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Bank Notes

January/February 2010

A timely information and idea statement

Due Diligence Considerations for Bank Mergers and Acquisitions

Banking organizations today are faced with a variety of challenges. All parts of the country are faced with challenging economic conditions with some geographic areas impacted more than others. In addition, the regulatory landscape is creating more obstacles and competition is becoming more intense. While some bankers may be discouraged by today's operating environment, others might view this as an opportunity to expand market share or to re-organize their strategic and operating plans for the much anticipated economic recovery.

In good times and in bad, mergers and acquisitions can lead to increased shareholder value. While we may all agree with this premise, care must be taken to analyze your strategic objectives and find transaction candidates that are a good fit for your long-term organizational goals.

Several types of transactions are available in today's market including: 1) distressed banks seeking additional capital or those hoping to partner with a stronger entity; 2) healthy banks that are in sound financial shape, but wish to expand their market reach; and 3) portfolio or department purchases with banks that have decided to exit a product or service line.

Strategic objectives and tolerance for risk

If your bank is contemplating a merger, acquisition or portfolio/department purchase, the first place to begin is by defining your overall strategic objectives and tolerance for risk. Key members of senior management and members of the board of directors should be gathered to discuss financial, geographic and cultural attributes of a transaction candidate that when added to your organization will create additional shareholder value. This process goes beyond basic financial analysis and allows your organization to narrow the field of candidates to those best suited to your long-term goals and objectives.

Establish a project team

A successful project is only as good as the team carrying out the work. Start by selecting a well-respected internal member of management with sound project management skills. The project manager should then be provided with a cross-functional team including finance, credit, operations, information technology, internal audit, risk management and regulatory compliance. The project team should perform a self-assessment to match up internal skills with those required to evaluate transaction candidates. Gaps that are indentified in staffing or capabilities should be matched with outside professionals to provide a full complement of resources to act when opportunities arise.

Don't go it alone. While your internal management team may be very good at performing their current duties, they may not have the time or experience necessary to execute on all aspects of a due diligence project. Consider professionals that have unique specialization including accounting, risk management, internal audit, attorneys, investment bankers and tax advisors. Proper leverage with outside professionals can allow your management team to focus on the big picture strategic issues associated with the transaction and allow outside specialists to perform the heavy lifting.

Candidate pre-screening process

Once you have determined your strategic objectives and assembled a project team, you can begin to evaluate potential candidates. The first step in the pre-screening process is to perform a "fly by" to identify any potential "deal killers." This pre-screening process will allow you to evaluate financial metrics, geographic fit and cultural considerations. This step usually results in a pass or fail test. Pre-screening will also save time and money, so that substantial resources are not devoted to a transaction that was doomed from the start.

Due diligence planning

Once a viable candidate is identified, due diligence planning is an essential element to ensure the project is properly focused on your organizational objectives. Early steps can include forming the "deal," establishing pricing assumptions and financial modeling. Often outside professionals can provide valuable advice to avoid potential problems from the start. Additional considerations include development of letters of intent and confidentiality/non-disclosure agreements.

A request for information should be formulated and delivered to the target that corresponds to all aspects of the scope of coverage. Then arrangements should be made on methods to provide the information to the project team. In today's age of technology, secure Web sites are available to host information and soft copy electronic documents can be easily delivered to expedite offsite analysis in advance of fieldwork.

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Year-End Tax Considerations

There are several tax-related rulings that have taken on increased significance for financial institutions and have created potential planning opportunities as well as obstacles. It would be beneficial to familiarize yourself with the following issues to help to place your bank into the most advantageous tax position available.

IRS Revenue Ruling 2007-32 and the Conformity Election

If your institution is faced with increased non-accrual loans, you might want to revisit IRS Revenue Ruling 2007-32 and the conformity election. This ruling made it clear that interest accrued but not collected on loans on non-accrual status must be included in taxable income but that a corresponding bad-debt deduction will be allowed if an institution has made the conformity election. A conformity election allows banks to follow GAAP and take a tax deduction for charge-offs with reduced scrutiny by the IRS.

Pursuant to Ruling 2007-32, any subsequent payments received on the non-accrual loans must be treated as interest for tax purposes to the extent of earned, but uncollected interest receivable, if the conformity election is not utilized. This is a departure from the GAAP treatment of subsequent payments, so electing institutions must maintain separate tracking records for subsequent payments.

The conformity election for bad debts is an accounting method and requires a request to change to this method. Additionally, for the conformity election to be valid, an institution must have an Express Determination Letter from their primary federal regulator covering the applicable period.

There are potential downsides to the conformity election. Please consult your tax advisor to discuss if this election is appropriate for you.

Is an Other Than Temporary Impairment (OTTI) charge deductible for tax?

The answer may be driven by the classification of the OTTI loss as credit or market value related. Banks are afforded a special provision under Section 582(a) of the Internal Revenue Code (IRC) to treat credit losses on debt securities as bad debts under IRC Section 166 rather than as a loss under IRC Section 165. If the measure of impairment is calculated by analysis of the collectible amount from the borrower, the impairment might qualify as a tax deduction under IRC Section 166. If, on the other hand, the impairment is based on the reduced fair market value of the security, or, in other words, what someone is willing to pay for the security, the impairment more than likely will not qualify as a tax deduction under 166 as it is based only on market fluctuations.

If you can substantiate the OTTI as credit related and it meets the requirements under IRC Section 166, the tax deduction will be the lesser of the credit portion of the OTTI charge or the OTTI charge.

The determination of tax deductions associated with OTTI charges is facts and circumstances based. Your tax advisor can assist in walking you through the maze.

Extended NOL Carryback periods

The carryback period for net operating losses has been extended for many businesses that may be experiencing financial struggles this year. For 2008 and 2009 tax years, eligible businesses may elect to carryback applicable net operating losses (NOLs) three, four or five years. Prior to this law change, businesses would have only been able to generally carryback NOLs to the previous two tax years. The carryforward of NOLs of 20 years remains unchanged.

An applicable NOL is an NOL for a tax year ending after Dec. 31, 2007 and beginning before Jan. 1, 2010. Taxpayers must make an election choosing which carryback period they want to use. There is one caveat to electing to carryback an eligible NOL for five years; in the fifth year the taxpayer is allowed to offset a maximum of 50 percent of its taxable income with the NOL.

There has also been a removal of the limitation of the amount of the Alternative Minimum Tax (AMT) NOL that can be used in a year. Typically, AMT NOLs can only offset 90 percent of alternative minimum taxable income. However, AMT NOL percentage limitations have been suspended for purposes of the extended period carryback.

A bank that finds themselves in a net operating loss position in 2008 and/or 2009 needs to consider many items to determine what year to carryback the NOL to in order to get a greater return on the carryback. Some items to consider when examining carryback opportunities are:

- Alternative minimum tax (AMT) situations in carryback years
- Corporate effective tax rates in carryback years
- Corporate cash needs
- Corporate rates in future years

If the bank has received any assistance under the Emergency Economic Stabilization Act (TARP), they may not be eligible to elect the extended carryback periods.

Each of these situations can be complicated and can significantly affect your tax position. Your tax advisor can assist in help in determining what the best course of action is for your institution.

Due Diligence, continued from page 1

Scope – High priorities

You won't have as much time as you would like to perform the due diligence. Therefore, it is of critical importance that you spend your time in areas of highest risk. Several high risk areas include the loan portfolio, allowance for loan and lease losses, deposit stability, investment portfolio, financial reporting controls and overall management capabilities. Other areas of importance include contracts/agreements, litigation, information technology, operations, consumer compliance, bank secrecy act and an evaluation of the potential tax implications to the transaction.

Daily meetings should take place with the project team during fieldwork to identify and discuss potential "deal killers." These discussions could cause you to terminate discussions or allow you to re-negotiate the price, terms and conditions. Throughout the process, candid and realistic assessments are required to avoid long-term problems. In addition, take care to avoid an emotional attachment to the transaction.

Common deal killers

Our experience in performing due diligence over the past 12 months has uncovered some common "deal killers" that surfaced prior to or during fieldwork:

- Loan quality – Cannot find the bottom on asset quality
- ALLL shortfalls – Typically ties in with inaccurate loan risk rating systems or optimistic views of work-out plans
- Investment impairment – Derivatives, sub-prime or high risk securities
- Long-term contracts – Premises, information technology or employment agreements
- Board composition – The parties cannot reach agreement on the new board
- Disclosure – Problems were understated by the candidate bank during pre-screening
- Deal pricing – Inability to reach agreement on pricing, terms and conditions
- Regulatory challenges – Lack of comfort with new risk profile

Evidence of work

Regardless of whether you decide to move forward with the transaction or exit the field, proper evidence of work and conclusions drawn are essential to justify your business judgments and decisions. During this stage, a report of findings is prepared that corresponds directly to your organization's original strategic objectives and the scope of work performed. Summary information can then be provided to your board of directors to ratify the decision.

Summary

When contemplating a merger, acquisition or portfolio purchase, strategic objectives should be defined in advance along with your tolerance for risk. This process can be used to pre-screen transaction candidates, assemble a project team and establish the scope of work. Ongoing communication among the project team is essential to identify high risk elements that could jeopardize the viability of the transaction. If the transaction is not a good financial, geographic and cultural fit for your organization call it a day and move on to the next transaction candidate.

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Issues for Financial Institutions in 2010

The financial landscape continued to change during 2009. There were some potential bright spots in the financial marketplace that took some of the sting out of continuing problem areas such as housing prices, foreclosures, commercial real estate and investment impairment. What issues will 2010 bring to the banking environment to make it more challenging?

For an analysis of important considerations for financial institutions in the coming year, including cost cutting, risk management and board involvement, visit www.rsmmcgladrey.com/banknotes.

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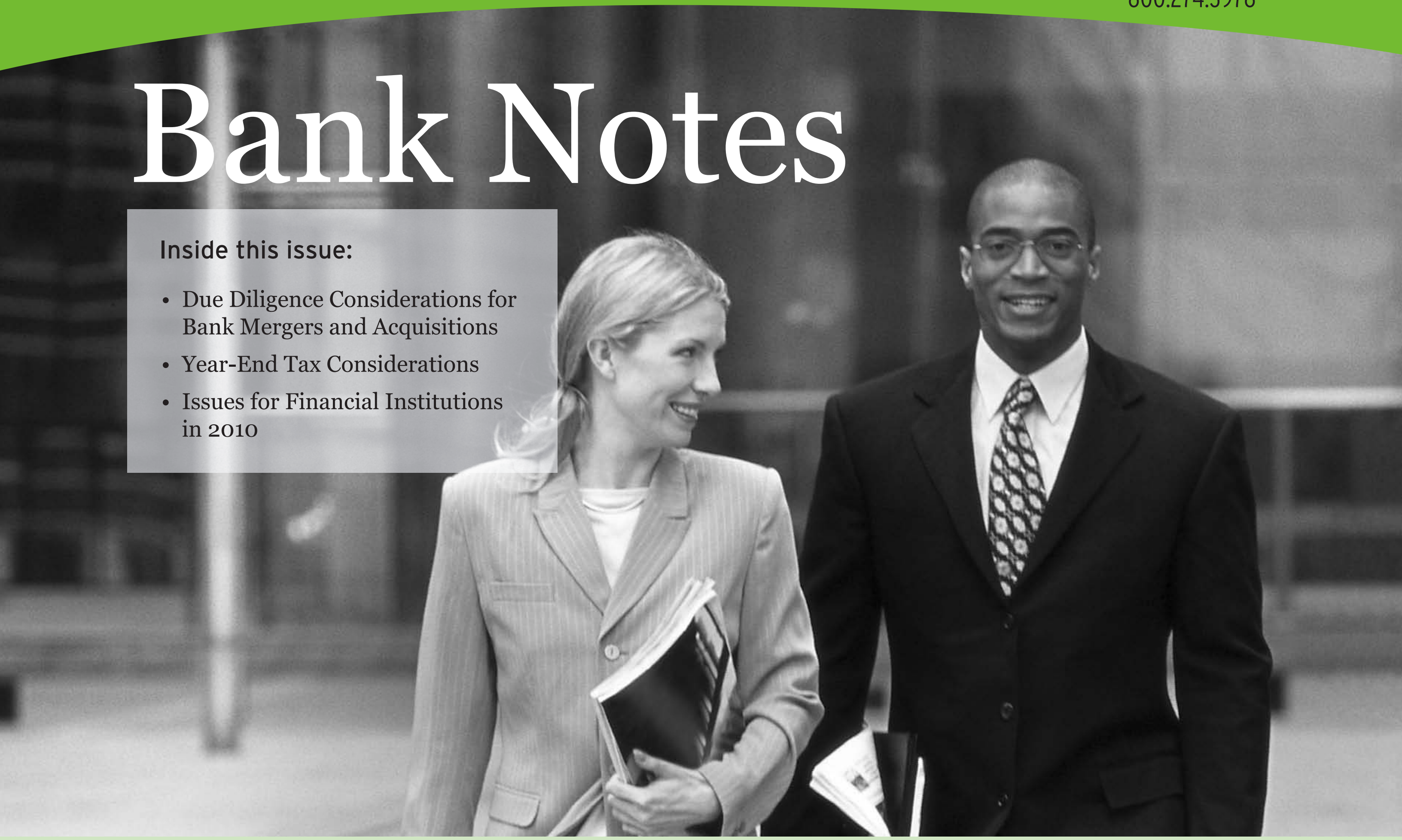

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