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The Changing Rules for FDIC-Assisted Acquisitions: Strategies for Minimizing Buyer's Risk in Failed Bank Transactions

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The FDIC's form agreement for loss-share transactions recently went through several rounds of revisions. This article explains the changes and how they will affect FDIC-assisted acquisitions.

The incentive for healthy banks to acquire failing banks in FDIC-assisted acquisitions is the value of the target bank's core deposits and franchise, coupled with the opportunity for virtually zero credit loss exposure as a result of the FDIC loss-share arrangement.

As valuable as these acquisitions can be for acquiring banks, the execution risk involved should not be underestimated. Moreover, the terms and conditions imposed by the FDIC in these acquisitions continue to evolve. Staying current on the financial effects of these developments makes for informed decision making and better estimates of the value of the institution acquired.

The FDIC's form agreement for loss-share transactions recently went through several rounds of revisions. The most significant change was the elimination of the 95 percent/5 percent loss-share guarantee above the stated threshold (discussed in more detail herein).

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The elimination of the opportunity for 95 percent/five percent loss sharing has several impacts. First, it makes FDIC-assisted acquisitions more challenging to bid. Second, it increases the credit loss exposure for the buyer. And finally, it makes managing the operational risk associated with the integration and stabilization of the acquired franchise all the more important as buyers defend the transaction value.

EXECUTION RISK IN GENERAL

Every acquisition presents execution risk. However, these risks are unique for FDIC-assisted acquisitions and can be acute unless well understood and mitigated through rigorous early planning. While the execution risks are numerous, there are three predominant categories of risk:

Runway risk;

Day 1 risk; and

Loss-share risk.

Failure to manage each of these risks properly can cause the acquiring bank safety and soundness problems, quickly deplete the value of the franchise acquired and jeopardize the buying institution's standing with the FDIC to participate in future failed bank acquisitions. Thus, managing the nuances of these special acquisitions requires strategic thinking and planning.

RUNWAY RISK — LANDING ON THE FLIGHT DECK

When one bank buys another bank in a typical acquisition, the courtship phase can span weeks and more likely months before a definitive purchase agreement is reached. After that, buyer and seller spend three to six months working the acquisition through the regulatory approval process leading to a closing date that can be as long as a year after the initial negotiations began. The runway in a typical bank acquisition can be fairly long, giving the buyer considerable time to plan and prepare, especially for the integration phase. FDIC-assisted acquisitions, however, require the precision a fighter pilot brings to landing an F-16 on an aircraft carrier in the middle of the Mediterranean Sea. The runway is short and the consequences for miscalculation severe.

A bidder in an FDIC-assisted acquisition can expect to be required to assemble a bid in a couple of weeks, complete due diligence in that same short period of time and, within a week after submitting the bid, find that it owns the assets and the liabilities of the defunct institution. In some instances, the FDIC further compresses the traditional bidding timetable, such that the successful bidder becomes the owner of the failed bank within days of placing the bid.

The time compression and unique features of the bid, legal receivership process, Purchase & Assumption Agreement ("P & A Agreement") and FDIC-driven milestones, put stress and strain on the buyer's senior officers when coupled with routine responsibilities to manage the institution.

To get this right, management of the acquiring institution should design a "deal team," an "integration team" and a process early, well in advance of submitting the first bid. The deal team would include outside counsel, a financial advisor to help construct the bid, additional credit diligence resources, accounting expertise for the purchase accounting elements of the transaction, as well as representatives of the various functional management areas in the buyer's organization, including finance, operations, HR, legal, compliance and communications. But, to be effective, these internal and external resources, need to be coordinated through a project leader.

While members of the deal team will naturally be included, a separate integration team of professionals needs to be assembled, that is qualified and adequately prepared to organize and manage the unique integration aspects of FDIC-assisted acquisitions. In larger organizations, key senior members of management can and should lead this effort. But even large organizations that have not previously done a transaction like this may benefit from external professionals who have managed through transactions of this type.

There are different ways to organize the integration team, but one effective method is for the buying bank to retain one or two senior level outside professionals who have served, in effect, as chief integration officer in similar transactions and have those outside professionals work side by side with management's integration leadership to create a blueprint for the integration phase and organize the resources necessary to execute on that blueprint. This stands in contrast to an arrangement where the buyer's senior management either chooses to go it alone or hires a large consulting firm to run the integration entirely. A more surgical, focused approach to leveraging may be preferable to enlarging the consulting group prematurely and risking a confused and disorganized process. All this suggests management needs to start thinking strategically about the organizational issues in the integration process even before it contemplates submitting a bid.

A buyer cannot spend too much time thinking through the blueprint early in the process. Indeed, the integration planning should begin when management first determines it is serious about submitting a bid on a failed bank in the near future. The planning process must run parallel to and accelerate in tandem with the bid preparation process. This is a lot for any management team to handle at one time, so attention to resources, and bringing in the right external resources to supplement the management team, must be a priority. The first priority is to select the project leader and the second priority is to map out the timeline for integration planning and execution. This then leads to the "Day 1" planning and related risks.

DAY 1 RISK

A lot can go right — and a lot can go wrong — on so-called "day 1," which is the first few minutes following the FDIC seizing the target bank and the first 24 hours thereafter. Planning for day 1 is part of the work done in developing the integration blueprint discussed above. In an FDIC-assisted acquisition, the FDIC will seize the bank, generally on a Friday, after it concludes normal business hours. The receiver will convey certain assets and liabilities of the seized bank to the buyer through the release of previously executed P & A Agreement signature pages. In a matter of minutes, the buyer takes control and begins to execute an integration process that preserves the value of the franchise it just purchased. Those first few minutes after the seizure and the first 24 hours are critical in winning the hearts and minds of the target bank's employees, ensuring a smooth experience for the target bank's customers and creating a "command and control" framework that puts the acquiring bank in charge of the business of the failed bank.

The emotional intensity of a failed bank seizure requires attention to all of the key people of the acquired bank, both employees and customers. The buyer faces two interrelated communication challenges:

- First, to allay employees' fears and anxiety, and calm their nerves; and
- Second, to convey to customers that their money is safe and the acquiring bank brings meaningful financial and operational firepower to enhance their banking experience.

Failure to win the hearts and minds of the target bank's employees and calm their nerves quickly can affect the customer retention rate, as the customers will look to the failed bank's employees for insights on the credibility of the acquiring bank. If the first 24 hours are handled poorly, the value of the franchise the buyer acquired can easily and quickly dissipate as customers and deposits run off.

LOSS-SHARE RISK

Another unique aspect of FDIC-assisted acquisitions, and indeed a key to the value proposition in most of these transactions, is the loss-share arrangement with the FDIC. Upon acquisition of a failed bank, in a loss-share transaction, the acquirer needs to establish a so-called "loss-share office," which is a business process designed and developed to report to the FDIC the amounts due and owing the acquiring institution from the FDIC pursuant to the FDIC guarantee of the credit losses in the target bank's loan portfolio. In effect, the P & A Agreement must be "operationalized" so that there is a robust business process in place that adheres to the multitude of deadlines set by the P & A Agreement for reports to the FDIC and ensures that the form of reporting is correctly and completely made.

In addition, the P & A Agreement sets forth conditions that must be satisfied in order for losses and expenses to qualify for FDIC reimbursement and actions taken by the acquiring bank with respect to the management of the acquired bank's credit portfolio. Failure to satisfy these conditions can jeopardize the FDIC financial guarantee. If a particular asset is covered by loss share and the acquiring bank fails to manage that asset properly within the parameters of the FDIC loss-share agreement, a "covered asset" otherwise subject to FDIC financial support can easily become a 100 percent loss to the acquiring bank. Thus, the stakes are high and establishing a leakproof loss-share office is a top priority. The nuances involved in this process design are many and the time period for establishing a functioning office can range from 30 to 120 days depending on when in a particular calendar quarter a target bank is acquired. The loss-share office design, therefore, needs to start at the time the bid is being prepared so it is ready to open and start processing, in effect, insurance claims within days after completion of the acquisition.

RECENT DEVELOPMENTS: FDIC LIMITS PROTECTION AND CAPS THE UPSIDE

Over time, the FDIC has revised and modified the form of P&A Agreement utilized in FDIC-assisted transactions. Previously, under the P&A Agreement with Loss-Share, the FDIC and the acquiring institution share all losses up to the point of the "Stated Threshold" on an 80 percent/20 percent basis and 95 percent/five percent thereafter. (That is, the FDIC would reimburse the buyer for 80 percent or 95 percent of its losses, if properly documented and submitted in compliance with the agreement). Recently, the FDIC eliminated the 95 percent/five percent layer of protection and the Stated Threshold concept. For newly executed deals, all losses are shared on an 80 percent/20 percent basis.

The FDIC also introduced the "Intrinsic Loss Estimate" concept (also sometimes referred to as the "Intrinsic Value Estimate"), which represents the FDIC's best guess regarding expected losses on the loan portfolio. If losses do not reach the Intrinsic Loss Estimate, the potential exists for an unexpected financial boon for the buyer. Therefore, the FDIC has revised the form P&A Agreement to allow it to "claw-back" some of that upside from the buyer. The P&A Agreement requires the buyer to reimburse the FDIC a portion of its gains, if the losses do not reach the expected level.

EQUITY APPRECIATION AND VALUE APPRECIATION INSTRUMENTS — MORE VALUE TRANSFER

The FDIC is cognizant of the fact that some publicly-held institutions that have been successful bidders on failed banks have experienced meaningful jumps in their stock prices following the public announcement of the transactions. The FDIC is seeking to share in those short-term positive gains. As a result, bidders on failed banks are now being offered the opportunity to incorporate into their bids an "equity appreciation instrument." The equity appreciation instrument will provide a warrant that the FDIC can fully or partially exercise in order to share in any post-announcement jump in share price.

The FDIC encourages the equity appreciation instrument as an optional aspect of the bidding process for both publicly traded and non-publicly traded bidders, although the FDIC is continuing to refine its approach for privately-held bidders and updates will be provided as they become available.

LINKED BIDS

In recognition of the increasingly competitive bidding environment and the complexities presented when the FDIC offers multiple targets for bidding on a single day, the FDIC has now introduced linked bidding as an option. Bidders may choose to submit multiple bids, of varying types, on a linked and unlinked basis for banks scheduled to be closed on the same date. As a result, the challenges associated with bidding have become increasingly complex.

The emergence of the linked bidding and the equity appreciation and value appreciation instrument exemplifies the evolving nature of the bidding process for FDIC-assisted transactions — and the critical need for potential bidders to remain informed and partner with experienced resources — in order to maximize their chances of successfully seizing the full extent of the opportunity FDIC-assisted transactions can represent.

SUMMARY

Buyers in FDIC-assisted acquisitions will do well to focus on this theme — *seizing and defending the transaction value*. This means that in composing the bid, careful attention to the FDIC rule changes as well as the nuances of the clawback and equity appreciation instrument need to be well understood and considered. Getting the valuation right in the bid is the first step to seizing value. But, that value can dissipate quickly if the integration and stabilization process, which begins on Day 1 and continues for months after the acquisition closes, is not well planned or executed. Buying a failed bank with loss-share protection is a unique transaction and because of the peculiarities involved, the acquisition requires special time, attention and expertise.