**Community Banking Monitor**
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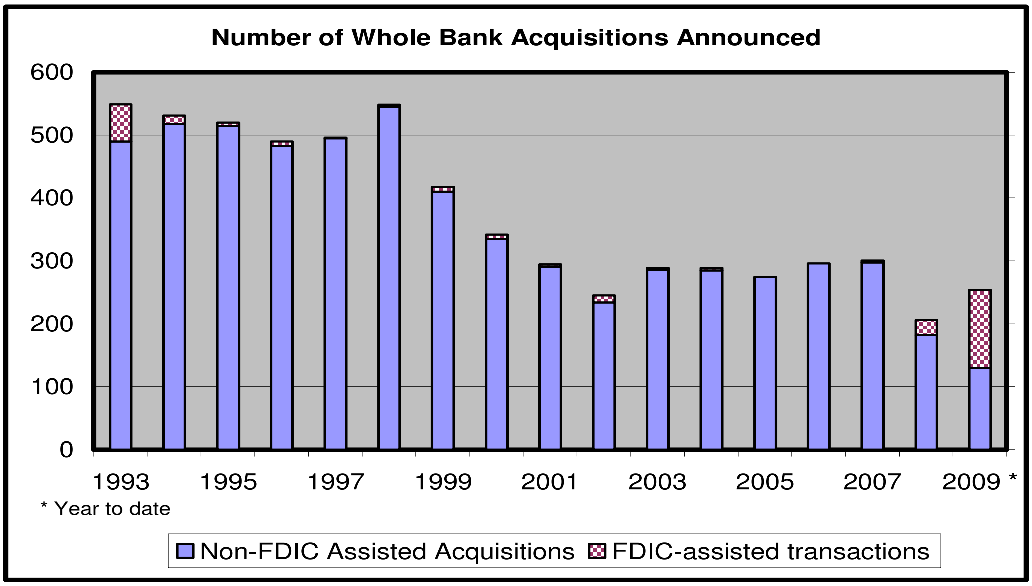
# Where Have All The Mergers Gone?

## *Go Ask the FDIC*

Past periods of severe industry stress have typically generated a notable pickup in bank M&A activity – those banks with life-threatening problems, or just those whose managements and boards of directors have simply grown tired of the struggle and have given up hope of near-term good times and healthy growth, have tended to toss in the towel of independence, sell their banks, and let someone else deal with the challenges.




Source: Highline Financial data

Although current industry operating pressures and the apparent depth of bank management pessimism has been as intense this cycle as in the 1990s, there has not yet been much evidence of a pickup in traditional merger activity, as shown in the above chart. In some ways, this is probably something of a timing issue, and might be neither unusual nor surprising:

- It is still fairly early in the credit cycle, with very little visibility/certainty regarding a given target's asset quality. A bank which can't be completely confident in its own credit quality is naturally uneasy, and probably unwilling, to confidently judge the quality of a potential target's loan book.

- Regulatory pressure for stronger capital ratios make it hard for a bank to make a typical acquisition without putting something of a cloud over its balance sheet. In the early 1990s, some banks (those banks which could do) got around this issue by raising substantial additional capital as the foundation for significant balance sheet expansion via acquisition. Unfortunately, much of the capital raised in this cycle has been to rebuild after the losses incurred in the past couple of years,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or to build reserves for the losses just around the corner. It might take a while, and some repayment of TARP funding, before the buyers feel wealthy enough to focus on growth through acquisition.

- Dramatic and inconsistent actions coming from Washington – Congress, the Administration, and the regulators – create a lot of uncertainty about what future ground rules might be. Regulators have typically played a pro-cyclical role in banking cycles, getting religion (tightening the rules) after the damage has been done. This shift probably pushes otherwise acquisition-prone bank managements to stay at home and tend their own fires for the time being.

In addition, there are a couple of new factors working to keep a lid on traditional M&A activity this cycle:

- Accounting standards have become more strict. In the 1990s, the prone-to-excess pooling accounting allowed acquiring banks to pay too much without slamming their capital ratios, while allowing them to manage future earnings through manipulation of reserves set up for future losses. The advent of purchase accounting, with its required marking to market of the target bank balance sheet (often triggering loan and even investment write-downs that drive the target's book value down near zero) make it difficult for acquisition-minded banks to accomplish a meaningful purchase acquisition without adding a whole lot of goodwill and significantly eroding its post-acquisition tangible capital ratios.

- Perhaps the most important though perhaps less obvious factor is the overwhelming influence of the FDIC. As it seizes failed banks and then sells them to other banks are very low prices (occasionally even paying the acquirer to take over a failed bank) and with very comforting risk-sharing arrangements, the FDIC is not only setting the price of troubled franchises but heavily influencing the value of healthy franchises. Moreover, the negative goodwill accretion can make these transactions nearly self-funding, negating the pressure on capital ratios occurring with traditional acquisitions.

In sum, a traditional acquisition of a reasonably healthy bank has become less attractive economically, while the FDIC has made failed bank acquisition easier and dramatically cheaper. Our colleague David Stieber has used this analogy: let's assume that you have a nice house in a nice neighborhood, but you need to sell it because your employer is transferring you to another city. Unfortunately, if there are three foreclosed houses and two that are being marketed under "short-sale" conditions within 3 blocks of your home, what do you think are your chances of getting a reasonably good price?

Since assisted deals are so compellingly attractive, acquisitive banks naturally want to go that route, so the FDIC-assisted transaction has become the predominant game in town, the marginal transactions that tend to drive the pricing of all bank acquisitions. Note the recent change in the mix of assisted vs. unassisted deals shown in the chart at the beginning of this report; nearly half of the year-to-date transactions have been FDIC-assisted.

**So what does this mean to community banks? Well, that depends on a given bank's intentions:**

**If you hope to sell your bank, this is clearly bad news.** With the FDIC effectively setting, or at least heavily influencing the acquisition price of banking assets, you might want to wait until the regulators have been able to clean the failing banks out of the industry, and the "free" deals are no longer putting a lid on franchise value. In the meantime, it would seem wise to bite any bullets that need to be bitten



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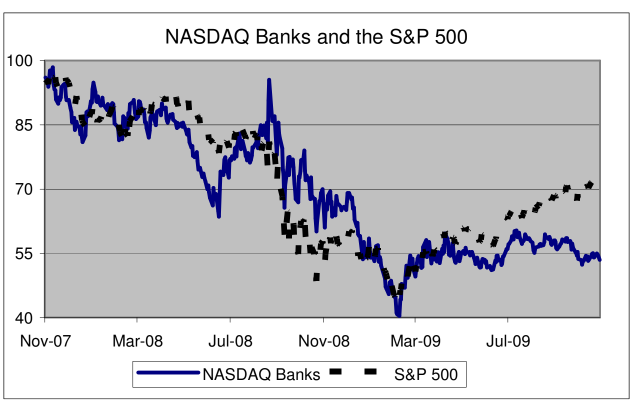
(rigorously deal with your credit and investment problem issues), since we believe that it will be quite a long time before potential acquirers will be interested in anything other than a clean bank. In addition, there could well be opportunities to generate healthy organic growth by taking market share from weak, "on the ropes" competitors.

**If you hope to be an acquirer in order to take advantage of the industry turmoil, this situation could be the most positive situation in a generation.** A bank that is positioned to be the buyer in an assisted transaction has the potential to substantially enhance its deposit base, its earning power, and its franchise value at an extraordinary, once-in-a generation low price. Just as in the 1990s, banks that can take advantage of this opportunity should be able to leapfrog over their less well-positioned competitors over the next few years, and shareholder-conscious management teams should be seriously investigating this opportunity.

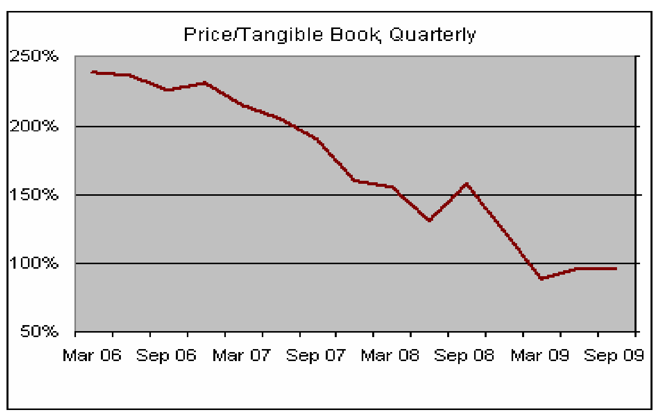
You need to get all your ducks in order, however. To be positioned to make one of these remarkably beneficial acquisitions, a bank should have its asset quality issues under obvious control, have built very strong capital and loan loss reserve balances, have good operating systems, have a relatively deep and solid management team, have updated and close working relationships with the bank's accountants and legal counsel, and most importantly, a good working relationships with its regulators, especially the FDIC.

**Bank Stock Valuation Trends:**

As the chart below left shows, bank stock prices have been languishing the last few months, following a very strong bounce off their March lows. Apparently, investors have increasingly come to realize that we are not out of the woods on credit losses, given the expectation of substantial increases in commercial real estate credit problems; this, plus the reasonable conclusion that a sluggish economic recovery is unlikely to trigger strong growth in loans and net interest income, seems to have put a bit of a lid on investor enthusiasm for bank stocks. And while the market is not always right, we suspect that this time it is correct in expressing fairly muted expectations regarding the near-term outlook for bank fundamentals.




Source: Yahoo Finance




Source: Highline Financial data, Oak Ridge calculations

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