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Navigating the Maze of Acquiring Failed Banks

Making the Deal a Success

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While acquiring a troubled financial institution is a likely topic of discussion at every bank's board meetings and at many private equity firms, the process of moving from the boardroom to the playing field is complicated. Even for institutions that are serial acquirers, the rules of engagement are difficult to follow and seem to change with each new deal.

This series of articles provides a guide to the entire life of a deal, starting with pre-deal considerations, continuing through the acquisition process, and ending with the integration of the newly acquired entity. Crowe offers lessons learned and insights gained from extensive experience with helping clients navigate the complexities of acquiring failed institutions as well as from what happens once the deal is done.

The topics covered in these articles include:

- The available transaction options and the associated risk;
- The critical elements of the current due diligence process that an FDIC-assisted deal usually involves;
- Accounting for a failed-bank acquisition, including loan accounting considerations, FDIC receivables reporting, and bargain purchase gain issues;
- Tax issues that need to be considered before a deal is consummated;
- The process for valuing the various components of an acquired failed bank and the associated complications;
- Insights into how to create and swiftly carry out a plan for integrating the newly acquired operations and assets; and
- The opportunity for banks to use private equity funding in the very active failed-bank market and the restrictions and added benefits that banks need to consider.

Knowledge of the entire complex process can help a buyer's strategic initiative become a successful acquisition – one that achieves the desired objectives identified when the deal was first being considered.

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Evaluating a Failing Bank: Key Factors to Consider

By William J. Wilhelm, CPA, ABV, Stephen J. Wagner, CPA, and R. Chad Kellar, CPA

Through May 28, 2010, 78 banks and thrifts had failed in 2010.[1] If this trend continues, the total failures for the year will exceed the 140 that occurred in 2009. A healthy bank contemplating whether to enter the failed-bank market must determine its own short-term and long-term business objectives first – and only then begin evaluating potential transactions.

The criteria for determining whether to acquire a failing bank from the Federal Deposit Insurance Corporation (FDIC) generally are the same criteria for evaluating an acquisition of a nondistressed bank, but they are weighted very differently. According to an independent survey and additional research conducted by Crowe Horwath LLP,[2] when evaluating a failing institution acquiring banks emphasize the potential for strategic growth opportunities, including branch expansion, generation of core deposits, and immediate and long-term income accretion.

Understanding the Transaction Options

Before evaluating whether to enter the failed-bank market, the potential acquirer should understand the different types of acquisitions the FDIC allows. The structure of the transaction for a failing bank directly affects the amount of risk associated with the acquisition – which, in turn, affects the resulting bid strategy. FDIC-facilitated transactions generally take the following forms:

- **Whole bank with an FDIC loss-sharing agreement.** A whole-bank acquisition with an FDIC loss-sharing agreement (that is, an FDIC-assisted acquisition) is currently the most common structure. It allows the acquirer a larger margin of error because the FDIC will absorb a majority of the losses.
- **Whole bank with no FDIC loss-sharing agreement.** This option is riskier because the acquirer will bear any and all losses. It may, however, be an effective bidding strategy for institutions looking to avoid the government loan modification programs that are required under a loss-sharing agreement and that could be seen as a potential drag on future earnings. In addition, this strategy may prove effective to the extent the resolution of the failing institution is due more to liquidity issues than to forecasted losses of capital.
- **Asset purchase.** Asset-purchase transactions are not accompanied by a loss-sharing agreement and are least common today for two reasons. First, the FDIC typically determines that these transactions are more costly to the insurance fund. Second, the sheer appeal of loss-sharing agreements typically results in numerous bidders, which affords the FDIC choices. The surplus of bidders for failing institutions means the FDIC rarely has to resort to selling only selected loans and investments of a failing bank.

Equally important to understanding the transaction alternatives is evaluating the various reasons to bid or not bid on a failing bank.

Expanding Into Strategic Markets

The opportunity to expand into strategic markets – and to do so without the typical pre-deal research and development time or the usual regulatory approvals – is a primary impetus behind healthy banks' pursuit of failing banks. According to Crowe's research, 53 percent of acquirers reported that the branches of the targeted failing institution were located in strategic markets for growth.

New Markets

Some banks aim to increase their size and footprint by acquiring a failing financial institution from a different state. If a bank's strategic goals include broader customer reach and an expanded and more diverse portfolio, an out-of-state acquisition from the FDIC can be a big step toward attaining those goals.

The opportunity to open branches in a new state via an FDIC-assisted acquisition is attractive for other reasons as well. According to one acquiring bank, the cost of its FDIC-assisted acquisition of deposits and branches in a state where the acquirer had no branching rights was roughly one-third the cost of what following the usual process of obtaining branching rights in the state would have been.

Current Market

Many FDIC-assisted deals have also been spurred by the potential for the buyer's further development of an existing market. Some acquisitions immediately increase the presence of the healthy bank in its market and position it to take advantage of opportunities the market affords. According to Crowe's research, more than half of acquirers identified a greater market share as a significant benefit of their transactions.

A significant advantage of in-market transactions is the resulting savings in both operating costs and capital expenditures. With the option to assume the deposits without purchasing duplicate or undesirable branch locations, acquirers have the ability to expand their branch network selectively. From a capital expenditure perspective, one survey respondent estimated that his institution's branch and deposit acquisition through an FDIC-assisted deal was two-thirds the cost of what building and developing a comparable branch network would require ordinarily.

Generating Core Deposits

The opportunity to increase core deposits generally is one of the more heavily weighted considerations when a buyer is evaluating a conventional (non-FDIC) acquisition. However, according to Crowe's research, only 19 percent of the FDIC-assisted acquirers mentioned that a core deposit acquisition was a significant benefit of the deal.

Core deposit acquisition typically is not considered a significant driver of FDIC-assisted deals because the failed banks typically have been maintaining higher levels of noncore funding. Many failing financial institutions are leveraged with significant concentrations in brokered deposits, certificates of deposit obtained through account registry services (CDARs), and subscription-service deposit accounts that can present challenges and little value to the acquiring institution. In a 2009 study by Foresight Analytics, the average bank failure had four times the national average of brokered deposits.[3] Failed institutions with high levels of brokered deposits will, for the most part, generate a lower deposit premium because of the lack of core deposits being acquired.

An acquiring institution must understand the nature of the core deposits to adequately forecast costs, including interest and servicing costs, as well as the cost of maintaining customers that are likely to consider moving their accounts when their bank closes. However, the retention of core deposits can still be a significant driver for the accretion of long-term value, and maintaining key customers and core deposits is critical to the long-term success of the acquisition.

Bargain Purchase Gains

Before the issuance of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 141(R), "Business Combinations" (now codified as ASC 805), bargain purchase gains (or negative goodwill) were allocated against particular acquired assets. Today, bargain purchase gains are required to be recognized through earnings at the acquisition date. However, the FASB expected bargain purchase gains "to be anomalous transactions – business entities and their owners generally do not knowingly and willingly sell assets or businesses at prices below their fair values."

Bargain purchase gains have been fairly common in failed-bank acquisitions. According to Crowe's research, a quarter of the acquirers mentioned the benefit of a bargain purchase gain in their post-acquisition press releases. The day-one gain allows acquiring institutions to provide noncash capital to offset acquired assets. Day-one gains depend on the structure of the deal and occur most commonly on transactions with high-asset discount bids.

Some acquiring institutions have relied on a bargain purchase gain to supplement existing capital, and subsequently these bargain purchase gains have been reduced upon finalization of the day-one accounting. In response to the complexities and uncertainties of retaining a pro forma bargain purchase gain, on June 7, 2010, federal regulators of financial institutions jointly issued guidance[4] that encourages bidders to include a pro forma balance sheet with two sets of pro forma capital calculations – one set that includes a bargain purchase gain and another set that does not. Regulators may impose additional restrictions as a condition of transaction approval when a bargain purchase gain is expected to result from a transaction and fair value estimates have yet to be validated.

Until March 26, 2010, the FDIC generally assumed 80 percent of losses on covered assets up to a stated threshold and 95 percent of losses over that threshold. Now, however, the loss-sharing agreement is generally a fixed 80 – 20 split. If this proportion becomes prevalent, bargain purchase gains are likely to diminish.

Other Considerations

Additional factors, though often not discussed, are also important for bank executives to consider when evaluating potential deals.

Execution Risk

The execution risk should be analyzed more carefully than any other aspect of an FDIC-assisted transaction. Execution risk encompasses the risk that the transaction ultimately will not be completed within the acquirer's desired expectations – for example, the bid may be unsuccessful, the healthy bank may overpay for its acquisition, or the deal's intended benefits may ultimately fail to materialize. Inherent in any transaction, execution risk can be minimized by developing the bid using careful analysis – weighing the benefits and, at the same time, crafting a competitive package.

Being a successful bidder for an FDIC-assisted acquisition requires a nimble management team that monitors potential upcoming bank failures, using various potential scenarios and opportunities to determine the targets most likely to provide long-term value. The team must be agile enough to move quickly when acquisition opportunities arise. This agility, if built on a foundation of careful preparation, can be a distinct competitive advantage over the field of other potential buyers.

A key component for developing the bid is derived from the information obtained during the due diligence process.[5] Although the FDIC's window for due diligence generally is short, the abundance of information that's publicly available allows an opportunistic acquirer to manage the execution risk while evaluating failing banks for strategic growth opportunities, current market expansion, and core deposit availability.

Personnel Retention

In a conventional bank acquisition, evaluating and retaining key members of management is an important risk factor that must be considered carefully. According to Crowe's research, however, very few acquirers (only 3 percent) mentioned the strength of the failed bank's management as a benefit of the FDIC-assisted transaction.

When evaluating personnel of the failing bank, acquirers typically are not concerned with managerial strength in the areas of credit – particularly when the loan performance has been poor and contributed to the bank's failure. Acquirers also do not take into account the strength of accounting personnel and certain operating staff who might be in redundant positions after the acquisition. Crowe's discussions with acquirers indicate that maintaining key personnel, at least in the short term, can be beneficial for the transitional phase. Some individuals might have significant operational knowledge critical to the transition and integration process. In addition, retaining familiar faces can help retain core customers.

Some bank executives have expressed a belief that completing a failed-bank acquisition also reassures existing customers that the buyer is a strong institution.

Workout Expertise

When a loss-sharing agreement exists, the limited amount of due diligence a buyer is able to complete results in less emphasis on evaluating credit considerations because of the protection the agreement provides against credit losses. However, acquirers with few credit issues in their past might not have sufficient experience with workouts of troubled loans. The expected time and expertise necessary for working through (and reporting on) troubled assets deserves careful consideration before an acquisition. Crowe's survey indicated that generally the amount of time attributable to troubled-loan workout, accounting, regulatory, and reporting activities turns out to be more than the acquirer originally expected.

Being Prepared

A healthy bank considering an acquisition should first define its strategic intentions and determine whether acquiring a failing bank fits into its short- and long-term goals. With advance approval of the key decision-makers, prioritizing potential geographies and institutions worth pursuing will help a potential acquirer react promptly as opportunities arise. The potential acquirer can then develop and use a troubled-institutions watch list to prioritize specific candidates for acquisition and monitor quarterly reporting to evaluate their Texas ratios, regulatory capital positions, liquidity, and ability to raise capital.

Once candidates have been targeted, high-level planning can address the relevant risks of acquiring them and identify a core group of internal and external resources that will be needed to mitigate these risks. From there, management can collect data about the markets, products and services, branch locations, and market demographics of the high-priority candidates. When a candidate becomes available for bidding, the acquirer will be positioned to act quickly to address the relevant risks and pursue the opportunity with alacrity.

It is not uncommon for an acquiring bank to lack a team that is ready and able to complete due diligence and financial modeling quickly, evaluate and implement bank integration, and assess the ongoing regulatory and reporting requirements. Working with professional advisers early in the process can enable management to determine its risk tolerance and capital requirements – as well as – transaction feasibility, various bid structures, hypothetical valuation, earnings accretion, and short- and long-term implementation issues related to the potential deal.

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[1] See www.fdic.gov/bank/individual/failed/banklist.html for a running list.

[2] The facts in this article are derived from 1) a Crowe survey in December 2009 of banking executives from recently successful bidders for failed banks and complementary selected follow-up interviews; 2) an analysis of press releases and Form 10-K filings from July 2009 to March 2010; and 3) Crowe clients that have acquired failed banks. For more information about the survey, see Jason V. Bomers and Mike J. Percy, "Troubled Bank Acquisitions: Understanding the Opportunity – and the Risk," http://folio.crowehorwath.com/files/PDF/PERF9232A_TroubleBankAcquisitionsWP_lo.pdf.

[3] Eric Lipton and Andrew Martin, "For Banks, Wads of Cash and Loads of Trouble," The New York Times, July 3, 2009, www.nytimes.com/2009/07/04/business/04brokered.html?pagewanted=1&_r=1.

[4] "Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions," June 7, 2010, www.fdic.gov/news/news/financial/2010/fil10030.html.

[5] For more information about due diligence, see Brian J. Hecker and Chad Kellar, "Due Diligence for Acquiring a Failing Bank," in this publication.

Due Diligence for Acquiring a Failing Bank

By Brian J. Hecker, CPA, and R. Chad Kellar, CPA

Acquiring a financial institution today almost inevitably involves considering failing or failed banks. Given the risk of acquiring banks in the current economic environment, due diligence is more important than ever. Planning ahead and understanding the current landscape can produce an effective due diligence process and help ensure a suitable bidding strategy.

The structure of a failed-bank acquisition from the Federal Deposit Insurance Corporation (FDIC) may limit the potential risk through loss sharing, but the time-compressed nature of such a transaction presents a unique set of challenges for potential suitors.

According to the latest issue of the Quarterly Banking Profile,[1] the FDIC has 775 financial institutions on its "problem list" – 10 percent of all reporting institutions. The list grew from 702 just a quarter earlier, and the pace does not seem to be slowing. Clearly, there is no need for potential acquirers to enter a transaction hastily – without proper preparation and due diligence – for fear of missing an opportunity.

The Current Due Diligence Landscape

Due diligence for FDIC-facilitated transactions is conducted in a very different manner than due diligence for traditional acquisitions. The biggest differences are that FDIC-assisted transactions occur over a much shorter time period, and the scope is ultimately controlled by FDIC field supervisors on-site.

The marketing process begins when the FDIC provides an executive summary and transaction recap to a list of invited bidders. One to two weeks is the typical amount of time between notification to a bidder by the FDIC and the on-site due diligence period. Bids for the failing bank are usually due within another week or two following the completion of on-site due diligence, with the ultimate resolution coming shortly thereafter. By contrast, the acquirer of a healthy bank generally has few rigid deadlines and limitations on the scope and timing of its due diligence efforts.

To conduct due diligence properly, bidders must understand the fluid nature of FDIC-assisted transactions and the form of transaction that the FDIC is offering. For example, the FDIC recently changed its loss-sharing structure because of the increased demand for these transactions. Previously, the FDIC assumed 80 percent of book losses up to a stated threshold and 95 percent of losses that exceeded the threshold on covered assets. Loss-sharing agreements now typically cover only 80 percent of losses on covered assets, with no 95 percent sharing threshold, and some recent transactions have more unusual features. The change in features can affect how much analysis of credit quality is performed and the bidding strategy of the acquirer.

Many FDIC deals include clawback provisions to recapture some of the loss-sharing payments or low bid price (purchase discount) when the losses are less than expected. Conducting effective due diligence based on the FDIC's loss estimate helps to form the projections needed to calculate the initial liability, if any, that will be recorded as a result of the clawback provisions. Potential acquirers can gain a leg up by understanding the ever-changing regulatory framework.

On-site due diligence is generally limited to a few days and a small team

Companies invited to bid are given access to the FDIC's secure online shared-document system one to two weeks before being allowed to deploy due diligence teams at the target bank. Typically, the available information includes detailed loan and deposit trial balances, financial data, a summary of premises and information technology, key dates, regulatory contact information, bid forms, instructions, and purchase and assumption documents. To develop its due diligence program, a bidder must immediately analyze this information in order to identify the loans to examine and formulate an approach to evaluating the deposit base.

Failed banks are usually closed on a Friday and reopened on Saturday as a branch of the acquiring financial institution. Part of the due diligence program, therefore, is determining the resources that will be required to understand the acquired bank's operations and make a substantial start on integrating operations in that short time.

Finally, while on-site due diligence is often possible, it is generally limited to a few days and a small team. These restrictions make it essential that potential bidders use the lead time provided by the FDIC to access the shared-document system and plan their due diligence in a focused manner. Prior to submitting a bid, internal resources (such as loan officers, operations personnel, and risk management staff) and external resources (consultants with expertise related to valuation, integration, and any special risks) needed to tackle the due diligence program should be identified.

Critical Elements of Due Diligence

FDIC-assisted acquisitions require special consideration of several factors during due diligence. The importance of some factors might vary depending on the form of the transaction.

Asset Quality

Regardless of the transaction form, a bidder must assess the risk of default on loans to estimate the principal and interest losses that will affect earnings after acquisition, as well as the staffing requirements and third-party collection costs the portfolio will demand as losses are resolved or mitigated.

A failing institution's list of performing credits often consists of recent troubled-debt restructurings

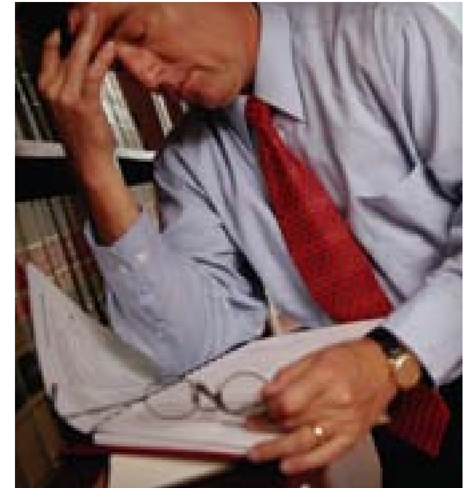
Analyzing the potential costs of the loan portfolio might require specialized knowledge of the loan products, mortgage loan modification programs, and location-specific collateral pricing – all of which should be factored into the due diligence plan. Identifying what the bank is reporting as "good" credits is just as important as reviewing loan files of the nonperforming or watch list credits. It is not uncommon to find that a failing institution's list of performing credits consists of recent troubled-debt restructurings, which present a significant level of risk due to a lack of demonstrated performance under the revised terms.

Liquidity

Liquidity is frequently a problem in failing banks with diminished or nonexistent core deposits. Any due diligence effort should include a detailed review of deposit accounts to identify the core accounts in order to adequately forecast future liquidity constraints. Many failing institutions are leveraged with significant concentrations of noncore deposits – brokered deposits, certificates of deposit obtained through account registry services (CDARs), and subscription-service deposit accounts, for example. An acquiring bank must understand the nature of the core deposits to forecast future costs, including interest and servicing costs, as well as additional costs to retain the customers most likely to move their accounts when the bank closes. Integration planning should optimize the retention of core accounts, which includes developing a communication plan and retaining critical frontline employees.[2]

Capital

Understanding the threshold of losses and the valuation of the assumed assets and liabilities is critical to estimating how much capital will be used by a failing-bank transaction. Estimates of asset values – based on interest rates, collateral values, and forecasted cash flows – vary widely. In a loss-sharing agreement, a discount bid for the assets and the FDIC reimbursement for shared losses will largely compensate for anticipated losses. It is important to note, however, that while recording the loans at fair value will result in a discount, the value of the loss-sharing receivable from the FDIC will not exactly offset this discount. As a result, a detailed understanding of the asset valuations is critical in order to bid effectively.



Some acquiring institutions have relied on a bargain purchase gain to supplement existing capital or to help avoid the need to raise capital. Understandably, the regulatory agencies are concerned that the initial valuations could be overstating the value of the transaction, leading to overstated capital positions. In part to address this situation, federal regulators recently issued joint guidance that addresses supervisory considerations related to business combinations that result in bargain purchase gains and the impact such gains have on the FDIC's acquisition approval process.

If the acquiring institution has an overreliance, as deemed by its regulator, on using the expected bargain purchase to support pro forma regulatory capital levels, then the imposition of additional conditions is possible. These may include but are not limited to maintenance of specified regulatory capital levels above statutory or policy limits, limitations on dividend payments and legal lending limits and requirements to obtain independent audits, agreed-upon procedures, and independent valuations.[3]

Competition

As a bank is failing, and particularly as it faces the FDIC resolution process, its reputation suffers with loan customers and depositors. These customers can be tempted to move to another bank. Competition might be poised to take advantage of customers' uncertainty and fear, further undermining an already vulnerable customer base. Discussions with bank personnel (to the extent permitted by the FDIC) may provide some insights about the relative competition in the market. Reviewing loan runoff and trends in the deposit mix also could be helpful for assessing the competition risk and the long-term value of the targeted bank.

Valuation and Accounting Issues

During the due diligence phase, a potential bidder must understand the post-acquisition accounting.[4] An FDIC-assisted transaction can take many forms, and, as noted earlier, the regulatory environment is constantly changing. Deal scenarios should be modeled using an array of potential forecasted losses, bid assumptions, and capital plans. Valuations of loans and intangibles is a highly specialized capability, and, if time permits, involving valuation specialists in the due diligence process can be beneficial. Furthermore, involving the principal decision-makers in the process and in the review of the resulting models will help to steer the ultimate bid or bids toward the soundest strategy.

Reporting

FDIC loss-sharing agreements entail ongoing reporting and recordkeeping requirements that banks must satisfy to obtain reimbursement for losses. A bank must have the resources to compile the documentation that demonstrates that it has taken steps to minimize losses. It's important to factor in the estimate of the cost of complying with the various modification plans and reporting requirements that come with a loss-sharing agreement.

Due Diligence Done Right

FDIC-assisted acquisitions come with a variety of twists and turns that call for a due diligence process that is more compressed and closer to all-encompassing than typical acquisitions are. The abbreviated timelines make planning essential to a successful bid. A clear due diligence plan shaped by the varied circumstances of these transactions and the acquiring bank's long-term strategy will help the bank accomplish its overall goals.

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[1] FDIC Quarterly Banking Profile, First Quarter 2010, p. 3, www2.fdic.gov/qbp/2010mar/qbp.pdf.

[2] For a further discussion of integration, see Jason V. Bomers and Jon J. Sampson, "Post-acquisition Integration of Failed Banks: 'Speed to Value' Is Crucial to Success," in this publication.

[3] "Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions," June 7, 2010, www.fdic.gov/news/news/financial/2010/fil10030.html.

[4] For more information about post-acquisition accounting, see Rick L. Childs, "Addressing Accounting Issues After a Failed-bank Acquisition," in this publication.

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Addressing Accounting Issues After a Failed-bank Acquisition

By Rick L. Childs, CPA, CFA

The process of acquiring a failed bank from the Federal Deposit Insurance Corporation (FDIC) can be complicated and fast-paced. The resulting accounting and financial reporting issues are usually complex and often unfamiliar to the acquiring bank.

Few financial institutions have significant experience with failed-bank acquisitions. Indeed, relatively few business combinations of any sort have taken place in recent years, so institutions' experience with the revised business-combination guidance from the Financial Accounting Standards Board (FASB) is not extensive. As a result, a bank that pursues an FDIC-assisted deal can face complex accounting and financial reporting challenges.

General Accounting Considerations

The primary applicable accounting guidance for business combinations, including FDIC-assisted acquisitions, is FASB Accounting Standards Codification (ASC) 805, formerly Financial Accounting Standard (FAS) No. 141(R), "Business Combinations." Because much of the acquisition must be recorded at fair value, ASC 820 – formerly FAS 157, "Fair Value Measurements" – also factors into the accounting. A few of the challenges related to failed-bank acquisitions include:

- The acquired assets and assumed liabilities are measured at fair value. Fair value, as defined by ASC 820, is the price that would be received to sell an asset or be paid to transfer a liability in an orderly transaction between market participants at the measurement date. This price is often referred to as the exit price.
- Accounting for certain acquired loans with evidence of credit deterioration for which the acquirer does not expect to collect all contractual cash flows adds complexity because of the expected cash-flow modeling and the systems challenges. The accounting is specified in ASC 310-30.[1] Loans within the scope are commonly referred to as purchased credit-impaired (PCI) loans.
- The quantity of low-rated and nonperforming loans and the contractual loss-sharing agreement[2] with the FDIC can make the valuation of loans, and the related FDIC indemnification asset, challenging. Valuing the intangible asset of a deposit customer relationship can be complicated by the risks of account closures associated with the abrupt ownership transition and the interest-rate-setting decisions of the purchasing bank.[3]
- Acquisition and restructuring costs generally are expensed as incurred.

Loan Accounting Considerations

Loans acquired in an FDIC-assisted transaction can pose complex problems of their own. How to identify loans that have evidence of credit deterioration for which the acquirer does not expect to receive all of the cash flows is a concern, as is how to initially value and subsequently monitor and account for those loans.

Once the acquisition has closed, the first step is separating loans into two categories:

1. Loans acquired with evidence of credit deterioration for which the acquirer does not expect to collect all contractual cash flows – in other words, PCI loans; and
2. Everything else.

For PCI loans, the cash flows expected to be collected in excess of the initial investment in the loan (fair value) represent an "accretable yield," which is accreted into interest income using a level-yield method[4] over the life of the loan. If a loan is not accounted for as a PCI loan, the entire fair value discount (or premium, which is unlikely in an FDIC-assisted transaction) would, using the same level-yield method, be accreted (or amortized) into income over the life of the loan.

Some acquirers may choose to aggregate loans with common risk characteristics into loan pools rather than accounting for them on a loan-by-loan basis. ASC 310-30 provides guidance on the pooling criteria, which are more stringent than those for pooling for other purposes. To qualify for aggregation, the loans must have common risk characteristics (that is, similar credit risk and one or more similar predominant risk characteristics).

In late December 2009, the Depository Institutions Expert Panel (DIEP) of the American Institute of Certified Public Accountants issued a letter that summarized conversations with the staff of the U.S. Securities and Exchange Commission (SEC).[5] At issue was perceived diversity in practice for the acquired loans that did not individually meet the defined scope of ASC 310-30 but for which a discount, due to credit quality, was evident. Because the fair value requirements of a business combination necessitate considering credit quality by using net fair value, most acquisitions of loans from failed banks are likely to have some element of a credit component in the fair value adjustment.

The DIEP letter indicated that the SEC staff would not object to an entity's decision to follow ASC 310-30 for acquired loans with a discount that is attributable, at least in part, to credit quality – as long as the rest of ASC 310-30, including the pooling criteria, is followed.

Accounting for the FDIC Loss-sharing Agreement

FDIC loss-sharing agreements can be accounted for as a derivative (ASC 815[6]) or an indemnification asset (ASC 805) as follows:

- If accounted for as a derivative, the asset is recorded at fair value initially and subsequently.
- If accounted for as an indemnification asset, the asset is recorded at fair value initially. Subsequent recording is on the same basis as the indemnified assets.

In practice, it appears that most, if not all, loss-sharing agreements have been accounted for using an indemnification asset approach. While most acquirers are accounting for the loss-sharing agreement as an indemnification asset, this approach has unique accounting considerations:

- The indemnification asset should be recorded initially at fair value, which would most likely be based on a discounted-cash-flow approach (that is, the present value calculation of the expected cash flows from the FDIC). The expected loss estimates and cash flows used for determining the fair value of the related covered assets – loans, other real estate owned (OREO), and in some cases debt securities – should also be used to determine the expected cash flows from the FDIC.
- Subsequent accounting for the indemnification asset becomes increasingly complicated. The indemnification asset should be measured on the same basis as the covered assets, but those covered assets are not carried on the same basis on day two and beyond:

- PCI loans are adjusted for an accretable yield recognized into income.[7]
- Loans other than PCI loans are adjusted for any purchase discount (or premium) and accreted (amortized) into income on a level-yield basis.
- OREO is carried at the lower of cost or fair value.
- Debt securities, depending on the classification, are carried at either fair value with changes in earnings, fair value with changes in other comprehensive income, or amortized cost.

While the covered assets are carried on various bases, the indemnification asset is one unit of account, so the accounting for the covered assets must be monitored and adjustments made as necessary to the indemnification asset. If cash-flow expectations on the covered assets increase – that is, are better than originally expected – the indemnification asset is reduced because losses subject to loss sharing are expected to be lower. Alternatively, a decrease in expected cash flows increases the indemnification asset. The economic objective is to offset any impact on the income statement because of changes in loss estimates on covered assets with corresponding changes in the value of the indemnification asset.

The regulator may impose certain conditions when approving an acquisition

Bargain Purchase Considerations

With the pricing of most transactions, including fairly low deposit premiums and significant asset discounts, the likelihood is high that the transaction will generate a bargain purchase gain. FAS 141(R) changed the accounting significantly for when the fair value of acquired assets and assumed liabilities exceeds the consideration given (excess over cost), commonly referred to as a bargain purchase. Prior to FAS 141(R), the excess was allocated as a pro rata reduction of the amounts that otherwise would have been assigned to all of the acquired assets. Under FAS 141(R), the excess is recorded in earnings.[8]

One of the motivations for acquiring a failed bank is to create a bargain purchase and thereby create capital to support the transaction's assets and liabilities. However, before recognizing a gain on a bargain purchase, acquirers should keep in mind that "the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review."[9]

Federal financial institutions regulators, taking note of the level of bargain purchases realized in current transactions, issued "Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions"[10] on June 7, 2010. The guidance addresses supervisory considerations related to business combinations that result in bargain purchase gains and the impact such gains have on the acquisition approval process.

Fair value estimates presented in an application are generally preliminary. As such, any estimated bargain purchase gain will be affected by retrospective adjustments made to the acquisition-date fair values during the accounting measurement period. Because of concerns about the quality and composition of capital when a bargain purchase gain is expected to result from a business combination and the related fair value estimates have not yet been validated, the regulators may impose certain conditions in their approvals of acquisitions.

If the acquiring institution has an overreliance, as deemed by its regulator, on using the expected bargain purchase to support pro forma regulatory capital levels, then the imposition of additional conditions is possible. These may include but are not limited to:

- The maintenance of specified regulatory capital levels above statutory or policy limits;
- A limitation on dividends at both the bank and holding-company levels;
- A requirement to obtain independent audits or agreed-upon procedures;
- A requirement to obtain independent valuations if the acquiring institution does not possess the internal expertise or has not already engaged a qualified expert; and
- Limitations on the institution's legal lending limit.

Also, institutions are encouraged by their regulators to include two pro forma regulatory capital calculations in applications:

1. Regulatory capital with the expected bargain purchase gain included; and
2. Regulatory capital with the expected bargain purchase gain excluded, as well as any bargain purchase gains from prior business combinations for which the conditional period is not yet ended.

Once acquisition-date fair value measurements have been finalized (that is, the measurement period has ended), they can be validated during an external audit or examiner review. Conditions imposed at the approval of an acquisition would likely end following this validation.

Time and Resources

Although a complex undertaking, participating in an FDIC-assisted transaction is also an effective way for healthy banks to expand. The time and resources the operations, finance, accounting, and credit departments will spend on regulatory reporting requirements are likely to increase, at least for a while – as will the day-to-day accounting pertaining to business-combination accounting.

Contact Information

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[1] Formerly Statement of Position (SOP) 03-3, “Accounting for Certain Loans or Debt Securities Acquired in a Transfer.”

[2] The FDIC recently changed its loss-sharing structure. Until March 26, 2010, it assumed 80 percent of losses on covered assets up to a stated threshold and 95 percent of losses that exceeded that threshold. Loss-sharing agreements now typically cover only 80 percent of losses on covered assets, with no 95 percent sharing threshold, and some recent transactions have included more unusual features.

[3] For more information about the valuation issues involved in failed-bank acquisitions, see Daniel L. McConaughy and Brian H. Lee, “Valuing a Failed-bank Acquisition,” in this publication.

[4] “Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases – an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17,” now codified as ASC 310-20.

[5] www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/Confirmation-letter-on-Day-2.pdf.

[6] Formerly FAS 133, “Accounting for Derivative Instruments and Hedging Activities.”

[7] For examples, see Appendix A of SOP 03-3 (ASC 310-30-55).

[8] ASC 805-30-25.

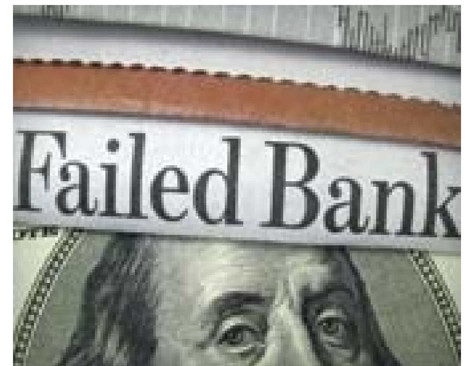
[9] ASC 805-30-25-4.

[10] www.fdic.gov/news/news/financial/2010/fil10030a.pdf.

Income Tax Considerations for Acquiring a Failed Bank

By Sheryl Vander Baan, CPA

The unique nature of acquiring a failed bank from the Federal Deposit Insurance Corporation (FDIC) requires close tracking and reconciling of the differences between book and tax accounting methodologies. Failure to address the differences adequately could result in significant misstatements of taxable income or loss in annual tax returns, particularly as it relates to loans covered by a loss-sharing agreement.



Acquiring a failed bank with an FDIC loss-sharing agreement complicates the relationships that usually exist between the bases of the acquired assets for tax and financial reporting (book) purposes. Instead of being identical, as can often be the case in an asset acquisition, the book and tax bases of acquired assets are likely to be dramatically different in an FDIC-assisted deal. The timing of the recognition of income and loss on these assets can differ significantly as well. Nowhere are these differences more challenging than in dealing with loans covered by a loss-sharing agreement.

Challenges Start on Day One

Section 597 of the Internal Revenue Code, "Treatment of Transactions in Which Federal Financial Assistance Provided," provides overriding guidance for the tax treatment of FDIC-assisted acquisitions.[1]

The tax basis assigned to loans covered by loss-sharing agreements (that is, covered assets) is the greater of their fair market value, which generally corresponds to the fair value assigned for book basis purposes or their highest value guaranteed under the terms of the loss-sharing agreement. When allocating tax basis to individual loans, a challenge exists if the loss-sharing agreement provides for reimbursement of one percentage of loan losses up to a stated threshold and a different percentage of losses beyond that threshold: Should the highest guaranteed value for an individual loan be computed using the first percentage, the second percentage, or some blended percentage derived from assuming the entire portfolio will be lost?[2]

When allocating tax basis to individual loans, a challenge exists if the loss-sharing agreement provides for reimbursement of one percentage of loan losses up to a stated threshold and a different percentage of losses beyond that threshold

Loss-sharing agreements also provide for reimbursement of up to 90 days of accrued but unpaid interest at the applicable loss-sharing percentages. An acquiring bank may not assign any book basis to accrued interest receivable on impaired and other nonperforming loans, but Section 597 dictates that tax basis be assigned at least to the extent of the amount that would be reimbursed by the FDIC.

Finally, financial reporting will record an indemnification asset for the net present value of the amounts expected to be received from the FDIC over the life of the loss-sharing agreement. No tax basis is allowed to be assigned to this separate asset.

Tax Rules for Recognizing Income or Loss on Loans

As a starting point, the general tax rules apply in determining the amount of income and loss recognizable each year on covered loans. For accrual-basis taxpayers, these rules include:

- Interest income must be accrued on the contractual amount owed by a debtor according to the contractual terms.
- On installment loans, tax market discount or premium (generally the difference between the tax basis assigned and the contractual principal amount outstanding) must be accrued over the remaining term of the loan.
- A loan may not be placed on nonaccrual status unless there is no reasonable expectation that interest will be collected.
- A full or partial charge-off of principal or accrued interest generally may not occur until evidence supports the conclusion that the debt is wholly or partially worthless.
- Ordinarily, the presence of a bad debt conformity election may allow for consistency between book and tax in recording charge-offs of debts owed and, to a certain degree, nonrecognition of interest.
- With proper identification in place, banks that qualify under tax rules as dealers in securities may be able to mark-to-market the acquired loans to their fair market values as of the last day of each tax period.

But, applying these general rules is complicated significantly and often modified by two important factors:

1. Section 597 mandates that prior to disposition the tax basis of a covered asset cannot be charged off, marked to market, or otherwise reduced to an amount that is less than its highest guaranteed value under the loss-sharing agreement or its highest fair market value, if that is higher.
2. The book basis assigned to covered loans will often differ significantly from initial tax basis. This is particularly true in the case of loans accounted for under the Financial Accounting Standards Board Accounting Standards Codification (FASB ASC) 310-30, “Loans and Debt Securities Acquired with Deteriorated Credit Quality” (originally issued as American Institute of Certified Public Accountants Statement of Position (SOP) 03-3, “Accounting for Certain Loans or Debt Securities Acquired in a Transfer”).

Tax reporting often may not equal book in the amount of interest income, charge-offs, recoveries, foreclosure property gains and losses, or other taxable or deductible amounts to be recognized on covered loans on an annual basis

These complications mean that tax reporting often will not equal book in the amount of interest income, charge-offs, recoveries, foreclosure property gains and losses, or other taxable or deductible amounts to be recognized on covered loans on an annual basis.

How Complicated Can It Be?

To demonstrate the complexities presented by a loss-sharing agreement, consider a commercial mortgage loan that had been on the failed bank’s balance sheet for $100,000, its outstanding principal balance, at the time of the FDIC-assisted acquisition. Because there is evidence of credit deterioration and the acquiring bank does not expect to collect all contractual cash flows, it accounts for the loan under ASC 310-30 and, based on expected cash flows, computes a fair value of $70,000 for book purposes. The loss-sharing agreement provides for a straight 80 percent loss share, so that the loan’s highest guaranteed value (and tax basis) is $80,000. The loan is not identified as subject to mark-to-market treatment for tax purposes.

Accruing Interest

For book purposes, interest would be accreted into the income statement based on expectations about cash flows to be collected.[3] However, for tax purposes, because collections are expected, interest must be accrued based on the debtor’s contract balance and terms. In addition, the tax discount of $20,000 ($100,000 contract balance less $80,000 tax basis)

must be accreted into income over the remaining term of the loan. These book and tax methodologies require different computational schedules and will yield different amounts of annual interest.

Expected Loan Cash Flows Decline

Suppose that after two years of performance, cash flow expectations are adjusted downward, when the book basis of the loan is $45,000,[4] contractual balance due is $80,000,[5] and tax basis is $70,000.[6] Based on revised cash flow expectations, the bank takes an impairment charge of $11,500 (not deductible for tax purposes) to drop the loan's book basis to $33,500. Assume no claim is currently made to the FDIC, but the bank adjusts the indemnification asset upward (because less cash is expected from the debtor, so more FDIC reimbursement is expected) although, because of the loss sharing percentage, not by the same amount as the impairment. Recall that tax basis in the indemnification asset is zero, so any adjustment would not be recognized for tax purposes.

Depending on the facts and circumstances surrounding collection expectations and collateral value, the bank may be able to take a tax charge-off of $6,000 at this time ($70,000 tax basis less the $64,000 FDIC-covered value, which is the $80,000 remaining contract balance multiplied by 80 percent). Identifying the opportunity to take that charge-off and computing the proper amount will take some effort. Tracking the book-to-tax differences also will take effort, especially if the impairment charge, the indemnification asset adjustment, or both are recorded through the loan loss reserve or bad debt provision expense (as opposed to some other loss account). This could disrupt a bank taxpayer's normal practice for computing book-to-tax basis differences in the loan loss reserve. In other words, following the recordkeeping for book purposes will not work for tax purposes.

Loan Is Foreclosed

Assume that one year after the impairment described above, the bank forecloses on the loan when book basis is $23,000, debtor balance is $74,000, tax basis is $67,000,[7] and net realizable value of the collateral is estimated at $20,000. Sale of the foreclosed property is not expected to be consummated until after year-end, and no FDIC claim will be made until that time.

For book purposes, the bank will reduce the loan balance to $20,000 by recording a $3,000 loss and transfer the $20,000 balance to other real estate owned (OREO). It also adjusts its indemnification asset balance as needed, although the adjustment would not be recognized in tax returns. For tax purposes, the loan (or the collateral once foreclosed) cannot be written down below $59,200 (80 percent of the $74,000 debtor balance). A charge-off deduction could be taken for $7,800 ($67,000 tax basis less $59,200). In this situation the bank will have to account for a book-to-tax basis difference of $39,200 in its OREO balance.

If $19,000 is realized upon the sale of the collateral, the claim to the FDIC will be for $44,000 ($74,000 debtor balance less $19,000 proceeds, which equals $55,000 multiplied by 80 percent). For book reporting, management will record a $1,000 loss on the OREO disposition. At that point, the bank may choose to clear out the allocated balance of the indemnification asset and establish a separate receivable or create a subledger account within the indemnification asset for the $44,000 due from the FDIC. The bank's tax return should reflect a gain, or recovery, of $3,800 ($59,200 tax basis in OREO less $19,000 proceeds less $44,000 FDIC receivable). The tax basis in the $44,000 FDIC receivable should agree with the book basis.

More Complications?

Many other moving parts add to the complexity of a covered loan. The bank can submit other amounts for FDIC reimbursement, such as certain foreclosure and collateral protection and maintenance expenses. Also, the FDIC provision to reimburse for a percentage of up to 90 days of accrued but unpaid interest should be addressed when a loan is placed on nonaccrual status for either book or tax purposes, or both. There could also be accounting implications for loan modifications. Divergent approaches could create still more book-to-tax differences to track.

For performing loans that a bank does not account for under ASC 310-30, it is possible that the initial fair value will exceed the FDIC-covered amount, and thus the assigned book and tax bases will initially be the same. If the loan continues to perform, it may be that the tax basis could follow the book basis in recognizing interest income. Should performance slip and nonaccrual, charge-off, or foreclosure become necessary, the required book and tax accounting treatment might diverge.

Confronting the Issues

Acquiring banks need a plan to deal with the myriad book and tax accounting complexities associated with FDIC-assisted acquisitions.

It is important to determine up front exactly how the relevant items are treated for book purposes in order to identify the items that will require reconciliation for tax purposes

It is important to determine up front exactly how the relevant items are treated for book purposes in order to identify the items that will require reconciliation for tax purposes. For example, once a claim is made to the FDIC, will a separate FDIC receivable be recorded or will cash simply be posted directly to the indemnification asset when received? Where will changes to the indemnification asset and loan impairments be posted? How will the interest activity and nonaccrual status adjustments typically tracked in the subsidiary loan system and posted to the general ledger be transformed into the unique amounts that must be reported for book purposes? The various approaches for book accounting will determine the number of accounts that will require book-to-tax reconciliation.

It's also important to determine what data is available to help track differences and calculate the correct annual taxable income. Can the underlying loan system that tracks debtor contract balances and similar information also track tax bases in these loans? If the bank has purchased software to account for loans under ASC 310-30, does the software include a tax module?

It's Just Timing, Isn't It?

Theoretically, these issues should be just a matter of timing income and loss recognition between years. However, banks without a solid plan could lose track of these book-to-tax differences and end up paying more taxes than necessary over the life of acquired loans. They also risk paying taxes prematurely or underreporting taxable income in the earlier years of the loans. If these mistakes are uncovered in a tax audit, a bank might owe additional taxes as well as penalties and interest. The indemnification provided by an FDIC loss-sharing agreement can certainly provide great value, but it also comes with a unique set of challenges – just one of which is proper tax accounting.

Contact Information

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[1] For details about how Section 597 affects the tax basis assigned to acquired assets, see Bill Wilhelm, Sheryl Vander Baan, and Steve Wagner, "Accounting and Income Tax Considerations for Acquiring a Failing Bank," November 2009, http://www.crowehorwath.com/crowe/Insights/detail.cfm?id=2380.

[2] The FDIC has shifted its loss-sharing agreements from 80 percent up to a stated threshold with 95 percent beyond that threshold to a straight 80 percent loss share. However, the FDIC is also willing to consider other loss-share percentages. Therefore, it is conceivable that tiered loss-share percentages will still exist going forward.

[3] For an example of the method for accreting interest under SOP 03-3, see Bill Wilhelm, Sheryl Vander Baan, and Steve Wagner, "Accounting and Income Tax Considerations for Acquiring a Failing Bank," cited above.

[4] Represents initial fair value of $70,000 less $25,000 reduction in the carrying amount.

[5] Represents initial contract of $100,000 less $20,000 reduction in principal.

[6] Represents initial value of $80,000 less $20,000 reduction in principal plus $10,000 in tax discount accretion.

[7] The new book basis of $33,500 after impairment was reduced by $10,500 during year three; the debtor's contract balance of $80,000 after year two was reduced by $6,000 of principal collections during year three; the tax basis was $70,000 after year two, and no charge-off was taken then. During year three, tax basis was reduced by the $6,000 of principal collections and increased by $3,000 of tax discount accretion.

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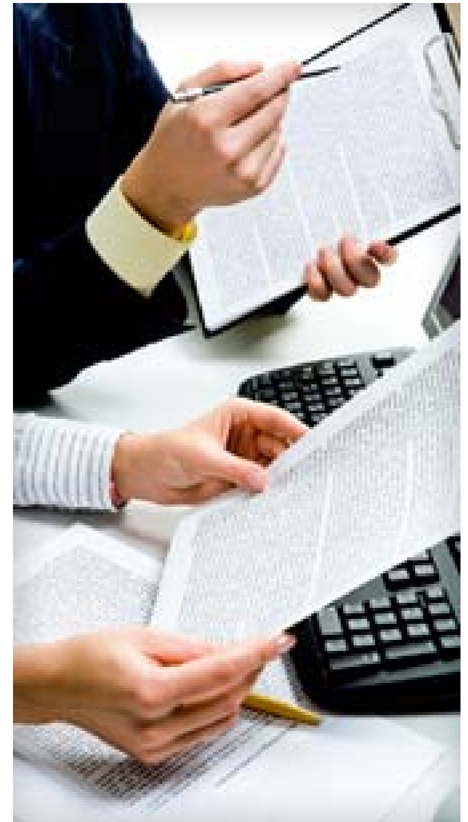
Valuing a Failed-bank Acquisition

By Daniel L. McConaughy, Ph.D., ASA, and Brian H. Lee, CFA

Financial institutions acquiring failed banks face significant accounting, tax, and regulatory issues – many of which are related to the post-acquisition valuation of the failed bank's assets and liabilities. The acquiring bank's management team needs to have a clear understanding of the valuation issues and to work closely with its professionals, appraisers, and auditors. Clear, early, and frequent communication during valuation greatly facilitates the process.



Determining the fair value of assets and liabilities assumed as part of acquiring a failed bank from the Federal Deposit Insurance Corporation (FDIC) is a complex – and sometimes stressful – process. Because the results of the valuation affect the financial statements, the valuation is a key early step that must be completed quickly, often in a matter of weeks, to avoid delaying the release of regularly scheduled quarterly financial statements.

Several accounting standards affect the valuation process in a failed-bank acquisition. The most prevalent include:

- Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 805 – formerly Financial Accounting Standard (FAS) No. 141(R), "Business Combinations," which provides guidance for acquisition accounting;
- ASC 820, formerly FAS 157, "Fair Value Measurements," which establishes a framework for measuring fair value; and
- ASC 310-30, formerly American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," which addresses certain acquired loans with evidence of credit deterioration.

To help ensure objectivity and provide the appropriate expertise, management typically uses a third-party valuation team. Because of the potential complexities of the process, and because valuation can have a large effect on the acquiring institution's financial results, understanding the time and resource commitments and having the valuation team on board from day one will aid in a smooth and timely process.

Assets and Liabilities

The acquired assets and assumed liabilities in a transaction generally must be measured at fair value. Fair value is the price that would be received for an asset or paid to transfer a liability in an orderly transaction between market participants.

The assets and liabilities that must be valued as part of an FDIC-assisted acquisition fall into four general categories:

1. **Financial assets.** These consist primarily of the bank's loan portfolio, constituting the major portion of the assets. The loan portfolio is by far the largest element of the valuation process, presents the most challenges, and requires the greatest amount of resources. This category also includes the receivable from the FDIC if there is a loss-sharing agreement.
2. **Intangible assets.** These assets include the bank's relationships with existing customers, particularly its core deposit customers. The value of other customer relationships such as time deposits, credit cards, mortgage servicing, and wealth management customers are also considered but typically play a lesser role. Intangibles such as a trade name or brand could, in theory, be included, but in the case of a failed bank, these values are usually immaterial.
3. **Tangible/nonfinancial assets.** This category includes leases, premises, and equipment as well as other real estate owned. In the current environment, obtaining fair values for real estate can be particularly challenging.
4. **Financial liabilities.** These include time deposits such as certificates of deposit and can also include Federal Home Loan Bank (FHLB) advances, trust-preferred securities, subordinated debentures, and other debt obligations. In most cases, the valuation of these liabilities is relatively straightforward.

Valuing the expected future reimbursements under the loss-sharing agreement is key

The acquiring bank's management team is instrumental in the valuation analysis. It is important for the acquiring bank to devote adequate attention to the valuation factors because the appraisers must rely on the bank's assertions about the risk characteristics of outstanding loans, the value of underlying collateral, and other issues. The valuation team then applies a variety of analytical tools and pricing models to determine the fair value of assets and liabilities.

Failed-bank Complications

Unique to many failed-bank acquisitions is the existence of the FDIC loss-sharing agreement, which typically covers 80 percent of book losses on charged-off loans. The key valuation issue is determining the value of the expected future reimbursements under the agreement.

The loss-sharing agreement is typically accounted for as an indemnification asset and valued using a discounted-cash-flow analysis, based on the present value of the projected loan losses and the loss coverage by the FDIC. Although the calculations themselves follow well-established formulas, uncertainty can arise from the inherent subjectivity involved in developing the cash flow estimates from the covered assets. These uncertainties add a level of complexity to the valuation process.[1]

Another complicating factor is the limited amount of time for due diligence in an FDIC-assisted acquisition. Usually, bidders have only a few days to perform due diligence, so the fair value estimates that they provide in the application to acquire the failing institution are preliminary and often will require further adjustment.[2] For bargain purchase gains, the possible impact on capital is a source of regulatory concern and is subject to regulatory review.[3]

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Major Loan Valuation Issues

Since a bank's loan portfolio is generally its largest asset, valuing this portfolio consumes the majority of the overall valuation effort. Achieving consensus on its fair value can be challenging, even in the acquisition of a healthy bank. Appraisers, management, and auditors must concur regarding future changes in interest rates and cash flows that directly affect the value of the loan portfolio relative to current market conditions.

The fair value of a loan generally consists of two components: expected cash flows and the market interest rates to compensate for certain risks. Examples of these risks include:

- Interest-rate risk, which is risk due to future variability in interest rates;
- Credit risk, which is the risk of loss arising from a defaulting borrower; and
- Liquidity risk, which is a market dynamic grounded in supply and demand.

In the case of a failed-bank transaction, a top priority may be to update the risk ratings of loans, a process that can take a lot of time and require significant resources. Large loans should be reviewed individually to evaluate collateral, loan-to-value ratios, and credit ratings. Support and documentation should exist for every input and assumption – including default probabilities, collateral appraisals, loan-to-value ratios, and loss-given-default calculations – that contributes to the valuation.

Both income and market approaches may be used to estimate these components. Income approaches include the spread model and the expected cash flow model. Market approaches include FDIC transactions, broker quotations, and reviews of internal loan transactions.

Before making a final determination of the appropriate valuation approaches, management and outside appraisers should try to ensure that the bank's auditors will agree with their methods. Ideally, they should also seek agreement on important assumptions such as prepayment rates, credit risks, default probabilities, collateral values, loan-to-value ratios, and other metrics.

Other Valuation Issues

Although the loan portfolio consumes the most time and attention, other assets and liabilities also need to be addressed. Chief among these are core deposit customer relationships. These intangible assets are valued as a low-cost source of capital. Their value is offset to some extent by the cost of servicing these accounts, including maintaining branches.

Although one might expect the methods for such valuations to be subjective, these sorts of valuations have been done for some time, and widely recognized industry norms exist for how to value these intangibles.

For example, core deposit intangibles generally are valued under the income approach based on the net cost savings earned in comparison to the market rates for alternative funding sources with similar maturities. Primary inputs to be considered include projected attrition rates, maintenance costs, the cost of funds compared with alternative costs of funds, and projected growth rates, reserve requirements, and discount rates. However, the likelihood that the failing bank has fewer attractive customer relationships and more above-market, high-cost deposit accounts than a healthy bank can make the valuation more challenging.

In general, the fair value of other financial liabilities, such as time deposits, FHLB advances, and other borrowings, are estimated using an income approach and well-established formulas.

Avoiding Valuation Problems

The valuation process is complex and technical, but with planning it can proceed smoothly and efficiently. To complete the valuation expeditiously, the management team should be prepared to discuss the characteristics of the acquired loans shortly after the acquisition. If at all possible, the valuation team, bank management, and auditors should meet at the outset to discuss the valuation process. Clear communication among the parties during all phases greatly facilitates the process.

From an operational perspective, management should consider whether the appropriate systems are in place. Particular attention should be given to the software used to comply with ASC 310-30 (formerly SOP 03-3) guidelines, and whether it is compatible with the platform that is being used for other aspects of the acquisition accounting. Data migration inefficiencies often can be avoided with a little forethought.

Finally, everyone involved should have realistic expectations about the time required to gather information, perform the analytics, present draft valuations, incorporate management feedback, and obtain auditor approval. Awareness of the calendar is especially critical when financial reporting deadlines are near.

A Well-established Process

The valuation process may appear technically complex, but the process is well-established and can be accomplished with a high level of efficiency. Considering the potential strategic, competitive, and financial benefits of an FDIC-assisted acquisition, the planning and resources a smooth valuation requires are likely to be well worth the effort.

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[1] For further discussion, see William J. Wilhelm, Stephen J. Wagner, and R. Chad Kellar, “Evaluating a Failing Bank: Key Factors to Consider,” in this publication.

[2] For further discussion, see Brian J. Hecker and R. Chad Kellar, “Due Diligence for Acquiring a Failing Bank,” in this publication.

[3] For further discussion, see Rick L. Childs, “Addressing Accounting Issues After a Failed-bank Acquisition,” in this publication.

Post-acquisition Integration of Failed Banks: "Speed to Value" Is Crucial to Success

By Jason V. Bomers and Jon J. Sampson

In addition to an abbreviated due diligence cycle and unique tax, accounting, and regulatory issues, a particularly rigorous and accelerated integration effort is required when acquiring a failing bank from the Federal Deposit Insurance Corporation (FDIC). The overarching goal of any successful integration is to achieve "speed to value" as quickly as possible – by realizing, and ideally surpassing, the anticipated increase in value that drove the deal in the first place.

As the financial industry slowly recovers, the trend toward industry consolidation is unmistakable. According to the FDIC, 140 insured institutions failed during 2009[1] and, with 41 failing in the first quarter of 2010,[2] the trend shows no sign of abating in the near future.

Many of the recent acquisitions in the banking industry have been FDIC-assisted transactions, generally as part of FDIC-assisted whole-bank acquisitions. Moreover, the end is not yet in sight. The agency's "problem list" rose to 775 at the end of the first quarter of this year,[3] and most Fridays in 2010 have brought the announcement of FDIC closings.

Most whole-bank acquisitions involve a loss-sharing agreement, in which the FDIC agrees to absorb a significant portion of the loan losses, typically 80 percent of losses.[4] Thus, even with the risk that is inherent in a failing bank's loan portfolio, the opportunity to participate in an FDIC-assisted acquisition can be highly attractive to a healthy institution.

Nevertheless, acquiring a failed bank also presents unique challenges, particularly related to customer-facing activities, which often require special sensitivity and expertise in the integration of the failed bank's operations into the acquirer. The need for an efficient transition is often further intensified by the limited time available for due diligence.

Due Diligence Versus Delivery – Two Very Different Challenges

Every acquisition invariably confronts a "moment of truth" – the time when it becomes apparent to all involved that the transaction is indeed likely to come about, and that investors, regulators, and customers will be desiring a smooth transition to new ownership.

It is at this moment of truth when the acquiring bank's management and integration teams must ask themselves, "How are we actually going to deliver the results?" This moment is also when the differences between due diligence and delivery – between doing the deal and making the deal work – become apparent.

Many strategic acquirers have developed experienced acquisition teams and comprehensive checklists of necessary tasks related to due diligence, tax, accounting, FDIC and other regulatory issues, and the administrative steps involved in merging operational and

shifting resources from other projects or identifying additional internal or external resources that can be called on to manage the integration.

At the same time, the acquiring bank should not discount the core competencies of the failed bank. Even a failed bank probably did certain things well. Absorbing best practices from each bank can provide added value beyond that which was originally expected.

Key Goals of the Integration Team

The broad aim of any integration effort is to minimize the risk of failure and maximize the value of the bank after the transaction is completed. To achieve this overarching objective, the integration team must accomplish some more immediate, near-term goals. Four such goals merit particular attention:

1. **Accelerate the transition.** Research shows a direct correlation between deals with a disappointing outcome and slow execution of the transition. Lack of a methodical, prioritized approach often results in a drawn-out period of integration that drains resources and morale.
2. **Minimize the risk.** This goal involves not only reducing the risk of failing to achieve objectives but also minimizing the risk of missed or overlooked opportunities during the integration period. Here is an area where an external perspective can be especially helpful.
3. **Realize the value.** The most successful integration teams draw on extensive portfolios of analysis tools to identify opportunities to cut costs, improve performance, increase revenues, and reduce risk. The purpose is to find the value the acquirer was looking for as well as to achieve added value that was not immediately apparent.
4. **Improve capacity for future integrations.** Since most acquiring banks plan to execute more than one acquisition, the integration team can add significant value through a rigorous post-integration quality review that helps to embed the new skills and techniques that are invariably incorporated during the course of the project. Such an environment of continuous improvement enhances the odds of success for future acquisitions and demonstrates to the board of directors and regulators the acquiring bank's effectiveness at integrating and managing the acquisition. This step can be very beneficial for obtaining FDIC approval for future opportunities, since regulators routinely evaluate the handling of previous transactions when approving acquisitions.

Creating a Plan for Successful Integration

In addition to an experienced team and qualified resources, a successful integration demands a comprehensive plan that encompasses all aspects of the integration, including:

- Setting the integration strategy and establishing clear leadership and organizational structure for the integration;
- Identifying potential financial and operational synergies as well as communication requirements, common targets, aspects of the business that cannot change, and additional synergies that must be addressed;
- Developing detailed plans to achieve the administrative and synergy targets, including specific, day-by-day execution plans that pinpoint individual roles and responsibilities;
- Establishing sound project management practices using predefined templates and project plans as a starting point, and then adapting them to address the unique requirements of a specific acquisition;
- Managing communication and change proactively, with a special focus on the initial two weeks after the transaction; and
- Conducting ongoing executive reviews of progress, including a governance model that enables all key stakeholders to stay in tune with progress. Measuring and reporting value throughout the integration process is essential and should be accomplished using objective metrics from the outset.

Each of these phases entails using numerous detailed checklists, which in turn encompass hundreds of individual steps, including detailed explanations about process owners, timelines, and scope. The development of the plan also includes mapping proposed changes in processes and functional areas, including:

- Human resources;
- Information technology, including system and data migration;
- Customer retention and migration;
- Public relations;
- Vendor management;
- Internal back-office operations, policies, and procedures;
- Outsourcing and shared services;
- Risk management, including legal, compliance, and regulatory issues;
- FDIC liaison issues;
- Accounting, including both financial reporting and tax;
- Portfolio valuation;
- Finance and treasury operations; and
- Real estate or other property management.

Worth the Effort

Despite the many demands a failed-bank acquisition places on the acquirer's resources, the potential benefits such an opportunity presents are often well worth the effort. In all instances, however, the ultimate success of the acquisition depends on the acquiring organization's ability to assess objectively its own acquisition capacity, analyze accurately how the potential acquisition will serve its strategic objectives, and, above all, integrate the acquisition with speed and purpose.

By accelerating the transition, prioritizing the activities that create value, and executing integration processes efficiently, the acquiring bank will greatly improve the odds of a successful acquisition – one that realizes the enhanced value and other potential benefits that brought about the deal in the first place.

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[1] FDIC Quarterly Banking Profile, Fourth Quarter 2009, p. 4, www.fdic.gov/bank/analytical/quarterly/2010_vol4_1/FDIC_Quarterly_Vol4No1_Full.pdf.

[2] FDIC Quarterly Banking Profile, First Quarter 2010, p. 3, www2.fdic.gov/qbp/2010mar/qbp.pdf.

[3] Ibid. p. 3.

[4] Because of the increased demand for these transactions, the FDIC recently changed its loss-sharing structure. Until March 26, 2010, it assumed 80 percent of the book losses up to a stated threshold and 95 percent of losses that exceeded that threshold on covered assets. The change in features can affect how much analysis of credit quality is performed and the bidding strategy of the acquirer. Loss-sharing agreements now usually cover only 80 percent of losses on covered assets, with no 95 percent sharing threshold, and some recent transactions have more unusual features.

[5] For more about the factors potential acquirers should take into account before pursuing an FDIC-assisted acquisition, see William J. Wilhelm, Stephen J. Wagner, and R. Chad Kellar, "Evaluating a Failing Bank: Key Factors to Consider," in this publication.

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The Role of Private Equity in Acquiring Failed Banks

By Edwin S. del Hierro, P.C., William J. Wilhelm, CPA, ABV, and Kenneth L. Harris, CPA

Private equity firms can provide healthy banking organizations with additional capital to pursue acquisitions of failed banks from the Federal Deposit Insurance Corporation (FDIC). It is important for banks to understand the laws, regulations, and related guidance that govern these investments and to appreciate the protection they afford.

The accelerating pace of bank failures has created attractive opportunities for healthy financial institutions to expand their market share by working with the FDIC to acquire deposits, banking facilities, and assets at substantial discounts to fair value. Executives at some healthy banks who would like to pursue these opportunities have considered turning to private equity firms or other professional investors to raise additional capital but have concerns – particularly about the level of control the outside investors may acquire or how professional investors will integrate into the industry's highly regulated environment.

Policy statements published by the Federal Reserve Board in 2008[1] and the FDIC in 2009,[2] along with clarification of the FDIC's policy statement published in the form of questions and answers posted on the FDIC's website,[3] provide important guidance for banks considering investments by private equity firms and other professional investors.[4] Banks that understand this guidance are likely to have fewer reservations about using private equity to bolster their capital positions in order to qualify for participation in FDIC-assisted transactions.

Limits on Ownership

One of the first rules to understand is that the Federal Reserve limits the ownership the noncontrolling investor may acquire. In general, a private equity firm cannot own more than 24.9 percent of any class of voting stock without being deemed a bank holding company. Because most private equity firms are not positioned to operate as, and do not want to become subject to regulation as, bank holding companies, these investors typically seek ownership stakes below the 25 percent threshold.

The Federal Reserve defines a class of voting stock as all classes that vote together as a single class. For example, if a bank holding company has three classes of convertible preferred stock with equivalent voting rights that vote as a single class on an as-converted basis with the common stockholders, the Federal Reserve would consider the three classes of preferred stock and the common stock to be a single class. The rules are written this way to provide the bank flexibility in structuring an investment transaction using a separate class of stock while also permitting the investor to avoid control as long as the investor's overall voting rights are structured to remain below 25 percent of the overall voting rights. This arrangement helps prevent the investor from acquiring a disproportionately large say over important matters.

Banks can seek capital from more than one investor

Banks that need more capital than a 24.9 percent owner is permitted to provide can seek to obtain capital from more than one investor. For example, in theory an organization could have five 20-percent private equity owners as long as no investor is deemed to be acting in concert with any other investor. For such an ownership structure to be put into place in a single transaction, the bank and the private equity investors would need to demonstrate to the Federal Reserve and the FDIC that each investor has acted, and will continue to act, independently. In certain cases, a lack of any prior history of common investments, together with passivity and nonassociation commitments and other limitations relating to the transaction in question, could help satisfy this requirement.

Exit Strategies

Typically, private equity firms look to make investments for a period of five to seven years. To appeal to private equity investors, a bank needs to be sensitive to this time horizon and to provide private equity investors with a suitable and timely exit strategy. Such strategies could include:

- A plan to become publicly traded through an offering that permits the private equity firm to participate as a selling shareholder or to sell into the market once an active market develops;
- A plan to cause the banking organization to be acquired; or
- Other exit transactions on which the parties agree.

Generally speaking, private equity funds make investments over a 10-year life and sponsors operate multiple funds with staggered maturities. The availability of multiple funds permits them to fit investments into a fund with an appropriate time horizon.

Protecting Banks' Decisions

Private equity firms often seek a controlling interest in companies in which they invest. However, the Federal Reserve's policy statement prevents private equity firms from seeking or exercising control over a banking organization – thereby providing a source of comfort to banks that accept capital from private equity investors.

Specifically, the Federal Reserve prohibits investors from requiring covenants or contractual terms "that place restrictions on, or otherwise inhibit, the banking organization's ability to make decisions about the following actions: hiring, firing, and compensating executive officers; engaging in new business lines or making substantial changes to its operations; raising additional debt or equity capital; merging or consolidating; selling, leasing, transferring, or disposing of material subsidiaries or major assets; or acquiring significant assets or control of another firm."[5]

When assessing potential sources of private equity, a bank should look for a firm that has sufficient knowledge of the financial services industry to serve as a constructive force on the board of the bank after the investment. In addition, assuming its bid for FDIC-assisted acquisitions is successful, the bank should look for a firm that has the financial resources to participate in subsequent capital raises to support future growth.

Recent Developments Affecting 5 Percent or Greater Owners

In September 2009, the FDIC issued guidance for professional investors that acquire ownership interests in financial institutions that acquire failed banks. This policy statement generally applies when a so-called covered investor, such as a private equity firm, becomes the owner of more than 10 percent of an acquiring bank.

The FDIC's higher capital requirement applies even if no single investor acquires more than 5 percent of the bank

The statement imposes certain conditions, including a requirement for the bank to maintain a heightened level of Tier 1 capital. Specifically, banks with such investors must maintain a minimum capital ratio of 10 percent Tier 1 common equity to total assets for three years. This requirement compares with a Tier 1 leverage capital ratio of 5 percent normally applicable to a bank that does not engage in FDIC-assisted transactions. After the three-year period, banks with investors that continue to own more than 10 percent must remain "well capitalized," according to generally applicable FDIC standards.[6]

To avoid the application of this rule, some banks and investment vehicles began to limit the ownership of professional investors to less than 5 percent, so that there would be a presumption of noncontrol with regard to each investor.

In response, on Jan. 6 and April 23, 2010, the FDIC modified its rule by posting changes on its website's Q&A page, titled "Statement of Policy on Qualifications for Failed Bank Acquisitions."[7] The changes indicate that if investors acquire more than 60 percent of the bank in a single transaction, the policy statement, including the heightened capital requirement, will apply even if no single investor acquires more than 5 percent of the bank. Banks should continue to monitor this Q&A page for possible additional changes.

Evaluating the Private Equity Option

As signs of recovery in the financial institutions industry continue,[8] a steady growth can be expected in the number of private equity firms actively pursuing opportunities to acquire bank assets and establish a position in the industry.

When considering FDIC-assisted acquisitions, healthy banks would be wise to evaluate the option of seeking additional capital from professional investors, including private equity firms. Before accepting private equity, however, banks should review with experienced advisers the laws, regulations, and related guidance governing such investments and develop a transaction structure that is consistent with regulatory requirements and addresses the concerns of the institution. Bank executives and boards need to understand not only the role private equity can play in these transactions but also the limitations and conditions affecting private equity and other professional investors.

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[1] Federal Reserve Board, "Policy Statement on Equity Investments in Banks and Bank Holding Companies," www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

[2] FDIC, "Final Statement of Policy on Qualifications for Failed Bank Acquisitions," www.fdic.gov/news/board/Aug26no2.pdf.

[3] FDIC, "Statement of Policy on Qualifications for Failed Bank Acquisitions," www.fdic.gov/regulations/laws/faqfbqual.html.

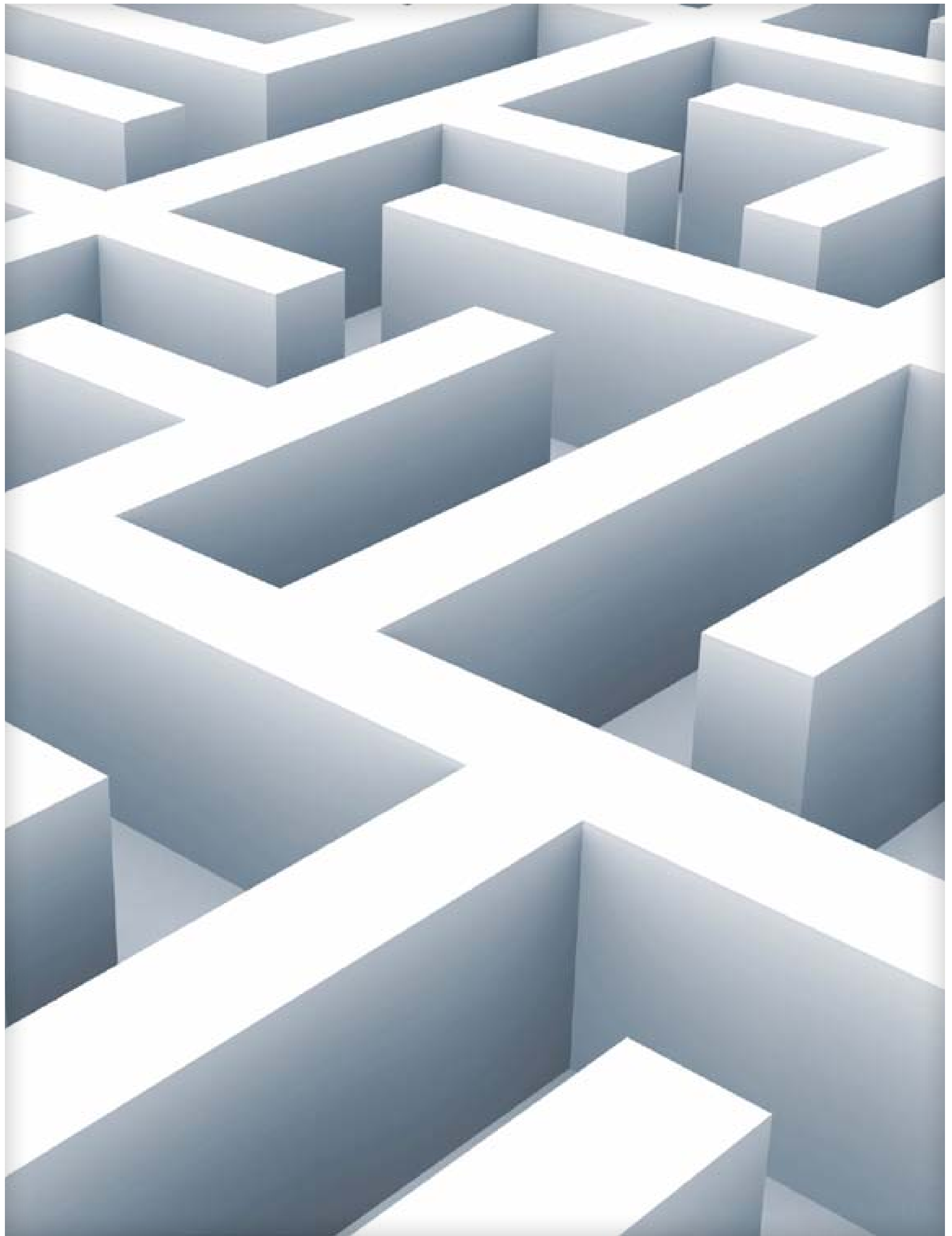
[4] Although this article focuses on the rules that apply to bank holding companies, the Office of Thrift Supervision (OTS) imposes similar limitations on investments in thrifts and their holding companies. The FDIC Statement of Policy applies to investors in organizations regulated by the OTS.

[5] Federal Reserve Board, "Policy Statement on Equity Investments in Banks and Bank Holding Companies," pp. 13 – 14, www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

[6] See www.fdic.gov/deposit/insurance/risk/rrps_ovr.html.

[7] FDIC, "Statement of Policy on Qualifications for Failed Bank Acquisitions," www.fdic.gov/regulations/laws/faqfbqual.html.

[8] For example, according to the FDIC Quarterly Banking Profile, fourth-quarter 2009 net income for the industry was $914 million, compared with a $37.8 billion net loss in the fourth quarter of 2008. Although that small profit amounted to an essentially break-even performance, it nevertheless was a welcome contrast to the record quarterly loss posted a year earlier.



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