How to Handle Loan Portfolio Valuation and Avoid Trouble Later

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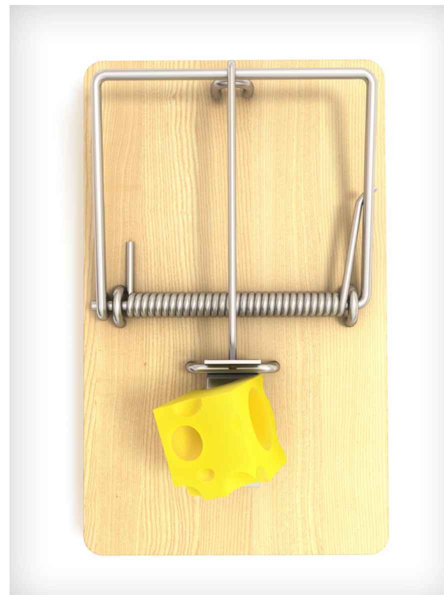

In most acquisitions, the selling bank's loan portfolio generally is the largest asset. Valuing it often consumes the majority of the valuation team's effort. Achieving consensus on fair value can be challenging, as there typically isn't an observable market price for most bank loan portfolios. In fact, the acquirers' management often is surprised by the difference between its pro forma balance sheet projections and the final independent, third-party valuations. These unexpected changes in valuation could have a significant impact on the acquiring institution's regulatory capital requirements and future earnings potential.

In most acquisitions, the valuation of the loan portfolio primarily is performed using a discounted cash flow method and various assumptions such as probability of default, loss given default, prepayment speeds, and required market rates of return on the projected loan cash flows.

What should management teams think about as they approach acquisitions and determine pricing and purchase price allocations? Here are a few considerations.

1. To achieve a result that can be managed on an ongoing basis, loan valuations require a balance between the acquiring bank's various internal management teams. For example, in many cases, finance teams significantly rely on the credit review due diligence team to assign the fair value marks on the loan portfolio. Note that the credit review team must provide its input for the results to be consistent with how the credits will be managed post-acquisition. An issue sometimes arises because most credit review teams typically provide identified loss ranges that are more applicable to an allowance for loan loss method. Alternatively, consider a range of life-to-date loss projections that can be presented to the board and management as best-case/worst-case scenarios to evaluate the overall merits of the transaction.
2. The absolute credit mark might be fine for due diligence, but to be in compliance with U.S. generally accepted accounting principles (GAAP) and Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 805, "Business Combinations," the timing and amount of expected loan cash flows need to be projected, and the market-required rates of return on the cash flows must be

considered. Both the credit review and finance teams need to keep this distinction in mind, because incorporating both the timing and amount of loan cash flows and market-required returns often will decrease the values from the basic credit marks.

Consider market factors other than credit, timing, and market pricing in the analysis. ASC 805 and the fair value standard ASC 820, "Fair Value Measurement," require acquirers to value loans using an "exit pricing" method, which loosely translates to what a willing buyer would pay a willing seller for that loan. This differs from other methods such as asset/liability fair values that often use a bank's own new loan rates as the basis for discounting the cash flows. Under GAAP, using the current interest rate for the institution to make a loan is labeled as an entrance price, while acquisition accounting GAAP requires an exit price, or the price to sell the asset or assume the liability.

3. One of the primary market factors to consider in addition to the basic valuation inputs (such as discount rate, credit loss factors, prepayments, and the contractual loan principal and interest payments) is the liquidity discount applied to each loan. It takes time and effort to sell a loan or a loan portfolio, and that time affects pricing. The more difficult a loan portfolio is to sell, the higher the liquidity discount that is factored into the required rate of return. Additionally, market perception is a factor that affects pricing no matter the credit quality. For example, loan portfolios with heavy concentrations of home equity or construction loans are discounted regardless of credit quality because of the market's negative perception of this lending type.
4. Plan for the post-acquisition accounting processes in advance of due diligence and deal completion. Accounting for loans in an acquisition after the deal is closed is complicated and requires systems, processes, and coordination with the various teams within the bank. For credit impaired loans, the teams working on those loans must provide feedback to the accounting team on the timing of cash flows and the ultimate values that might be realized for each loan.

Because loan valuations are complex, it is crucial that banks coordinate between their internal teams and external resources. Proper planning and process development can result in due diligence expectations that are consistent with post-completion valuations.

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