharing feature have become the focus of bank acquisition activity because of a unique risk-reducing feature that provides FDIC reimbursement of a portion of the acquirer's expected future losses.³

¹ http://money.cnn.com/news/storysupplement/economy/bank_failures/list/

² <http://www.reuters.com/article/ousiv/idUSTRE57Q34M20090827>

³ In addition to loss-sharing transactions, the FDIC sells banks through standard purchase and assumption agreements in which the bank assumes the liabilities and assets of the institution; and purchase and assumption agreements that provide the option to bid on designated loan portfolios.

Banks that consider pursuing loss-sharing transactions as a way to generate growth should understand the process and all the aspects associated with acquiring a bank. Potential buyers should first determine what types of deals will fit their business strategy, and then get on the FDIC's radar screen as a potential, credible acquirer. Advance deal preparation is needed, as FDIC sales happen in a dramatically compressed time frame. Also important is an understanding the advantages and disadvantages of loss-sharing arrangements and how this type of transaction fits into the organization's overall strategy. Finally, the time pressure of a short-fuse deal will add urgency to integration planning.

Getting in the game

The first imperative for a bank considering an FDIC-related acquisition is to assess whether the transaction fits into its strategic business vision. What markets does the institution want to be in, and what products and services does it want to sell? Will the acquisition improve portfolio diversification?

Financial and operational questions also need to be addressed. How will the acquisition affect the bank's asset and liability mix? Does the acquirer have sufficient capital to take on the assets and maintain regulatory capital ratios? Does it have the structure, personnel, resources, and risk management capabilities and controls to handle an acquisition, especially one that takes it into new lines of business?

Potential acquirers can benefit from preparing an introductory packet for the FDIC that provides a comprehensive profile of their institution. Key information should include, among other things, financial performance data; supervisory issues; descriptions of the size and type of institutions they feel equipped to pursue; and a pro forma picture of what the bank might look like should such a transaction occur. If the bank has targeted a specific institution, it should conduct pre-takeover due diligence to the extent possible.

When the FDIC is ready to put an institution on the market, it considers potential acquirers that it believes can handle the deal. Establishing communication with the agency and providing information that showcases the bank's strategy and strengths can be instrumental in getting on the FDIC's list.

Among the benefits of FDIC-assisted transactions, the buyer acquires a new deposit franchise, increases market share, may enter a new market and can increase economies of scale

Preparing for and executing the deal

FDIC bank sales often happen at breathtaking speed. A potential acquirer may receive notice to submit a bid within 24 hours and three days later own the institution.

Such abbreviated timetables make it crucial for banks to identify acquisition targets as soon as possible, preferably well ahead of an institution being taken into receivership. Particularly, in cases where target institutions are in its own operating region, a potential acquirer may be able to gain competitive advantage by conducting due diligence before a failure as if it were going to contribute capital or buy the institution outright.

Absent such opportunity, a review of available financial and regulatory information can provide the basis for modeling exercises to estimate what the institution is worth and how it fits into an acquirer's strategy.

Special attention should be given to potential deal killers – for example, credit or capital risk, deposit loss, and key talent loss. Early identification of factors that could make an acquisition unworkable or ill-advised can save valuable time and resources. However, identifying these challenges does not necessarily mean walking away from a particular deal; they may well be manageable given the right forward and contingency planning.

Credit risk is often the primary deal killer in today's market. An acquirer must understand the potential capital and earnings impact associated with various portfolios, even after consideration is given to any loss-sharing arrangements

Failing to understand the pro forma regulatory capital impact of transactions is a common shortcoming among potential acquirers. It is critical to assess the fair value of the assets and liabilities of the institution being purchased and how acquisition accounting will affect regulatory capital calculations going forward. The greater the loan write-downs, the more capital the acquirer will need to invest in the business.

A target's deposit profile also warrants close attention. Are its customers "sticky" and likely to stay with the institution through the transition, or will they flee to a competitor? Do those customers fit with the acquirer's existing customer base and account types?

Management and operational considerations are also important. Are the target's processes, personnel, and culture a good fit, and can they be adapted to the acquirer's profile and way of doing business?

Potential acquirers should also consider their organization's ability to handle an M&A transaction – from detailed planning through execution – while also "running the bank" from legal day 1. The compressed timeframes of FDIC deals can require a fully dedicated team, with knowledge and experience beyond that of people within the bank. Obtaining the assistance of professional advisors to aid in deal execution can help fill capability gaps, add resources at the most critical time, and free internal personnel to focus on day one preparation.



Understanding loss sharing

As mentioned earlier, loss sharing agreements provide for reimbursement of a portion of an acquirer's future losses. It is important to note that in spite of the fact that the majority of FDIC transactions are termed "whole bank" acquisitions, certain assets and liabilities are typically carved out.

In typical "whole bank" FDIC transactions, most assets are acquired, together with assumption of federal home loan advances and deposits. However, broker deposits, bank-owned life insurance, and other assets ancillary to banking operations typically are not acquired.

The acquirer usually receives an option to purchase fixed assets at fair market value over a period after the acquisition

Although loss-sharing agreements give the buyer partial downside risk protection, it is worth noting that the FDIC has fairly standard contracts whose terms may be not be negotiable. The agency follows standard processes covered by established rules and regulations. Due diligence is limited, a condition mitigated somewhat by the loss-sharing agreement. The acquirer must estimate expected losses on the loan portfolio and anticipated recovery under the agreement.

While downside risk is limited in loss-sharing agreements, it is not eliminated, as sharing kicks in for losses above a "first-tranche" threshold. At the same time, upside gains are limited, as asset recoveries are shared with the FDIC in the same proportion as the reimbursement of future losses. Furthermore, gains associated with covered assets may also be subject to claw-back provisions which can limit a portion of the acquirer's potential upside in a transaction.

Loss-sharing agreements present other potential limitations for acquirers, as well. Residential and nonresidential loans have different terms and conditions. In particular, handling of residential loans must adhere to government loan modification specifications. While some negotiation of these requirements may occur during the acquisition, the buyer must still attempt to modify residential loans to keep borrowers in their homes. The buyer also cannot bulk sell these assets and expect the FDIC's loss-sharing agreement to be transferable in the transaction.



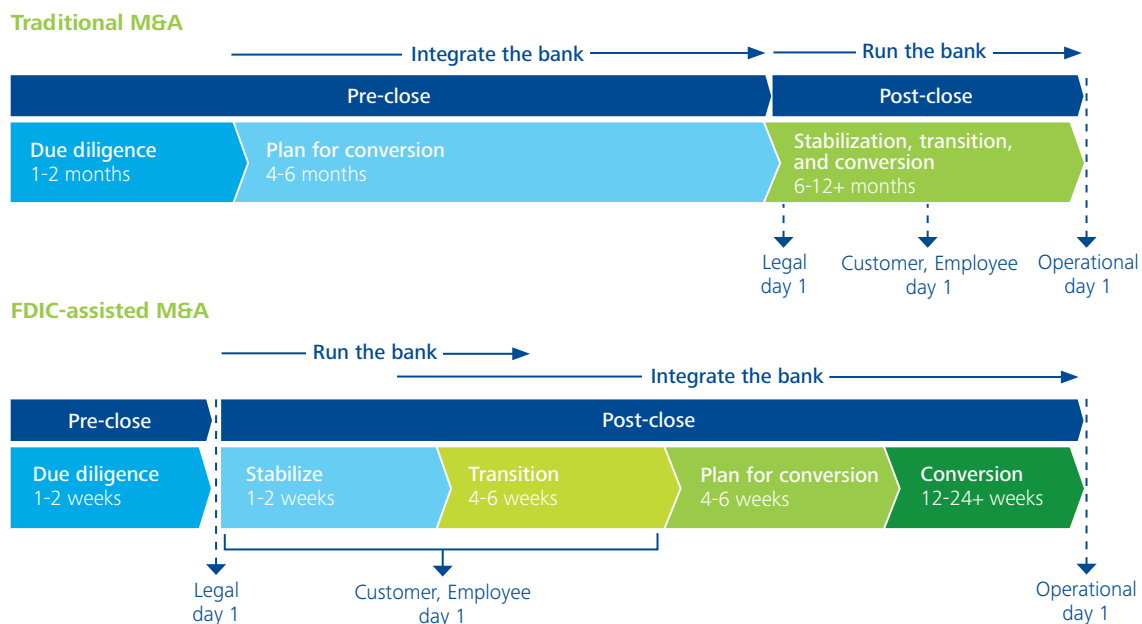
Addressing integration issues

The timing and nature of FDIC transactions present additional considerations for merger integration. The chevrons in Figure 1 illuminate how much more quickly an acquirer can go from bidder to owner in an FDIC deal. With virtually no pre-close window for transition planning, a new owner could be running the entire operation within days of submitting a bid. Consequently, getting on top of how to “run the bank” – for example, key controls, performance metrics, products, service, and employee nuances – while simultaneously planning how to “integrate the bank” can be daunting.

During the short time available pre-close, the acquirer can benefit from absorbing the details of the purchase and assumption (P&A) agreement and how it will guide the transition. While the P&A agreement includes specific timetables, some provisions can be tailored – for example when the acquirer will assume responsibility for employees and their benefits; how loss sharing will be reported; and how data management and security will be maintained and transitioned. The acquirer can benefit from working proactively to nail down specifics with the FDIC.

Advanced preparation also can include loan, credit, and investment reviews. The new owner may also want to develop an understanding of the institution’s infrastructure position, for example what bank assets are paid for. It will also help to learn the FDIC’s role in supporting continuation of shared services the institution may be receiving.

Figure 1: Illustrative comparison of traditional and FDIC-assisted M&A timelines



Source: Deloitte experience in traditional and FDIC assisted M&A transactions



Post-close the acquirer will need to move quickly on several fronts. Key steps include:

Understanding deposit and customer loss triggers –

An acquired bank's customers have endured the disruption of the bank's failure and felt the subsequent relief of landing in the arms of the FDIC. Many simply want to stop worrying about their financial institution and will wait and watch how the new owner performs – for a while. Low initial customer attrition can lull the new operator into thinking things are going well, while problems are bubbling up. Plus, attrition can occur in bunches. An FDIC transaction can have as many as 100 customer touch points, 70 of which are critical to deposit and customer retention. Once a letter goes out announcing the bank's new ownership, customers will call, email, and write with questions and concerns. It is important for the acquiring bank to proactively communicate consistent guidance and provide appropriate training and support for customer-facing employees throughout the organization.

Addressing knowledge capital needs – Inertia will often compel many employees to stay put in the same way it does customers. At the same time, key personnel – for example, top talent such as relationship managers, branch managers, and operations and technology leads – may see limited future opportunity and seek or be sought out for positions elsewhere. Again, frequent communication can help reassure employees that their interests are being kept in mind, both those with long-term retention potential and those who are critical to the transition but have limited futures in the organization beyond.

Stabilizing systems rapidly and insulating against major service disruptions –

Customers who cannot interact with the bank the way they want may quickly choose to go elsewhere. To maintain the reliability of services such as online bill payment, transfers, and statement review, it is advisable to not plan any major platform changes during the initial stabilization phase of the integration. Also monitor service-level agreements with external vendors to help maintain service continuity.

Locking down critical contracts and inventorying all projects –

An acquired institution may have contracts for everything from facilities management and benefits administration to pencils and paperclips. However, these contracts are rarely contained within a central repository. Rarer still does an individual caretaker of that repository exist. The FDIC will typically provide a list of contracts they've been able to find, but the reality is that most acquirers will need to perform their own diligence to flush the system.

FDIC sales allow the buyer to repudiate such contracts within an established time period after the deal closes, with the agency handling the dissolution. In deciding which contracts to keep and which to let go, the buyer will first want to examine resources with a significant impact on customers and employees such as processing technology, call center operations, and ATMs. Potentially millions of dollars can be saved through discontinuing redundant or disadvantageous contracts, or re-negotiating with vendors given opportunities for larger volumes, even in relatively small deals.

It can be beneficial to assign a "P&A czar" to manage the numerous, rapid developments during the transition process. Providing dedicated leadership can help the acquired institution stay on top of the FDIC's formal mandates, as well as additional requirements it may impose along the way.

Taking a new pathway to growth

Midsized banks have taken heavy blows during the financial crisis. However, many among those still standing are looking to the future. By understanding the unique considerations of purchasing FDIC bank assets and planning for the compressed deal timetables, bankers can use such transactions to help achieve their growth goals.

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