SHARING LOSSES

by Steve Brown

Bank closings are getting to be so very 17Ys ago. While none of us wax nostalgically for the early 90's, the FDIC has acquired a certain efficiency in bank closings that was last seen in 1992. With 3 or 4 closings a week, the industry is starting to fall into a rhythm. To accomplish this efficiency, the FDIC has dusted off it iconic Loss Sharing Agreement ("LSA").

This structure, first used in 1991, is instrumental in helping both the acquiring bank and FDIC speed the settlement of troubled institutions. The LSA allows for faster due diligence, gives the FDIC a way to leverage its balance sheet, provides for less expensive dissolution on the part of the FDIC and limits uncertainty for the buyer. For acquiring banks, instead of just taking on the deposits, they can feel comfortable acquiring assets (in order to capture the complete client relationship). For banks asked to bid on failing institutions, we thought it would be helpful to conduct a quick review of what we learned in the early 1990's about such loss sharing agreements.

In order to promote the sale of assets, the FDIC enters into a loss sharing agreement. Interested banks get 2 to 3 weeks to conduct cursory due diligence on a troubled bank and then bid with a LSA. In the 90's the LSAs mostly just covered C&I and CRE loans. Now, the FDIC is starting to use them on a variety of sectors, including consumer and mortgages. Typically, the loss ratio is such that the FDIC will agree to handle the first 80% of net charge offs (charge offs less recoveries) plus reasonable 3rd party expenses. This loss ratio has varied throughout history and is still a point of negotiation (although these days it has coalesced around 80%/20% for most community bank deals). During the time when the agreement is in effect, plus 3Ys to 10Ys after (the time varies according to the portfolio), the acquiring bank pays the FDIC their pro rata share of all recoveries less applicable expenses. In most agreements, there is a limit of maximum losses set by the FDIC where the acquiring bank's losses are further shared. After this limit is exceeded, the FDIC usually takes 95% of losses over that amount (sometimes payment on this additional guarantee is deferred until the end of the agreement). This limit varies from portfolio to portfolio and is a result of an analysis of expected losses given the underwriting, diversification, loan type, average dollar amount and other risk factors. There are also provisions for lines of credit and construction loans that most bankers believe are reasonable.

Once the LSA is executed, assets are then taken on at book value. The acquiring bank must file a Certificate of Payment quarterly that details the performance of the loan. Any net losses or gains are usually settled within 15 days after receipt of Certificate. In addition, annual audit attestations and semi-annual internal audits are required. The LSA ceases to be in affect if assets are sold or if the terms are violated.

As far as loss sharing agreements go, the FDIC's is about as fair as it gets. While the LSA creates an additional burden on the acquiring bank to administer, this cost is minimal for asset purchases. While some of the larger banks in their LSAs have taken first loss pieces, most community bank acquirers stay with the typical 20% last loss piece. Keep in mind that the probability of first loss on the total portfolio is far greater than the last loss or pro rata sharing of losses. When negotiating loss sharing agreements, one can calculate the value of such agreements by taking the present value difference for the loss given default between having an agreement and not having one.

We will be talking more about valuation methodology for troubled banks (both assets and liabilities) at our upcoming Executive Management Conference in May (click to register, as conference registration goes up next week: http://www.pcbb.com/2009Conf_Summary.asp . In the meantime, banks that are looking to deploy capital and increase franchise value are smart to focus on working with the FDIC to purchase a troubled institution. An accurate asset bid and LSA can add instant shareholder value.

BANK NEWS

Branching Change

The FDIC reports brick-and-mortar branches still represent 90% of all banking offices in the country. Perhaps more interesting, from 2007 to 2008, smaller retail offices grew at more than double the pace (about 5.4% annualized) of full service traditional branches.

Deposit Growth

Banks seeking deposits should note that offices in metropolitan areas (with more than 50k people) had more than double the growth rate of deposits (about 5.1% per year) in micropolitan areas (between 10k and 50k people). This is despite the fact that branch competition in these larger metropolitan areas was significantly higher.

Slightly Less Lending

A recent study finds about 40% of small business customers of banks acquired unsecured loans in 2008, down from 44% in 2007.

Nationalization?

Analysis done by PIMCO finds that already 20% of all bank capital is now owned by the US Gov't.