BIDDING ON TROUBLED BANKS

by Steve Brown

Both teams put in amazing performances as we watched one of the better Super Bowls ever played. Both quarterbacks were tactically sound, but Pittsburgh executed slightly more effectively. In similar fashion, many bank CEOs are called on to step up their game when they receive notice from the FDIC of a receivership bid situation. Many bank CEOs are rising to the challenge. Being tactically sound can help with the game.

Acquiring banks have between 1 to 2 weeks to determine the price of a target troubled bank and can choose to bid in one of 3 ways. They can bid for the whole bank, all deposits or just the insured deposits. How banks bid depends on the quality of the troubled bank and the bidding bank's available resources. For the most part, bidders have focused on the deposit side, since this is the easier execution. While we will talk about whole bank valuation in the future, today we focus on valuing the liability structure.

Most successful liability bids have been between 0.15% and a 2.00% premium (with 5.50% the recent high). This range is low by most standards and is a function of the tight time frame given for analysis and imperfect information. The reality is that deposits are worth multiple times that.

There are 2 primary ways to value deposits, the Relationship

Method and the Discounted Cost of Funds Model. In the former, bidding banks make an estimate of the lifetime value of what that target set of customers can produce. Here it helps to know what your bank pays to acquire customers (since you won't need to), what the cross-sell ratio is, the net profitability of other products and the average "life cycle" of a customer at your bank. This is a typical valuation method for a whole bank bid, except in a deposit bid, the cross-sell ratio is typically reduced by 33%, since some of these customers already have loans outstanding that may go to other institutions (but not necessarily another bank). This calculation usually produces a higher valuation and in a world with perfect information, would result in a premium of 6% to 8%. The higher the acquiring bank's product profitability and crosssell ratio, the more they should be willing to pay for average deposits. The higher percentage of business customers, the higher the premium should be. Some bidding banks make further adjustments to what is known about the deposit base (such as demographic information or average balances), as a proxy for past profitability.

The 2nd approach is to utilize the classic cost of funds model. Here, valuation is a function of the cost and duration of a bank's existing liability structure and of the target liability structure. This is basically a discounted cash flow model, where banks look at their own structure and then calculate the value gained by acquiring a higher or lower cost structure (usually higher). If a bidding bank already has a low-cost deposit base, then their acquiring premium should be theoretically lower, as the target deposit base will increase the bidding bank's overall liability cost. The deposit base may still be worth a premium, as the acquiring bank can run off the higher cost/rate sensitive deposit base and still derive core value. Conversely, if the target deposit base has a low cost of liabilities, a long duration and positive convexity, it should result in a higher premium. As a proxy, most bidding banks make assumptions utilizing average balance size and deposit composition as a way to calculate general duration and convexity (the calculation a bank would do if it had better information). Because the costs of fee or loan services are not valued, this calculation methodology normally results in a premium for a bank's liability base of between 4% and 6%. However, since banks in receivership usually have higher cost deposits, lower duration and less positive convexity (which all helped drive their demise), we find premiums for these banks are closer to the 2% to 4% range.

The reality is that given the time and information, most banks bid the value of only the first year's earning attribution. Over the course of this year, we expect the value to improve (as the FDIC gets better at providing information, banks get more comfortable with their models and the quality of troubled banks improves slightly).

BANK NEWS

Bank Failures

Three more banks failed on Friday, taking the total so far this year to 6. The banks that failed were Ocala National Bank ($224mm, FL), Suburban Federal Savings ($360mm, MD) and MagnetBank ($293mm, UT). No buyer was found for Magnet, while Suburban's deposits were acquired by Bank of Essex ($722mm, VA) and Ocala's deposits were acquired by CenterState Bank ($1.2B, FL).

Capping CEO Pay

Senator Claire McCaskill (D, MO) introduced a bill on Friday that would cap annual CEO compensation at banks that took TARP at $400k (the salary of the President of the US). We would take her more seriously, but we tuned out after the 12th time she used the word "idiot" to refer to said CEOs during her Meet The Press interview.

CRE Lending Tightens

The FRB reports that in the 4Q, 87% of banks tightened lending standards on CRE.

Adjustable Rate Loans

The WSJ reported that 28% of option ARMs were delinquent as of Dec.