SHARING LOSSES

by Steve Brown

When we were children, our parents taught us to share things and to be nice to others. The FDIC must have learned the same lesson, as it is sharing with more and more bankers these days through "loss sharing" agreements (LSA). We get asked all the time how these agreements work, so we break that down more in today's edition.

Why they exist. The FDIC created LSAs decades ago in an effort to sell as many assets as possible, align the interests of the FDIC and investors and make sure nonperforming loans were professionally managed.

How they work - General. Under an LSA, the FDIC agrees to absorb a significant portion of losses (usually 80%) on a given portion (or all) of a failed bank's loan portfolio. The acquiring bank also shares in a portion of losses (usually 20%). This is enough to get the acquirer's attention, make sure the loans are managed aggressively and limit risk enough to get more acquirers interested in bidding.

How they work - Detail. Under the LSA, assets initially are recorded at the failed bank's book value. The value is increased by additional advances, capitalized expenditures or accrued interest and decreased by principal payments or charge-offs. Advances cannot exceed certain specified percentage limitations (generally 10% of book value) and are not allowed on any loan where the acquiring bank has recorded a charge-off. Modified loans cannot extend beyond the date of the loss share agreement or coverage ceases. FDIC reimburses for 80% of net charge-offs plus reimbursable expenses and is paid 80% of recoveries. Expenses not covered include income taxes; salaries and related benefits of employees; occupancy, furniture, equipment; data processing; accounting/consulting fees; (other than legal/environmental); or overhead.

What's in it for the FDIC? LSAs have many benefits to the FDIC. They better preserve the value of the assets, bring in more interested bidders, align management and disposition incentives (between FDIC and winning bidder), and they provide a way for the FDIC to quickly dispose of problem assets. In addition, the FDIC keeps bank loans in the industry and reduces the overall cost of cleaning up the failed bank. In short, the structure is designed to sell off all the assets, while still receiving a bid premium for the failed bank's deposit franchise.

What's in it for the acquirer? Banks that are interested in bidding on a failed bank will often find themselves without much time to do so. The FDIC tries to keep these things as quiet as possible and performing due diligence is a difficult process. LSAs help bridge that gap by protecting the bidder's downside risk (by basically building in a guarantee).

How long does it last? While each transaction can be different, LSAs usually last 3Y to 5Y (some larger bank deals have even gone as long as 10Ys).

A little bit of history. The first LSA happened on 9/19/1991 (Southeast Bank, FL, $10.5B assets). FDIC agreed to 85% loss share, took a note (nonaccrual asset note) bearing a rate of nominal interest (as a funding mechanism for the assets) and agreed to purchase perpetual preferred stock (to offset the additional burden on the acquiring bank's capital). They have evolved since then and become more standardized, but if history is any guide, they tend to be less expensive than purchase and assumption agreements without loss sharing.

Pro's and con's of the structure. Pro's: lowers FDIC costs; reduces chances failed bank assets will lose as much value as if placed in conservatorship; softens the effect of a bank failure on a local market; avoids exacerbating the problem by eliminating the need to "dump" problem loans; aligns the interest of FDIC and acquirer. Con's: costs more to administer; loss sharing requires audits and ongoing compliance reporting; additional reporting is required; coverage ceases if the acquiring bank exercises collection preference regarding a loan already in its portfolio with the same obligor (may create a conflict with existing bank relationships); is usually only available on pools $100mm; and recoveries/profits are also shared (limiting potential upside).

We have now shared with you how these sharing agreements work - Mom would be so proud.

BANK NEWS

5 Bank Closures (89 YTD)

On Friday, the FDIC closed banks in AZ, IA, IL and MO. Banks closed were: [1] First Bank of Kansas City ($16mm, MO, TX Ratio 456%) bought by Great American Bank ($40mm, KS). Great American acquired 1 branch, all of the deposits and all of the assets. [2] InBank ($212mm, IL, TX Ratio 672%) bought by MB Financial Bank ($8.39B, IL). MB acquired 3 branches, all non-brokered deposits and essentially all of the assets. [3] Vantus Bank ($458mm, IA, TX Ratio 112%) bought by Great Southern Bank ($3.3B, MO). Great Southern acquired 15 branches, all of the deposits and about 85% of assets. [4] Platinum Community Bank ($148mm, IL, TX Ratio 34%) was closed and deposits will be paid out (no buyer was found). [5] First State Bank ($105mm, AZ, TX Ratio 224%) bought by Sunwest Bank ($468mm, CA). Sunwest acquired 6 branches, all deposits and essentially all of the assets (under FDIC loss share agreement). Est. cost to the FDIC insurance fund is $401mm.

3Q Bank Warning

Large banks are already signaling the 3Q and 4Q could be a struggle and profitability will be much harder to achieve than in the 1st half of the year.