

Why you should be looking for trouble carefully (April 30, 2009)

Acquiring a troubled bank can do a healthy bank a lot of good—if you take the right bank, in the right way, at the right price

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An increase in regulatory scrutiny and an economy in recession have combined to increase bank failures and problem banks across the board. Unfortunately, the government appears to have taken a “too big to fail” and “too small to matter” approach. This attitude has led to a number of community banks find that their best—or, in some instances, only—option is to market themselves for sale as a “troubled institution”.

The proliferation of community banks marketing themselves as troubled institutions has resulted in acquisition opportunities for healthy institutions that were previously unavailable. These troubled institutions have also created a whole new set of decisions to be made by a healthy institution’s board of directors as they enter the merger and acquisition arena.

A troubled bank acquisition can prove to be a profitable strategic move if the acquiring institution properly plans for and executes the deal. For those that do not, the results can be disastrous.

The following are five principles a board should follow in planning for and executing a successful troubled bank acquisition.

1. Decide whether the bank will pursue a troubled bank acquisition before the opportunity presents itself.

Does an acquisition fit within the bank’s long-term strategic plan? Some banks’ strategic plans are conducive to acquisitions while, for others, an acquisition of a troubled bank does not make sense no matter the situation nor how “cheap” it may seem initially. Making this decision early allows the board to fully understand, debate, and plan for the issues associated with a troubled bank acquisition. More importantly, it allows a board the benefit of being free from the pressure of time constraints under which troubled institution acquisitions normally operate.

As part of this analysis, a board should consider whether its appetite for risk matches what such a deal would bring. Some boards, no matter what the terms of the deal or condition of the target, simply don’t have the stomach for this. The board should also determine whether the bank itself has the ability to withstand the ups and downs and the uncertainty of a troubled bank acquisition.

2. Identify the ideal target institution.

Next, the board should identify the bank's "ideal" target. This does not mean pinpointing a specific institution and waiting for it to become a troubled acquisition candidate. Instead, identifying the ideal target institution requires a board to determine the general attributes of an ideal troubled institution.

A board should compile a list of the characteristics that will give the highest probability of a successful and profitable troubled bank acquisition. Among these are: the geographic location and size of an ideal target and the severity of the target's problems.

It is unlikely a troubled bank acquisition opportunity will meet exactly each one of the ideal characteristics. However, identifying the ideal characteristics before an opportunity presents itself will allow a board to quickly gauge whether an opportunity matches its criteria closely enough to warrant further consideration.

3. Determine the structure of the acquisition.

Troubled-bank transactions have been coming in all shapes and sizes. Some recent troubled-bank acquisitions have been structured as whole-bank purchases. Others have been structured as a purchase of assets and assumption of liabilities. Some modern troubled bank acquisitions are not acquisitions at all, but are more properly characterized as equity injections. With an array of options available to troubled bank purchasers, it is important for the acquirer and their consultants or attorneys to identify exactly what acquisition structure will yield the greatest likelihood of a successful troubled bank acquisition. Outside assistance will help the potential acquiring bank's board to determine what structure makes sense.

4. Don't stint on due diligence.

Troubled institutions are troubled for a reason. The majority of today's troubled institutions have earned their status, due to poor or declining asset quality. However, this is not the sole reason for the increase in the number of troubled banks. A number of institutions have become troubled institutions because of securities losses; fraud or embezzlement; or some other reason.

There are two critically important aspects of due diligence when acquiring a troubled institution. First, the acquiring institution must determine exactly what is being purchased and what led the troubled institution to its current condition. Second, the acquiring institution must determine how the acquisition of the troubled institution will return a profit.

In addition to these steps, a healthy institution should devote time in due diligence to pricing issues. A troubled institution, no matter how hobbled, could be a great deal if it is priced correctly. On the other hand, a slightly troubled institution can turn out to be a bad deal if the price is not right. A buyer should spend time during due diligence to determine a purchase price that adequately reflects risk and expected returns.

5. Don't overallocate resources to the troubled institution.

Troubled bank acquirors devote a substantial portion of their time and resources to "fixing" their recent acquisition. While this is expected in a troubled bank acquisition, overallocating financial or managerial resources to the recently purchased institution can lead to a new set of problems. An acquirer with too much focus on a recent acquisition can neglect their original, healthy institution and jeopardize its safety and soundness.

Acquirors need to be vigilant in their oversight of both the original and the acquired institution. Particular attention should be paid to striking the right balance of resources allocated to both. A healthy institution can quickly turn into a troubled institution if too much time and resources are spent fixing the troubled institution and not enough time and resources are spent maintaining the healthy institution.

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