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Caveat Emptor: Community Banking M&A in the Post-recession World

By Kamal Mustafa

Nearly every aspect of community banking has changed radically since the 2008 recession: the economic environment, regulatory oversight, federal monetary policy, deposit and liability structures, and capital requirements. This has led to major adaptations in the analytical methodologies that underlie capital and strategic planning activities. The one glaring exception has been in mergers and acquisitions.

Legacy methodologies and processes continued to dominate this critical segment, even as regulators are paying close attention. It's with good reason that the Office of the Comptroller of the Currency said in its latest semi-annual **risk perspective** that its examiners were going to begin to assess community banks' "merger and acquisition processes and procedures."

Although every acquirer recognizes that its own bank has changed dramatically since the recession, a vast majority fail to investigate how potential target banks have changed. This article explores these common mistakes and oversights:

1. Regulatory Capital and Acquisition Pricing

The new regulatory environment has imposed higher leverage ratios across the entire community banking system. For more than 80% of the U.S. banking market, regulators have required stress testing to accurately estimate capital requirements. In the remaining 20% — the community banking system — regulators have imposed leverage ratios on a more subjective basis. The community bank benefits of not having to stress test themselves have been offset by the naturally more conservative ratios that have been used to ensure sustainability within the community banking system.

Traditional accounting statements have extremely limited value when assessing a bank's capital requirements in this post-recession world. Yet these legacy statements – and pro formas generated from them – are still used to analyze most M&A transactions.

Some acquirers take false comfort in the loan review due diligence process, the limitations of which will be discussed in the next section. The reality is simple: *Without stress testing the target, it is practically impossible to get an accurate assessment of the regulatory capital required to support the assets of the bank being purchased.*

An Invictus Consulting Group comprehensive review of post-recession community bank M&A transactions shows massive variances between the capital requirements of seemingly identical transactions. These variances turn seemingly great acquisitions into gross overpayments and sometimes — fortunately for the acquirer, unfortunately for the seller—the reverse. (**Editor's Note:** *Bank Insights* will begin publishing reviews of transactions in the coming months.)

2. Loan Review and Classification-based Due Diligence

In the pre-recession world, the due diligence process of reviewing a target's loans and loan classification system was a critical part of an acquisition. Historically, this allowed the acquirer to impose its asset quality discipline on the target and make adjustments to the final purchase price for improperly classified loans. In the steady-state pre-recession environment, this exercise was also a limited proxy for future performance. Regulatory capital adequacy mirrored this approach; regulators evaluated a bank's capital based on annual historical performance.

The recession of 2008 totally disproved the validity of this historical method. Classification systems based on historical performance were no longer reliable because history was no longer a predictor of future economic events and/or their magnitude.

The loan review process is still an important exercise in evaluating the present condition of a bank's assets, but it cannot be used to estimate future performance under diverse economic conditions. Under the new economic environment, monetary policy and regulatory response, extrapolating loan review/loan classification analysis to the future will provide misleading answers.

The only proper way to gauge the pro forma performance of an acquired portfolio involves a detailed evaluation of loan vintage. Identically classified loans of different vintages will have different risk criteria. Every banker knows that collateralized loans made during depressed real estate prices have very good loan-to-asset values, while identically classified loans made during real estate booms have questionable loan-to-asset values. Under existing loan review processes, two ostensibly identical performing loans with the same loan-to-asset value (on the books) are treated the same, irrespective of their vintages. The false comfort from a detailed loan review process will not only skew the purchase price in the

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wrong direction, but it will also create potential performance issues under changing economic conditions. In summary, the loan review/re-classification process is an excellent tool for evaluating historical performance, but misleading and dangerous when extrapolated into the pro forma.

Remember: M&A is nothing more than a compressed contribution to a bank's long-term strategic plan. Having the correct assumptions about loan performance becomes even more critical in the evaluation of potential targets.

3. Loan Portfolio Yield Analysis

The post-recession era has been dominated by an "unnatural" rate environment, due to a monetary policy designed to deal with the global recession. This rate environment has had a substantial impact on bank portfolio yields. Interest rates artificially controlled by monetary policy have created periods of low yielding loans across different loan categories. Different rates of loan growth during these time periods have in turn created different loan yield mixes in bank portfolios. These varying rates of growth, coupled with different maturities established during these periods, have substantially affected loan portfolio yields.

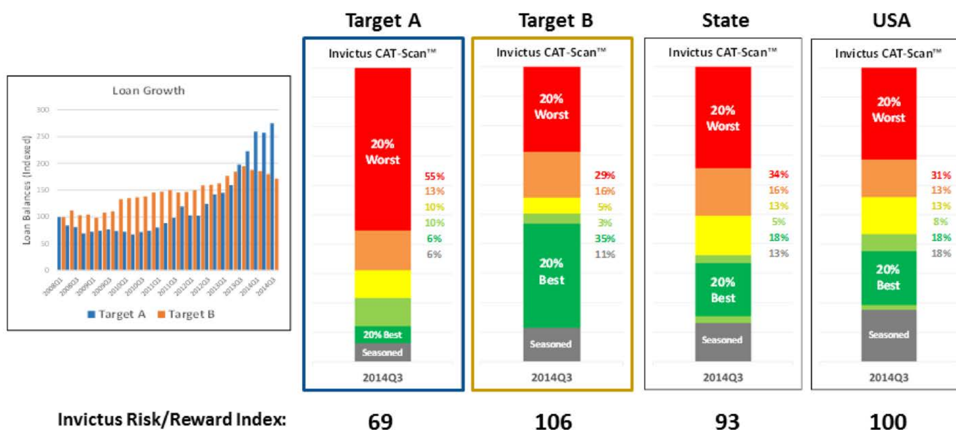
Audited financial statements, loan reviews and other outdated analytics cannot quantify and segregate these parcels of loans with unique maturities and yields, which are driven by loan growth rates during different periods. *The only tool for quantifying this critical information is vintage/origination analysis of a target's portfolio*. Relying on average return on assets or even marginal return on assets is a formula for gross misinformation. Two banks with identical average return on assets could have radically different actual pro forma performance.

These three areas reflect a few of the more common and serious flaws in present-day M&A analytics. While the short-term impact of these analytical deficiencies might seem negligible, and perhaps even offset by the perceived success of a transaction, many acquirers and their shareholders will pay the price in the intermediate and long term.

Concluding thought: – if you're an acquirer and your investment banker loves you, watch out. ▪

How New Invictus Analytics Reveal M&A Pitfalls

Invictus Total Loan Portfolio Risk/Reward Analysis

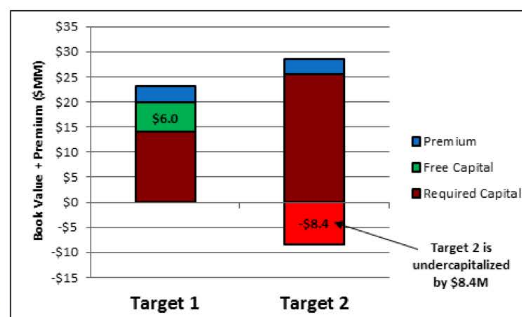


Invictus calculates a Risk/Reward score for loans originated in every quarter since 2008 based on average yields and macro-economic risks. Loans originated in quarters with the 20% worst Risk/Reward scores (high risk-low reward) are shaded red, while the best 20% are shaded green. For example, 55% of Target A's loans were originated in quarters with the 20% worst Risk/Reward ratios.

Each bank in the country is assigned an Invictus Risk/Reward Index number based on its deviation from the national average. Values >100 indicae a bank with better than average risk/reward profile and vice versa.

FreeCapital Effect on M&A Pricing Multiples

(all figures in $M)	Target 1	Target 2
Book Value	$19.9	$17.1
P/BV (Announced)	*@ 1.17X*	*@ 1.18X*
Deal Value	$23.2	$20.3
FreeCapital:	$6.0	-$8.4
Effective Multiple: *(with Free Capital Adjustment)*		
P/BV (Announced)	*1.17X*	*1.18X*
P/BV (Adjusted)	*0.87X*	*1.67X*



"Required Capital" is the amount of capital required to support each bank's unique asset mix, as determined by Invictus' proprietary public data stress tests (run quarterly on every bank in the country). Any remaining capital in excess of this requirement is FreeCapital™.

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Why CEOs Must Pay Attention to Regulatory Capital Silos: A Strategic Planning Primer

No matter who –or what department—at your bank handles regulatory capital testing, the outcome will ultimately reflect on the CEO. And that means regulators are going to pay attention to the entire process.

"Every CEO must recognize that a capital adequacy exercise is ultimately an evaluation of a bank's executive management's ability to guide the bank through a range of economic circumstances, taking into consideration the bank's existing financial strength and operating performance within its geographic footprint," said Invictus Consulting Group Chairman Kamal Mustafa.

Most banks have completely separate stress testing, capital planning and strategic planning functions. Unless these units operate together, using the same methodology and data, the capital adequacy analysis will be useless, and maybe even wrong. And that will reflect on the CEO, not the risk officer or risk department. "History has shown that, whether it be a failure of strategy or a failure of analytics, the CEO and executive management is always held responsible," Mustafa said.

CEOs are faced with competing interests when evaluating regulatory capital adequacy. After all, regulatory capital adequacy is focused on risk. Reward (profitability) is of relatively lower importance to regulators beyond the fact that it contributes toward the accumulation of the bank's capital cushion. The CEO's obligation to shareholders is primarily maximizing reward (profitability) within acceptable levels of risk. This is essentially a reversal in prioritization to the regulatory approach.

CEOs must walk a tightrope, making sure that they integrate both the risk and the reward parts of their mandate, using consistent data and a cohesive process and methodology. *Absence of this total integration is obvious to regulators and inevitably reflects poorly on the bank and its CEO/executive management.*

The symbiosis between strategic planning, capital planning and stress testing is vital, yet banks often make these common mistakes:

- Separation of management responsibility and accountability between the functions.
- Differentiation of methodologies between the functions.
- Use of legacy analytics that have little or no relevance to the present-day banking environment.
- Lack of consistency in the use of data and information between the functions.
- No alternative scenarios linking the functions.
- Macro (national) focus rather than regional (bank geographic footprint) focus.
- Parallel approach to each step rather than progressive steps leading from strategic planning to capital planning to stress testing.

These are the recommended steps in the post-recession strategic planning process:

Step 1: Development of an operating strategic plan. That is the prime directive for all CEOs/executive management. It is the optimization of short and long-term risk/reward scenarios. The strategic planning process cannot be based on a "crystal-ball" approach, but must evaluate a range of likely scenarios to help define a primary operating strategic plan with appropriate contingencies.

Step 2: Generation of a capital plan designed to support and fund the operating strategic plan. Regulators want to know the capital impact of contemplated strategic options.

Step 3: Stress testing of the strategic/capital plan based on extreme scenarios defined by regulators (CCAR, Dodd-Frank).

Step 4: Identification, quantification, and analysis of capital shortfalls, if any, identified in the stress testing process.

Step 5: Back to Step 1 if any capital shortfalls are identified in the stress testing process.

Step 6: Constant monitoring of real-world performance against strategic plan with appropriate ongoing adjustments.

Thanks to the successive CCAR exercises, regulators have developed considerable expertise in analyzing bank stress tests. With even a cursory review, they can instantly identify banks that have followed the "intent of the law" versus banks that attempt to meet the "letter of the law". Volume and detail are not any replacement for substance. ▪

About the Expert

As the former head of global M&A for Citibank, Kamal Mustafa is uniquely qualified to give M&A insights to the community bank market. While managing director of M&A and merchant banking at PaineWebber, he was one of a select few entrusted with handling hostile takeovers and defenses. He also was managing director at KSP, handling all acquisitions for John Kluge's $1 billion leveraged-buyout fund. Mr. Mustafa also was founder and chairman of Bluestone Capital Partners and Wildwood Capital, and earlier in his career was head of corporate finance/credit at Connecticut Bank and Trust. He founded Invictus in 2008, and serves as chairman and CEO.

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

Small Bank Assessment Change Could Lead to Higher Capital Requirements

The FDIC's **proposal** to change the way it assesses deposit insurance for small banks will have an adverse impact on banks with a high concentration of construction and development loans, bankers **complained** at the latest FDIC community bank advisory committee meeting. That's because the rule would count such loans as high-risk under a new loan mix index, primarily because those types of loans contributed to a large number of community bank failures after the 2008 recession.

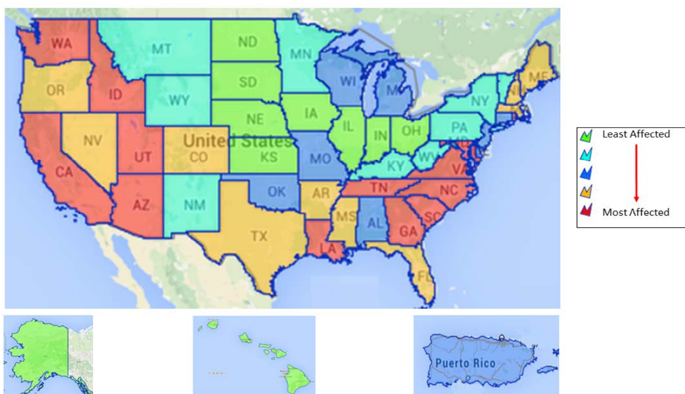
There is one way that banks with large concentrations of C&D loans can mitigate higher assessments, advised Diane Ellis, FDIC Director of Insurance and Research: Increase capital levels. "The way the formula works, that would reduce the assessment of a bank," she said.

Bank CEOs at the meeting said the FDIC was indirectly penalizing banks because of their business models. "We're approaching this like most insurance companies do," Ellis responded. "They look at the portfolios of risk they are underwriting. Certain business models create higher risk and that is what we are trying to charge for."

In a **comment letter**, Carl Dodson, EVP and COO at John Marshall Bank in Reston, Va., said the proposal would increase the $831 million bank's premiums by more than 30 percent to more than $500,000 yearly – even though the bank's financial performance has improved since the recession. "Well run banks fueling economic growth and located in strong markets should not have to pay higher assessment rates due to what has been partially caused by weak regulatory oversight of reckless lenders," he wrote.

The following map shows which states would be most negatively affected by the proposal.

Invictus Consulting Group Estimated Impact of FDIC Insurance Changes



Regulators Unveil Cybersecurity Assessment Tool

The prudential regulators want all CEOs and boards to understand and determine their institution's overall cyber risks. The FFIEC has released a **cybersecurity assessment tool** to help. The FFIEC stresses that CEOs and the board **must develop plans** to conduct a cyber risk assessment and institute risk management practices to mitigate potential problems. The tool allows banks to **calculate their inherent risk profile** and **cybersecurity maturity level**.

CFPB Cites CEO for Lender Originator Compensation Plan

Take note: The Consumer Financial Protection Bureau **fined** RMP Mortgage Inc. and its CEO for illegally paying bonuses and higher commissions to loan originators who steered consumers into costlier mortgages. The fines would total $20 million, including a $1 million civil penalty to be paid by the CEO individually. Banking experts warn lenders to review their loan originator compensation plans now. Failing to comply can disqualify loans from being considered qualified mortgages, which can have serious implications.

FDIC Planning New Tools for Boards

The FDIC is working on a vendor management video to be completed by the end of year that will include case studies, according to Doreen Eberley, Director of the Division of Risk Management Supervision. She told the July community banking advisory meeting that the FDIC is also updating its videos on interest rate risk management and putting together a new practical handbook for directors . The guide will include information about corporate governance, risk management and ethics, with particulars on how a director's responsibilities differ from day-to-day management, how to develop a sound business plan and a robust strategic plan, and ways to effectively communicate with examiners. The handbook will also discuss the differences between rules, guidance and best practices. ▪

About Invictus

*Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the **Invictus website**.*

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