STEALTH MERGERS, HIDDEN RISKS, AND WATCHING OUT FOR #1

Where do you stand if your bank joins another?

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As I've gone about my business recently I've heard about exploratory merger activity among community banks that's occurring out of sight, away from the market's attention. The latest is a story this week of a community bank of a $100 million or so in assets with substantial balance sheet equity, but at least a short-term difficulty in generating an adequate return on equity due to the inability to generate new loan volume.

This brings up two challenges: the need to find new ways to survive, and the changing face of operational risk.

What's driving the bank's strategy

After our experience as an industry over the past four years it's hard to imagine any bank considering itself overcapitalized. But a conservative credit philosophy combined with very lackluster loan demand gives rise to a problem that requires a creative response.

So the bank is talking to a competitor, headquartered in an adjacent county, that has had some credit issues and finds itself less well-capitalized than the first bank. Its regulators also want to see capital levels hiked. It's smaller than the better-capitalized bank.

The two banks would have a complementary market presence and be capable of presenting a better competitive front to larger banking companies that currently operate in their markets. The pro forma balance sheet is attractive and probably better suits the interest of the shareholders of the two companies on a combined basis than operating independently.

Combinations of banking companies at the smaller end of the size spectrum make the additional sense of helping the resulting combination of charters be better able to generate an appropriate return. ROE is an imperative that shareholders watch and management must produce. Then there's also the need to absorb the additional costs of regulatory compliance over a larger asset base.

So, there are many reasons why a merger looks attractive.

Less-watched exposure: Operating risk, but in new forms

These are the sorts of trends that are occurring today and are driven by one or a combination of forces consisting of credit risk, liquidity risk, capital risk, and operating risk. What's surprising to me is the role that operating risk seems to be playing today.

Operating risk is the risk to earnings and capital of failing to operate as profitably as one reasonably can. Normally, or I should perhaps say historically, operating risk has been associated with the risk from natural disasters and from the sorts of difficulties or errors that tend to exist in substantially manual processing environments. Today, and going forward, operating risk can just as easily, and perhaps more ominously, exist in other ways, such as in the failure of bank management to invest in appropriate technology for the future.

Nevertheless, operating risk seldom seems top of mind in the current environment. Capital and credit difficulties have been more urgent and compelling in recent memory. The combination of these risks seems to be causing the quiet discussions among competitors today.

Is it possible, though, that a discriminating observer may see more impetus from operating risk than is normally visible to the unassisted eye?

Steps you may need to take

The effects on customers and staffs of business combinations will likely be profound no matter how much business sense a merger makes from a traditional analysis of ROE and competitive "heft." Any business combination frequently puts individual corporate cultures on a collision course and creates anxiety among staff members, some of whom will inevitably conclude that their jobs are in danger of abolishment.

Assuming that you find yourself in such a situation, where a combination with a competitor is likely or certain, what can you do to improve your own circumstances? How can you showcase yourself in an appropriate and favorable way to position yourself for both survival and career growth?

1. Recognize that production people are always valuable.

Production people are those who generate revenue (whether it's in the form of interest income or fee income). A bank thrives on revenue; as loans are amortized, they must be replaced.

Fee income is scarce enough in the current environment that anyone who has a reputation for generating fee income needs to be nurtured within any institution.

2. Remember that banking is a relationship business.

The customer relationship people are the mortar in any bank's foundation. Community bankers seem to understand that better than their larger competitors do, and act accordingly on that insight.

During this time, when the future may seem so unpredictable, it's more important than ever to be close to your customers-and to your prospects. Don't overlook your prospects by making an uninformed assumption that all may be well with relationships of people (non-customers) you know and their banks.

Keep asking for their business. Make that practice one of business as usual.

3. Pick the right team.

If you're in a position to make the decisions about the future organization chart and who fills the boxes, pay careful attention to the experience of the current staffs of both institutions.

Make the best call for the shareholders of both and don't bend the org chart into unnatural shapes and contortions just to satisfy a constituency of one of the predecessor institution or the other. This is a formula for failure and will make a culture amalgamation more difficult.

4. Get behind a unified credit culture and encourage--if not compel--your direct reports to play ball.

I've seen too many mergers fail to live up to their full potential (or take way too long to get there) by the banks involved simply not doing the hard things up front that a strong culture needs to be repotted and firmly rooted.

Rewrite the credit policy, redefine the internal controls with enforcement teeth, and take a hard look at continuing education and career development for the lenders.

Consider some serious career pathing for the lenders too. This takes a long while and should be started right away whether a combination is imminent or not. Career development is a process, not an event. It should be institutionalized to have any durability and credibility.

Getting past the immediate worries

Meanwhile, there is uncertainty and worry in the immediate future.

Change is stressful, even for those who may be perceived to be the big winners. Employee morale, impeded by short term, ad hoc thinking in merger planning, often takes a hit. Some of this is unavoidable--but much is not.

The marketplace is delivering one overriding constant--change. It may come for different reasons and take different paths but the end results will all be similar.

To do nothing is a choice, too.

As I look forward, it's one choice you will neither like nor control.

About Ed O'Leary: Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

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