

ProSight M&A Playbook for Community Banks



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ProSight M&A Playbook for Community Banks

The ProSight Bank Mergers & Acquisitions (M&A) Playbook for Community Banks is the definitive guide to successful M&A transactions for community banks. Drawing on the collective wisdom of ProSight's experienced professionals, the playbook provides checklists, frameworks, data, and real-world advice to help community banks navigate every stage of the M&A process—from initial consideration to closing.

The playbook covers all aspects of the M&A process, from due diligence and valuation to post-merger integration. It also includes detailed information on key topics such as asset and liability management, credit risk management, and regulatory compliance.

The ProSight M&A Playbook for Community Banks is an essential resource for community bankers who are considering a merger or acquisition.

About ProSight Financial Association

ProSight Financial Association empowers financial services leaders to strengthen and advance our industry. Formed through the merger of BAI and RMA, trusted organizations with rich histories and deep expertise in risk, compliance, and retail and commercial banking, we are here to support you during times of great change, guide you towards new opportunities for growth, and help you act with confidence. As ProSight, we've enhanced our ability to support you at a time when the industry is challenged to meet changing customer needs, adopt new technologies, and manage more complex risk and compliance issues. Our work creates positive ripple effects throughout financial services organizations and our industry—and ultimately helps consumers, businesses and communities thrive. Learn more at ProSightFA.org.

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CHAPTER 1

Understanding M&A

Six questions risk executives/bank boards should ask and debate before a bank begins merger discussions:

1. Why?
2. Who?
3. What?
4. Where?
5. When?
6. How?

The “Why”

The pre-deal phase of an acquisition is the most critical phase in the merger process. Effort spent by boards and the management to lock into agreement about critical issues before entering merger negotiations will save time and money long term. One of the greatest risks associated with mergers is the time and effort consumed by the board and key management who are taken away from their “day jobs” of serving clients- customers. Entering merger discussions can be exciting but comes with the meaningful risk of disruption to running the bank. Banks that know who they are, why they are unique, and what they would seek from a merger before entering merger discussions are more likely to meet strategic and financial objectives than banks that chase every deal.

The most important “why” questions an acquiring bank should ask are:

- “Why do we want to buy another bank/firm?”
- “Why do we believe we can achieve this merger without putting momentum at risk with current customers/ clients?”
- “Why do we believe the merger will not put at risk the acquirees most profitable current customer/ client relationships?”
- “Why do we believe this merger will achieve the synergies needed to make this a successful investment of shareholder capital?”
 - Define the synergies and synergy risks. Develop a high-level model to:
 - › Identify critical synergy expectations
 - › Develop effective means to monitor and report
 - › Develop and maintain controls for synergy risk mitigation

The Goals of M&A

Every merger should clearly satisfy one paramount goal: 1) shareholder value creation. In addition, mergers can achieve four other primary objectives: 2) diversification/financial risk management, 3) talent acquisition; 4) distribution improvement; 5) product/service enhancement, especially digital offerings.

1. **Shareholder Value:** Every merger should be designed to enhance shareholder value. The most common ways bank mergers translate into enhanced shareholder value include:
 - Efficiency/expense reduction
 - Branch overlap
 - Management redundancy
 - Third-party services redundant
 - Scale/market share
 - Growth/pricing power
 - Revenue growth
 - Enhanced products and services
 - Greater geographic distribution
 - Salesforce augmentation
2. **Diversification/Financial Risk Management/Scale-Cost/Access to Core Deposits**
 - In recent years acquirer banks have stepped up acquisitions of banks with low-cost core deposits to lower funding cost as well as improved liquidity
 - Since the mid-1990s mergers have been viewed as a tool to lower operating costs (overhead and efficiency ratios)
 - Diversification
 - > Geographic diversification reduces concentration risk
 - > New business lines reduce concentration risk
3. **Talent Acquisition**
 - Mergers can sometimes improve and protect long-term shareholder value because of the addition of key talent
 - > Enhances succession planning especially for critical CEO, CFO, CRO roles that are likely to be even more difficult to fill in the 2020s
 - > Enables acquirer to add key revenue producers to bank
 - > Provides a pipeline of key talent to non-traditional roles where banks often have critical gaps, e.g., Chief Information Officer, Supply Chain Management, Digital Platform Management
 - > Diversification/financial risk mitigation
4. **Distribution Improvement**
 - Distribution of existing products and services can be improved through an acquisition
 - Improved distribution allows for greater economies of scale which improve productivity
 - Can take the form of:
 - > A larger salesforce (e.g., branch personnel, commercial lenders, financial advisors)
 - > An improved digital platform on which greater products can be made available cost effectively

5. Product/Service Enhancement, especially digital offerings

- Banks often acquire firms for products/services. For example:
 - › Wealth management firms that allow the acquirer to enter a new business or fortify existing capability
 - › Investment banking as a complementary service to traditional commercial lending
 - › Asset-based lending as an add-on service to commercial banking
- Digital
 - › Banks are increasingly confronted with the decision of how to accelerate digital capabilities
 - › Acquisitions can provide an acquirer the opportunity to accelerate digital capabilities by buying a bank that has a more mature and developed digital strategy
 - › Acquisitions can also allow acquiring banks to identify key digital talent as well as fintech relationships that have the potential of jump-starting the acquirers digital offering

Capital Considerations

Do not begin any serious discussions about acquisitions until the bank CFO has provided a regulatory capital adequacy framework covering pre- and post-merger.

Payback/Financial Targets

Parameters should be in place that articulate the board's expectations for financial performance. During merger negotiations, some banks fall into the trap of compromising payback and financial targets. The best evidence of knowing when this happens is when the CEO or board chair call the acquisition "strategic". Strategic acquisitions are often how acquisitions are described that fail to meet payback and financial targets. Before engaging in merger talks, bank boards should have:

- Going-in assumptions about tolerance for the financial impact of a merger on shareholder value
- Payback expectations for dilution, one-time charges, targeted date for accretion to core earnings (immediate is best)
 - Payback is commonly measured by:
 - › IRR (Internal rate of return) goal (less than 10% is rarely acceptable)
 - › Timing for positive return on premium (less than 2 years is preferred)
 - › Shared understanding among the board and key shareholders of the bank's tolerance for impact to EPS, ROE, ROA over short-term (year or less) and long-term

Strategy

Be clear as to strategic objectives required for a merger; some banks quickly sort through acquisition candidates by setting predetermined parameters around these key bank attributes:

- Size
- Location
- Business focus
- Asset mix, credit quality

Nearly every bank has a chosen strategy and business model that results in a unique “DNA” made visible in key financial metrics:

- Deposit mix, cost of funds
- Loan focus, mix, yields
- Operating costs/efficiency/overhead ratios
- Margins
- Asset quality
- Loan and securities duration
- Capital and loan loss reserve ratios
- Compensation and productivity practices

Some great banks avoid mergers so as not to risk changing their unique strategy or destroying their unique DNA. Acquisitions that are at a lower risk for changing an acquiring bank’s DNA generally occur when the acquired bank:

- Is less than 20% the asset size and profitability of the acquirer
- Is in the same market
- Has a business model and strategy that aligns to the acquirers

Acquisitions that have a greater risk of changing an acquiring bank’s DNA generally occur when the acquired bank:

- Is more than 50% the asset size and profitability of the acquirer
- Is out of market
- Has a business model and strategy that is different than that of the acquirer

Great banks tend to differentiate themselves on one of four key attributes:

1. **Customer Intimacy:** High-touch, deep knowledge of local market and local clients, focus on key client niche; e.g., a private bank or a strong community bank with a great reputation as the market’s leading bank for local commercial real estate lending; these banks are attractive to the affluent segment, especially business owners
2. **Efficiency:** Highly efficient banks tend to be low-cost producers of banking services; these banks tend to be attractive to the mass market
3. **Innovation:** Innovator banks tend to invest heavily in next-generation services and tend to partner well with third parties that have talent and services to augment the bank’s offerings
4. **Convenience:** Such banks invest heavily in multiple channels of delivery, which include most prominently branch offices, ATM distribution, online banking/bill payment, and other digital/ telephonic means for customers to access banking services

Prior to engaging in merger activities, boards should address key strategy questions:

- Will a merger enhance the bank’s ability to meet its documented strategic objectives?
- If the strategy must change or be modified to achieve a merger, is the board willing to modify the bank’s unique “DNA”?
- If the potential for shareholder value creation from a merger is so clear, is the board willing to modify its strategy to do a merger?

Strategy and Risk Profile

Bank strategy is impossible to articulate without a clear understanding of the bank's risk profile. Risk managers need to articulate with precision the potential for the bank's risk profile to be altered because of a merger. The board in turn must debate its willingness to modify the bank's risk profile to effectuate a merger.

Strategy is brought to life in and by the experience of customers and clients; as strategy is translated into customer/client experience, these two questions should be addressed:

- How will our 20 most profitable clients benefit from a merger? Top 100?
- Is it possible that a merger could significantly distract the bank from serving the needs of existing profitable clients and clients in the pipeline?

Four Common “Why” Risks Banks Encounter During Pre-Deal Phase

1. The motivation for the merger is driven by contagious merger “bug”
 - Historically, mergers often occur in clusters across geographies
 - The motivation to merge may be more influenced by the action of competitors rather than sound business reasons that enhance shareholder value or improve customer-client experience
2. The motivation to merge is influenced by third parties with a vested benefit from a merger
 - Investment bankers who advise banks during mergers often only get paid if a deal is transacted
3. The motivation to acquire is overly influenced by emotion: “Ego”
 - Buying another bank can stroke the ego of the acquirers, not unlike a football team beating another football team or a country conquering another country
 - While ego motivates people and banks to excellence, it can also blind people and banks to risks and compromise
4. Bank mergers can cause “board overheating.” In the words of the inimitable Warren Buffett: “I can't resist telling you a true story from long ago. We owned stock in a large, well-run bank that for decades had been statutorily prevented from acquisitions. Eventually, the law was changed, and our bank immediately began looking for possible purchases. Its managers – fine people and able bankers – not unexpectedly began to behave like teenage boys who had just discovered girls.” Source: Berkshire Hathaway 2009 Annual Report.

“Strategic Fit” of an Acquisition

Acquirers must be clear as to what they are buying

- Deposits/funding?
- Asset generation?
 - New markets?
 - New distribution channels?
 - New products and services?
 - More lenders?
- Talent?
- Efficiency improvement?
- Culture?

Deal-breakers

- Be clear and disciplined about expectations
- Identify deal-breakers as early in the process as possible
- Be especially alert to
 - Outstanding litigation
 - Contracts with material termination clauses
 - Excessive change of control payouts
 - Unexpected credit problems
 - Unacceptable securities duration

The “Who”

Control

The board should enter merger negotiations with a pre-determined preference for future organizational structure. Questions regarding the following are best addressed prior to engaging in merger discussions.

- Board composition and control
 - The acquiring bank should have a pre-determined view of willingness to allow an acquired bank to gain some or even a majority control
- Management appointments
 - The acquiring bank’s board should have a pre-determined view of willingness to give the acquired bank’s management key leadership positions in the merged bank, including the role of CEO
- Engagement in merger talks/merger analysis
 - Boards should determine clear roles for talks with potential board or management of a potential acquisition

Legal Advice

Legal advice is warranted prior to any contact with another bank. Ground rules should be clearly established as to what is appropriate and inappropriate for discussion. Some mid-tier banks devote dedicated staff to merger analysis; this approach offers several benefits:

- Dedicated staff generally possess deep merger expertise
- Dedicated staff reduce the potential that members of the management team are so busy engaging in merger analysis and talks that the bank risks business interruption
- Dedicated staff make it easier from a cost accounting perspective to determine how much bank overhead is spent related to merger activities

Due Diligence Team

Selection of the team and team leader:

- Often this function is played by a small team devoted to merger analysis and execution
- When this is not the case, the leader of the due diligence team should be an executive with deep knowledge of all aspects of banking together with a select small number of executives and subject-matter experts who bring knowledge and experience needed to examine the acquired bank in the most efficient and effective manner possible
- A principal responsibility of the team leader is to be able to sift through all issues and identify those that are material to a “buy decision” and deal structure.
- Likely at this stage, several outside experts (investment banking, legal, accounting, cyber) will be brought onto the team

Merger Integration Team

Selection of the team and team leader:

- The team leader:
 - Should be a respected, high potential executive
 - Should bring a strong understanding of the acquiring bank’s culture
- The rest of the team should be comprised of the acquiring bank’s top talent, who bring both deep subject matter expertise and an air of diplomacy needed to introduce the acquiring bank’s culture into the merged bank
- Integration team members should be identified prior to integration activities so that there is no delay once integration kicks off
- Outside consultants may be needed to fill gaps on the integration team

Ideal team members have expertise in:

- Team leading
- Project management
- Finance
- Human resources
 - Executive compensation
 - Payroll
 - Employee satisfaction/complaint management
- Lending
 - As appropriate: CRE, C&I, C&D, home lending, consumer, card, farm/ag, third party originations
- Securities/trading/balance sheet
- IT/systems/cyber
- MIS/data/information security
- Deposits
- Compliance
 - BSA/AML/OFAC/CRA
 - Privacy

- Risk management
 - Credit, markets, securities, interest rates, pricing
 - Operational, compliance
 - Enterprise
 - Systems/IT/cybersecurity
- Business development/salesforce management
- Online banking/digital services
- Marketing/customer communications
- Branch management

The “What”

The Desired Characteristics of an Acquisition

- Aligned to Strategy
 - A great bank views acquisitions as an extension of the bank’s strategy and commitment to create shareholder value. Therefore, there is a clear understanding by the board as to the general attributes of a desired acquisition
- Targeted
 - Boards avoid going down the rabbit trail of merger negotiations by clearly stating during the pre-deal phase the desired attributes of a potential acquisition
 - Desired attributes should align to strategy
 - If a desired bank acquisition is not aligned to the acquiring bank’s current strategy, the board should have a clear understanding of what elements of strategy will not be compromised
- Right-Sized
 - A risk that often gets too little attention, especially when the acquiring bank is buying a bank that is relatively large to the acquirer, is synergy risk
 - The risk organization should elevate synergy risk to a top concern during transition
 - This means heightened attention to the protection of existing and prospective customer/client relationships in both the acquiring and acquired bank
 - Accurate and timely identification, mitigation, monitoring, and reporting of revenue at risk is a hallmark of a successful transition and ultimately the merger itself

Hostile Takeovers

In a word, AVOID. If in doubt, study the failure of Royal Bank of Scotland (RBS)—the largest bank failure in history, which came on the heels of its reckless 2007-08 hostile takeover of Dutch bank ABN AMRO. (The British government in 2011 issued a 452-page analysis of the failure of RBS.)

Hostile takeovers rarely occur in banking for one good reason: due diligence limitations. Although the banking industry likely benefits from having the most available public data of virtually any industry, a due diligence based only on publicly available data is virtually never adequate for determining the risk-return profile of a targeted acquisition. The principal problem with limited due diligence is the inability of the acquirer to thoroughly assess loan and securities portfolios. Consequently, hostile takeovers run the risk of the acquiring bank failing to assess future cash flows properly and accurately and after accounting for mark-to-market adjustments.

Opportunistic Acquisitions

The mere fact a bank has put itself up for sale should not be reason in and of itself for a potential acquiring bank to engage in preliminary discussions. The exception to that rule may occur when a potential seller is experiencing short difficulty and the price of a potential acquisition is temporarily skewed favorably to the acquirer.

To be clear, the mere fact a bank can be acquired cheap is the last reason to do an acquisition. Absent unique knowledge about a potential troubled acquisition, acquiring banks should assume they always get what they pay for. It is not unreasonable to assume a bank's troubles are worse than the acquiring bank can determine, even after engaging in the most effective due diligence.

History shows that many of the best acquisitions occurred at challenging times during the business cycle. Twice in the past four decades, the FDIC has had to auction banks and Savings & Loans (S&Ls). FDIC auctions provide healthy acquirers an ability to expand their geographic footprint or eliminate a competitor with overlapping branch distribution. They also provide an acquirer the opportunity to gain new distribution without incurring credit risk. The big trade-off that comes with opportunistic acquisitions during a time of financial turmoil is that the merger process has the potential to distract management from day-to-day operations or the opportunity to build new and deeper relationships with customers and clients whose banks are impacted by financial turmoil.

Regulatory Relations: Update/Risks

Regulators measure and track a bank's quantity of strategic risk and are ultimately the judges and jury of whether the merger is approved. Regulatory risks should be discussed early and often. Several mergers in recent years have been delayed for 30+ months after a bank announced an acquisition. The most common reasons for delay include BSA/AML tracking related to regulatory concerns about the timeliness and accuracy of data. Other reasons for regulatory delay include bank failure to resolve MRAs in a timely manner and CRA deficiencies.

Acquiring banks can be delayed in efforts to merge if the CRA program has material deficiencies. Be proactive in addressing CRA issues before engaging in merger activities, and identify and communicate with key individuals and community groups who are most likely to submit public comments when invited by bank regulators.

The lead director, CEO, and CRO are well-advised to determine which of these three key roles will be responsible for advising the lead bank supervisor of the bank's strategy and appetite for mergers and other opportunities. Discussions should address:

- A broad overview of strategic goals including acquisition parameters, financial targets, and payback expectations
- Planning processes

As merger negotiations proceed, discussions should touch on key areas of concern that regulators have for bank mergers:

- Capital adequacy
- Due diligence plans
- Risk tolerance and controls for risk of business disruption and systems failures
- Risk tolerance and controls for failures in execution, delivery, and process management
- Potential impact to reputation
- Regulatory compliance

If available, review MRAs/MRIAs.

The “Where”

In-market

In-market mergers appear to create less risk to the acquiring bank than out-of-market and can be less disruptive as management is more alert to local customer/client needs and competitor behavior.

Management’s deep knowledge of a local market is a big plus for determining risk-return of timing and amount of expense cuts. In addition, expense cuts can be effected with more surgical precision given the intimate knowledge of local market.

Out-of-market

Management knowledge of out-of-market acquisitions is rarely as deep and intimate as in-market. There is a risk that:

- Expense cuts are not performed surgically but with a meat axe
- Management knowledge of the local market is a learning curve that takes time

Competitors often exploit the acquirers lack of local knowledge by aggressively courting the acquirees most profitable customer/client relationships. Competitors in the home markets of the acquirer are likely to step up aggressive marketing to the acquirers most profitable relationships while the acquirers management attention is devoted to the merger.

The “When”

Business Cycle

There are good and bad times to enter merger discussions. Bank boards should have a view of the health of the economy prior to engaging in merger discussions. History proves that banks that acquire other banks are largely successful in meeting long-term shareholder objectives if the merger occurs when GDP for the national and local economies is growing by at least 2%. When the economy is growing 3%+, the margin for error in an acquisition is relatively low.

- Since 1972 there have been over 21,000 bank mergers in the U.S.
- Of that total, 3,700 were “assisted” mergers, meaning the transaction occurred with the FDIC acting as broker of a failed bank
- Of the remaining more than 18,000 bank mergers, the vast majority have occurred during times of a healthy economy

When the economy is in decline or in a recession, bank profitability historically declines; for a quarter in 2008, after accounting for an increase in provision, bank profitability fell slightly negative. Acquisitions at this point in the cycle can be successful if deals are structured with deep discounts and a clear understanding of contingent liabilities.

During a recession, as was seen in 1988-1992 and 2009-2011, acquiring banks can often engage with the FDIC to acquire banks at deep discount and with certain protections against asset deterioration. Some of the most investor-friendly mergers have occurred during this time in the cycle:

- NationsBank-First Republic (TX, 1988)
- JPMorgan Chase-Washington Mutual (2008)
- Wells Fargo-Wachovia (2008)

The worst mergers in history took place when the banking industry was on the cusp of the financial panic of 2008-2011:

- Royal Bank of Scotland-ABN ARMO (Summer 2007)
- Bank of America-Countrywide (January 2008)

Strong Economy/Weakening Economy/Recession

Bank boards should not only have a clear view of national economic health, but local economies as well. Banks with a concentrated geographic risk profile are highly vulnerable.

- Banks in Texas in the 1980s, the state of Washington in 2000-2006, and the Atlanta MSA in 2000- 2007 grew commercial real estate lending at a velocity that ultimately proved so fast that it set up those markets for a massive correction
- Bank boards must be alert to the potential that the local market banking conditions are “too good to be true”, i.e., growth in lending far outpaces local and national GDP
- History has shown that markets that grow more than two times GDP eventually suffer a correction (reversion to the mean growth of the market over time)

The “How”

Goal: Effective, Efficient Planning and Execution of Due Diligence and Transition

Due Diligence Discipline

- Define the universe of material risks most critical to the board
 - Focus on high priorities, materiality
 - Determine deal-breakers versus risks that allow flexibility
 - Understand expectations for organic growth

Due Diligence Preparation

- Have an acquisition team in place and prepared to move quickly
- Develop and maintain comprehensive checklists to ensure appropriate review of pertinent attributes of a target bank
- Have pro forma P&L and balance sheet models built in concert with finance/CFO
- Seek to be efficient and effective in both the due diligence and integration phases
 - Prepare and distribute requirements for due diligence to the bank prior to sending a due diligence team in
 - The acquiring bank due diligence team should ask for specific information and determine specific subject matter experts in case acquired banks will need to be interviewed during the due diligence process; meetings with personnel from the potential acquisition should be limited to only the most critical information given the highly confidential nature of a bank merger, and this is especially true with publicly traded banks.
 - Commit to a fixed number of days of on-site due diligence

How Much to Pay, How to Pay

Perhaps no factor is more important to the return on a merger investment than the determination of how much to pay for the acquisition. History shows that the cost of mergers above a certain price-to-book value threshold often requires the acquirer to commit to aggressive cuts in operating expenses that too often prove counterproductive. For example:

- Having paid 4.5 times the book value for a large mid-tier out-of-market regional bank, the acquirer committed to a plan to achieve a 45% reduction of operating expenses of the acquired bank. The result was a disastrous transition in which customer/client satisfaction plummeted and the eventual loss of significant revenue as customers/clients were wooed to competitor banks
- Having paid three times the book value for an in-market mid-tier competitor, a bank committed to an aggressive time schedule for realizing cost savings. The aggressive schedule for expense cuts backfired as customer/client dissatisfaction with the transition led to the loss of profitable relationships

(Determining to pay in cash or stock or a combination is a complex decision requiring significant analysis— and outside the scope of this playbook.)

Transition

Define a formal set of processes led by a transition team leader who will ensure the execution of the merger occurs on time, on budget, and achieves operational excellence. Flawless execution of the transition requires the bank to have a comprehensive checklist of activities like the one presented in the ProSight M&A Playbook. During transition three risks usually stand out for risk organizations as well as other organizations across the bank:

- Expense reductions
 - Organizations across the bank including the risk group are expected to meet expense cut goals without impairing effectiveness and efficiency
- Maintaining operational excellence
 - Flawless execution of systems, HR, etc. transitions
 - Employee communications
 - › Employee concerns about job stability can be disruptive to the banks
 - › Timely and candid feedback
 - › Employee retention agreements executed early in the transition process to ensure key talent retained
 - › Culture building
 - Customer communications: accurate and timely
- Protecting reputation, credit quality
 - During the transition, the bank will want to be aware of customer/client concerns and issues

CHAPTER 2

Risk Assessments and Due Diligence

Ten material matters every bank due diligence team needs to consider before acquiring a bank:

1. Credit, Securities, Interest Rates, Market, Pricing
2. Deposits, Liquidity, Pricing, Branches
3. Synergy Failure/Business Disruption Risks
4. Finance/Accounting Policy
5. Model Risk Management, Including Pro Forma Models for Acquisitions
6. IT, Systems, Data/Information, Cybersecurity
7. Human Resources – Talent Retention, Incentive/ Executive Compensation, HR Policies
8. Enterprise, Strategic Risk
9. Non-Financial Risks
10. Marketing and Communications

Credit, Securities, Interest Rates, Market, Pricing

Material Concern

Loan portfolios in most acquisitions are generally the acquired bank's largest asset, and therefore, credit quality and the potential for losses make or break mergers. Getting loan portfolio valuations right is a prerequisite of a successful merger. The good news is that the banking industry is highly regulated and reports credit performance quarterly through the public FDIC Call Report database.

Action

- Identify and examine the credit relationships that constitute 80% of the bank's CRE, C&I, C&D, and multi-family loan book
 - Determine geographic and product concentrations
 - Understand underwriting policies and procedures, especially:
 - › Cash flow lending policies
 - › Advance rates on collateral

- › Guarantor requirements
 - › Covenant policies
- Determine how policy exceptions are identified, mitigated, monitored, and reported
- Review of regulatory examinations, if possible, should be examined
- Loan loss reserve adequacy and calculations to be reviewed with a CECL lens

Warning

- Look for loan activity that is too good to be true and lending activity that may be growing at a velocity several times faster than local/national GDP. An example of this occurred in 2006 when Wachovia bought Golden West, a super high growth home lender specializing in variable rate mortgages
- Spectacular growth in banking is easy to achieve over the short-term
- This risk exists at the market level (systemic) as well as at an individual bank level (idiosyncratic)
- Be alert to fast growth competitors or markets whose lending risk profile is such that it could compromise local market lending conditions
 - Covenant light lending
 - Absence of personal guarantees
 - High loan advance rates on real estate and other collateral
 - Pricing that does not appropriately balance risk and return
- Determine if the bank engages third parties to originate loans
- Be alert to shared credits not originated by the bank
- Be alert to emerging fintech lenders who originate loans on a bank's behalf
 - Understand controls and reporting that are in place to ensure credit quality objectives are met when third parties originate
- Determine if they have fast growth competitors or markets whose lending risk profile is such that it could compromise local market lending conditions
 - Covenant light lending
 - Absence of personal guarantees
 - High loan advance rates on real estate and other collateral
 - Pricing that does not appropriately balance risk and return

People, Processes, Controls, Systems

- Examine the bank's credit review function policies, processes, and procedures
- Assess policy exception reporting
- If appropriate, review meeting minutes of the Loan/Risk Committee
- Examine systems used for:
 - Credit decision-making
 - Collateral tracking
 - Credit performance tracking, including past dues
 - OREO discovery/review

Deposits, Liquidity, Pricing, Branches

Material Concern

Core deposit intangible (CDI) values result from the acquiring bank calculating a fair market value of the deposits based on an analysis of the acquired bank's DDA (interest-bearing and non-interest bearing), savings accounts, and money market accounts (see Warning below). CDI accounting can be arcane and requires the expertise of the bank's CFO and outside audit firm to verify.

Action

- Review deposit base to determine 20 to 50 top depositors
- Review acquired bank's deposit pricing strategy and be prepared to calculate pro forma cost of funds based on changes in assumptions for retention and interest rates paid
- Note: Branch closures are often associated with bank mergers

Warning

- See Synergy/Business Disruption Risks below
- Branch closures will jeopardize deposits
 - Analyze deposits by branch and determine retention strategy
 - Be alert to risk of losing top 25 depositors per branch; develop retention plan by branch
- Depositors: Be prepared to analyze depositor retention for DDA, MMA, Savings, and CDs
 - Assume "hot money" (brokered CD) is rate-driven
 - Analyze retention strategies of key DDA depositors, especially major commercial accounts where a lending relationship may be key to deposit retention

People, Processes, Controls, Systems

- CDI requires engagement of CFO and outside auditor
- Identify senior person in acquired bank who is responsible for deposit pricing and strategy
- If available, review deposit pricing policies and processes

Synergy Failure/Business Disruption Risks

Material Concerns

History indicates that bank mergers, especially ones where the acquired bank is relatively large in relationship to the acquirer (e.g., 50% of its asset size), often entail a significant disruption to the servicing of clients and customers. The result is customer/client retention challenges that impact both the acquired bank and the acquiring bank. Too often, acquirers are so focused on the acquired bank and associated cost cut commitments and operational excellence that they risk not paying adequate attention to their own existing high-value customers/clients. Competitors exploit this risk by doubling efforts to win business of banks involved in mergers.

Warning

Frequent and comprehensive review of revenue trends for both the acquired and acquiring banks should be conducted to monitor the potential for a “slow leak” that can sometimes go undetected until damage has been inflicted to the income statement and balance sheet.

- Early in the merger process, ideally before a deal is struck, synergy risk should be debated and, when possible, quantified
- Tools for synergy risk should be developed to identify, mitigate, monitor and report
- Clear goals should be established at the front end of the merger process and rigorously tracked

A second form of synergy risk occurs when a bank fails to effectively adopt best practices and new business activities into the acquired or acquiring bank.

- Acquisitions are made to benefit from the business relationships and unique business skills and knowledge of personnel in the acquired bank
- Employee retention risk of key talent is sometimes not well understood, as senior bankers in the acquiring bank tend to focus their attention on their peers running the acquired bank rather than rank- and-file customer/client facing employees whose departure threatens the successful introduction of critical new business practices and activities into the acquired bank

People, Processes, Controls, Systems

- People
 - The risk organization should assign a leader to the transition team with the expressed responsibility of working with customer-facing management and the finance organization to monitor synergy/business disruption risks
 - The CEO and management teams should address the subject of synergy/revenue with the same frequency and intensity as expense cuts
- Processes/Systems/Controls
 - Financial models for the merger should provide both high-level and detailed line of business reporting of synergy/business disruption objectives
 - › Goals should be in place for all customer/client facing organizations
 - › Risk organization should play a challenge function to ensure processes for risk identification, mitigation, monitoring, and reporting are timely and accurate
 - Reporting should be robust around customer/client and employee satisfaction/retention
 - Controls should be in place that provide early warning indicators that identify synergy/business disruption risks

Finance/Accounting Policy

Material Concerns

- Banks engaged in mergers treat an acquired bank as an investment and, therefore, the assets acquired are marked at fair value
- Purchase acquisition accounting requires the bank’s CFO and outside audit firm to comply with U.S. generally accepted accounting principles (GAAP) and Financial Accounting Standards Board (FASB) Accounting Standards Certification (ASC)

- Marking asset and deposit values is part art and part science
- Impact on valuations
- Credit/securities portfolios
- Owned real estate
- Core Deposits
- Mark-to-market adjustments can materially impact traditional valuation metrics such as price-to- tangible book value
- Loan loss reserve valuations require assessment reflecting the newly implemented accounting CECL

Warning

Determining marks/credit portfolio valuations can be arcane and subject to debate; factors to consider when determining the absolute credit mark include:

- Timing and amount of expected loan cash flows
- Identified loss ranges
- Liquidity discount for loans to be sold

CECL is a work-in-process which lacks uniform guidance among banks and accountants for determining Loan and Lease Loss Reserve. The potential for material impact to loan loss reserve and capital must be examined and debated. The Financial Accounting Standards Board as well as the OCC provide guidance for calculating the value of “core” deposits acquired during a merger.

- Core Deposit Intangibles (CDI) are realized when the acquiring bank assigns a value to core deposits
- In today’s low interest rate environment, CDI is on the rise
- Since CDI is an intangible asset, acquiring banks must determine a method of amortization
- OCC and FASB guidance for accounting for CDI should be reviewed and definitively determined before an acquirer makes a formal offer

People, Processes, Controls, Systems

- People
 - CFO, Accounting Policy Executive, Audit firm
- Processes, Systems, Controls
 - Review acquired bank’s accounting policies, accounting systems
 - Review internal and external audit findings
 - Review, if appropriate, regulatory exams

Model Risk Management, Includes Pro Forma Models for Acquisitions

Material Concerns

The model for determining price to pay for an acquisition is critical to meeting the board's target for shareholder value creation.

Pro forma model for the merged bank:

- Experienced third-party advisors will play a critical role in the development of the pro forma for the merged bank. However, the CEO is fully accountable for the accuracy of the model
- A capable pro forma model should spell out key risks with associated probabilities
- The board should understand both idiosyncratic and systemic risks as well as have a full view of contingent liabilities
 - Identify critical models used by bank
 - Evaluate findings to identify material risks
 - If appropriate, request review of verification and validation activities of second and third line

Warning

A lesson learned from the Great Panic of 2008-2011 was that models, especially those based on statistical probabilities such as the commonly used VaR (Value at Risk), proved inadequate in their ability to consider outlier ("Black Swan") events. Be prepared to challenge all models, especially arcane ones, that tend to dazzle with fancy statistics. Sound judgment and common sense must be applied to the interpretation and debate of all models; no merger decision should ever be made based on models alone.

People, Processes, Controls, Systems

- Determine ownership of models
- Review RCSAs
- Determine rigor of processes to construct and debate models
- Determine systems requirements of models
- Review policies and procedures for models and, if appropriate, examine process maps
- Review regulatory examinations if appropriate

IT, Systems, Data/Information, Cybersecurity

Material Concerns

- Determine whether acquirer is doing a systems conversion or a true integration. Systems conversions tend to be a quick way to get an acquiring bank into the conversion, but conversions rarely bring material expense savings outside the renegotiation of third-party contracts. In contrast, a true integration can sometimes allow for a new systems architecture that brings two-fold benefits:
 - Meaningful expense savings
 - Reduces the risk of an acquiring bank being hamstrung by legacy systems

- Cybersecurity is of paramount concern. It requires the engagement of critical information security and data protection experts.
- Examine first, second, and third line risk assessments and regulatory examinations
 - Document material gaps or lapses that could threaten the timing of gaining merger approval
 - Determine potential, if any, material regulatory fines for non-compliance
- Examine policies, monitoring schedules, training, and complaint-management practices
 - Include internal as well as third-party systems for review

Warning

Systems conversions is a quicker solution than a true integration of banks. However, a systems-only conversion can create two risks.

- The first is that customers of the merged banks can be inconvenienced when they discover that the systems of the two banks do not “talk” to each other, and therefore, full service is not available across the newly merged banks.
- The second risk is that banks defer a full integration of systems because of financial constraints. However, history shows that bank regulators can force the full integration of the banks when weaknesses in AML/BSA or financial reporting are detected.

Cybersecurity policies, procedures, process maps, and incident tracking records provide a plethora of insight into the safety and soundness of the acquired bank’s IT systems.

People, Processes, Controls, Systems

- People
 - CIO
- Processes, Controls, and Systems
 - Review audit findings
 - Review regulatory examinations
 - Review RCSAs

Human Resources – Talent Retention, Incentive/ Executive Compensation, HR Policies

Material Concerns

- Employee retention is nearly always the highest priority of an acquirer in a bank merger
- Conduct a “culture” assessment to determine “fit” of the acquired company
- Determine the aggregate cost of all contractual obligations associated with change of control, incentive compensation, golden parachutes, and other personnel-related costs accelerated at time of merger
- Change of control often is a significant financial burden on acquirers
- Determine if the acquired bank’s management team has a balanced performance scorecard that appropriately motivates management to achieve profit, revenue, and expense targets while also protecting the bank’s reputation, credit quality, and long-term vitality

- Determine flexibility to modify incentive compensation models after the merger
- If appropriate, examine employee and customer complaint records
- If appropriate, request a review of the verification and validation activities of the second and third line, being especially alert to risks associated with sales practices
- Conflicts of interest should be identified and assessed as to whether they are material to a merger transaction

Warning:

- Cultural issues should be monitored and considered in the negotiation of new contracts with key executives. Develop a plan for retaining employees whose services are needed over the short-term but are not needed long-term:
 - These employees can often bring great value in preserving the culture and influencing others
 - This is especially true for employees who will be part of any transition effort
- Most mergers, especially in-market mergers, often are justified economically before planned reductions in the workforce
 - Once a deal is announced, the top employees of the acquired bank immediately begin fielding calls from prospective employers
 - Retention measures and contracts for key employees need to be contemplated before any merger is announced
 - Acquiring banks should be prepared on day one to begin retention efforts of key talent
- If the management team does not have a balanced scorecard:
 - Be alert to over-emphasis on revenue production at the risk of protecting the bank from short-term thinking
 - Be alert to inadequate controls around unintended consequences
- Change of control compensation can be a material cost to any acquisition. Calculate the cost of honoring contractual obligations and executive compensation issues in the event of control.
 - “Golden parachutes”
 - Contractual terms restricting acquiring bank from modifying the compensation of the executive(s) of the acquired bank
 - Be alert especially to Section 409A of the Internal Revenue Code which is triggered when compensation plans are modified
 - Calculate the cost of honoring incentive compensation models in the event the acquiring bank intends to impose new incentive compensation models after the merger
 - Determine the risk of key employee retention if incentive compensation models are changed after merger
 - If the bank lacks a rigorous system for tracking customer and employee complaints, be alert to data accuracy concerns
 - Many banks rely heavily on third-party consultants to design, and in some cases, manage incentive programs; be alert to risk of an inappropriate engagement of a third-party consultant prior to any public announcement of a merger
 - Document all conflicts of interest

People, Processes, Controls, Systems

- Processes and Controls
 - Assess the rigor of processes in place protecting the bank from adverse sales practices
 - Determine processes for identifying, monitoring, mitigating, and reporting customer and employee complaints
 - Examine applicable policies and procedures
 - Review RCSAs
- Systems
 - Assess the systems used for tracking incentive compensation
 - -Assess the systems used to track employee and customer complaints

Enterprise, Strategic Risk

Material Concerns

- Determine top 3 to 5 enterprise risks as identified through acquired bank's processes
- Request review of verification and validation activities of second and third line for the determination of the enterprise's top risks
- Determine if the top 3 to 5 enterprise risks are effectively mitigated, monitored, and reported

Warning

Be prepared to challenge the determination of the top 3 to 5 enterprise risks in discussions with the CRO, head of audit, and board chair of the risk committee. Do not be contentious: The purpose of the challenge is to assess the rigor of the debate and processes used to identify the top risks.

People, Processes, Controls, Systems

- People
 - Review risk management organization chart to determine who is responsible in the second line for the enterprise risk assessment
 - If enterprise risk is in role, determine skill and whether person is key talent needed after merger
- Processes, Controls, Systems
 - Determine reporting processes
 - Determine process flow to board for debate
 - Assess acquired bank's processes for identifying, mitigating, monitoring, and reporting emerging risk

Non-Financial Risks

Third-Party Management/Supply Chain

Material concerns

- Understand material contractual obligations
- Determine the cost to break third-party contracts
- While the traditional view of third-party management normally excludes landlords of leased property, during merger discussions the acquiring bank should identify material lease obligations
 - Conditions and terms of early termination should be understood
 - Potential penalties for early termination and buydowns need to be documented
- If appropriate, request review of verification and validation activities of second and third line
- Review regulatory examinations

Warnings

- Exiting contracts with systems providers can have a material impact on transactions costs
- It is not enough to rely on the acquired bank's assessment of material contracts
- Critical contracts must be examined by acquirer
- Regulators examine most critical third-party suppliers to the banking industry
 - Be alert to potential compliance issues, notably BSA/AML/OFAC
 - Be alert to MRAs

People, Processes, Controls, Systems

- People
 - Determine key personnel responsible for managing critical third parties to ensure seamless transition to target state
 - Determine if dedicated supply chain management team is in place
- Processes and Controls
 - Engage supply chain management and risk management, if appropriate, to determine the acquired bank's processes for verifying third-party performance
 - Assess RCSA data related to third parties
 - Examine policies and procedures, and, where appropriate, process maps, including process maps of key third-party suppliers
 - If appropriate, review audit findings validating third-party management
- Systems
 - Determine systems on which third-party contracts are managed
 - Develop library of all third-party systems if one does not exist

Operational Risk – Dodd-Frank Act Stress Testing (DFAST)

Material Concerns

- Determine key findings
- Assess rigor of DFAST processes
- Discuss with potential acquisition bank's risk executive and possibly the chairman of the board risk committee key findings to get a qualitative sense of data accuracy and rigor
- Give acquiring bank the opportunity to evaluate risk management and governance talent needed after the merger
- Pending legal actions, including those with and without reserves, should be reviewed and, if appropriate, sized by qualified legal counsel for potential materiality to a potential merger transaction
- If appropriate, request review of verification and validation activities of second and third line

Warnings

- Be alert to possibility that DFAST is strong on process but weak on common sense and judgment
- Determine quality of debate associated with the discussion of DFAST findings with bank management as well as the board

People, Processes, Controls, Systems

- Determine ownership and accountability for processes and output
- Determine controls in place to ensure rigorous debate
- Examine DFAST policies, procedures, and process maps

Risk and Control Self-Assessment

Material Concerns

- Identify the top 5 inherent risks in the bank
- Be alert that the quality of RCSAs varies tremendously among banks; determine strengths and weaknesses of current processes
- Identify potential material risks that may not be captured in the RCSA
- If appropriate, request review of verification and validation activities of second and third line

Warning

- If RCSAs exist, assess the rigor of the processes to develop the RCSA
- If appropriate, engage the acquiring bank's Risk Management Board Committee in a discussion of material risks identified in the RCSA
- Ask what risks are missing from the RCSA

People, Processes, Controls, Systems

- Processes, Controls
 - Assess reasonableness of determination to identify inherent risk
 - Assess reasonableness of determination to identify and quantify residual risk
 - Examine, if appropriate, policies, procedures, and process maps
- Systems
 - Determination systems used to track and report RCSA
 - If appropriate, determine cost of system and potential exit fees

Business Change Risk Assessment

Material Concerns

- Be alert to the risk that the acquired bank deferred maintenance of critical systems/real estate
- Be alert to the risk that the acquired bank failed to merge and integrate systems of banks it has acquired in the past
- Determine if deferred maintenance is a potential material cost to a merger
- Identify critical change currently underway; determine cost if change is stopped or interrupted temporarily

Warning

Some banks with low overhead ratios and low efficiency ratios have achieved their superior ratings by deferring expenses. Too often, deferred systems, especially if the acquiring bank does not plan to immediately integrate the acquired bank into its systems, present two challenges:

- Dated systems that do not adequately address AML/BSA concerns
- Esoteric systems that operate on old code (like COBOL) that can be managed by only a small number of existing staff, thus creating a key talent risk

People, Processes, Controls, Systems

- People
 - Determine organizational structure for managing business change
 - Determine if business change is managed centrally or distributed
 - Determine if business change is managed by dedicated individuals/teams
 - Identify key change talent for managing a merger transition if appropriate
- Processes, Controls, Systems
 - Review bank policies and procedures for change management
 - Review, if appropriate, risk management and audit verification and validation of business change

Loss Event Capture

Material Concerns

- Examine the acquired bank's loss event history—credit and non-credit—for the past 10 years
- If the data is not available, inquire to understand why
- Be sure to examine non-credit loss events that may not have been booked as a loss but have the potential as a result of litigation
- If appropriate, request review of verification and validation activities of second and third line

Warning

Remember: Banks that exist today exist largely because they have not suffered major loss events in the past. Consequently, these banks, especially mid-tier banks, may not have a wide view of the types of losses banks have experienced over the past three decades. It is especially important to be alert to the potential for large non-credit losses.

People, Processes, Controls, Systems

- Processes and Systems
 - Determine ownership of loss event data
 - Determine rigor, and if possible, accuracy of the processes and data used to construct and track loss events
 - Examine loss event process maps, policies, and procedures
 - Determine systems requirements for loss event data capture and tracking

Compliance/Reputation

Material Concerns

- CRA, BSA/ALM
- CTR/SAR
- OFAC
- Fraud monitoring and reporting
- Reputation risk tracking and reporting
- Complaint tracking, reporting, mitigation

Warning

CRA and BSA/ALM are potential deal-stoppers.

People, Processes, Controls, Systems

- People
 - Chief Compliance Officer
 - Determine accountability for reputation risk
 - Engage Finance to confirm status of any fines or financial penalties

- Processes, Controls, Systems
 - Review compliance and reputation policies and procedures
 - Review audit findings
 - Identify gaps, responsiveness
 - Review regulatory examinations
 - Identify MRA/MRIAs if applicable
 - Review RCSAs
 - Assess reputation and complaint tracking systems

Marketing and Communications

Material Concerns

The chief concern is the possible presence of long-term marketing financial commitments.

Warning

Some marketing initiatives, e.g., naming rights sponsorships, involve 10 to 20 years of financial commitments. Determine contractual obligations of marketing initiatives and, if appropriate, determine buy-out.

People, Processes, Controls, Systems

- People
 - Chief Marketing Officer
- Processes, Controls, Systems
 - Review marketing contracts, budgets

CHAPTER 3

Merger Checklists

This Playbook provides risk managers with tools and steps to ensure process excellence when analyzing and executing a bank merger. Yet process excellence is only part of the reason mergers succeed. Ultimately a merger transaction requires both process excellence and the exercise of sound judgment.

And it is sound judgment based on a deep knowledge of the art and science of banking that defines the successful risk manager in banking.

Pre-Deal Objectives and Organization

Pre-Deal What

At this stage of the merger process the bank should limit analysis of targeted merger partners to a small team of people who comb publicly available data to identify potential merger candidates. Because banking is so highly regulated, a plethora of data as well as public analysis is available on most banks. It is possible at this stage of the merger process to conduct preliminary due diligence without contact with a target acquisition.

Pre-Deal Who

Confidentiality is paramount throughout the merger process. Banks should limit all merger activities to the smallest team possible of corporate insiders and trusted advisors (investment banker, M&A legal expert, M&A financial accounting expert). Depending on the frequency of a bank's merger activity, banks of all sizes are well-served to designate one, two, or three bankers that serve as a permanent "M&A Team." The team leader is responsible for engagement with the CEO, CFO, and trusted advisors. Individuals selected to lead the M&A Team are often viewed as high-potential employees with a deep background across multiple areas of the bank. This person must be highly respected and able to develop strong and trusted relationships with counterparts at the other bank in the possible transaction. The M&A Team leader most likely will report to the bank CEO or possibly the bank's CFO. The CEO is responsible for engaging the board on merger matters.

Due Diligence Activities

Due Diligence What

Due diligence begins once the boards of two banks agree to enter an in-depth analysis of a merger. This decision leads to a series of activities that allow each bank to identify material risks. Both banks should have a detailed set of due diligence checklists like the ones identified in this Playbook to guide the bank through the process. Analysis should lead to an identification of critical questions, key gaps, and factors that influence price and deal structure.

Due Diligence Who

A small, dedicated team is required for due diligence. At this stage of the merger process some of the due diligence occurs at the site of the potential merger partner. For confidentiality reasons, especially when the banks involved in a merger are publicly traded, all parties engaged in the due diligence process must sign confidentiality agreements as well practice discretion when on-site conducting due diligence. Because some aspects of a potential merger transaction will require the due diligence team to bring in subject matter experts for specific analysis (e.g., evaluating duration risk or assessing cybersecurity controls), it is critical that the need for confidentiality is reinforced at every turn.

1. Engage in the data request log process
 - All documents requested from the acquired bank are logged and attached to the request. This cuts down on duplication and ensures transparency of the information shared from the acquired bank.
2. ORM/ERM - Review risk management programs to ensure the programs at the acquired entity are adequate and/or deficiencies are known and within risk tolerance. Programs to review include:
 - Third-party management
 - Model risk management
 - Loss event capture
 - Operational risk – DFAST
 - Incentive compensation risk assessment
 - Risk and control self-assessment
 - Business change risk assessment
 - Enterprise risk assessment
3. Credit - Review loan and credit related documentation to assess and identify impact to risk appetite and policies, and sectorial, customer, and geography exposure limits.
4. IT – Review BSA surveillance, CTR / SAR filings, enhanced due diligence, fraud monitoring, and OFAC monitoring and reporting.
5. Conduct gap analysis calls with the potential acquisition
 - Document gaps, decisions, and target state.
 - Assess bank's current state to existing project portfolio and determine how to onboard the bank into existing state of change.

Tools/Documents

1. Corporate documents – Corporate structure by entity
2. Ownership – Current shareholder list
3. Copy of company's strategic plan
4. Human resource organization
 - Org chart
 - Employment contracts
 - List of employees with compensation information
 - Summary of benefits
 - Severance plans

- 5. Historical financial information**
 - LTM income and expense trial balances
 - Branch profitability
 - Cost center and profit center reports
- 6. Projected financial information**
 - Projected detailed income statement and balance sheets for next three years
 - Projected loan and deposit growth
 - Profitability, asset quality, market share, and fee income goals
- 7. Accounting, audit, and tax**
 - Deferred tax asset schedule
 - Schedule of NOLs and tax credits
 - External audit reports
- 8. Loan portfolio and credit quality**
 - Current composition and target composition
 - Most recent loan tape and previous three quarters
 - Copies of third-party loan reviews or stress testing analysis
- 9. Deposits**
 - Current and target deposit compositions
 - Review of current and historical trends in deposits
- 10. ALCO, investments & borrowings**
 - Last two years ALCO reports
 - Investment portfolio (in Excel)
 - Most recent portfolio accounting and investments reports
 - Current valuation for financial instruments
- 11. Facilities**
 - Summary schedule of current premises utilized (size, rent, leased, owned, etc.)
- 12. Contracts**
 - Core system/data processing contracts and termination provision
 - Description of IT infrastructure and major support systems
- 13. Key Information on mortgage banking, including org structure, list of locations, production statistics, and balance sheet / income statement for last three years**

Pre-Planning

Planning for Modeling What

The investment banker will have models for pricing and structuring a merger transaction although some banks engaged in serial merger transactions will often prefer to use their own models. The purpose of the model is to capture salient financial factors that influence pricing and deal structure. It is critical to the efficiency and effectiveness of the due diligence process that the due diligence manager balance the need for a comprehensive understanding of the potential merger partner while at the same time strive to zero in on material matters that truly determine the recommendation to buy or not buy.

Planning for Modeling Who

Critical players for developing the financial models for the merger are the bank's CFO, the due diligence manager, a due diligence project manager (could be the investment banker), and trusted advisors, most notably the investment banker and key accounting advisor.

Objectives

1. Create MS Project or Excel schedule
 - Outline high level tasks and deliverables
 - Understand inter-dependent work across departments
2. Prepare existing bank risk management programs for the merger by reviewing the following:
 - Third parties with services that will continue to be provided post conversion
 - Bank models are satisfactory for incorporating merged entity data, and determine if model validation activities are required for configuration changes
 - Regulatory and audit findings from merged entity are sufficiently remediated with ongoing application of bank risk management programs
 - Determine business change risk assessment applicability for new products and services unique to the merged entity that will continue post-merger
 - Enterprise risk appetite statements are reviewed and updated

Key Activities

Planning On-site Due Diligence What

To ensure an efficient, effective, and confidential due diligence process, each bank should designate a due diligence manager who coordinates due diligence communications and requests. All information must be treated with the strictest of confidentiality. Merger "books" should be numbered and assigned on a need-to-know basis where the recipient acknowledges in writing the obligation to not disclose any information except solely as advised in writing by the due diligence manager. The safest way for banks to protect confidential information of the potential merger partner is to require that review of such material only take place on the partner's premises. In rare cases a bank may be so concerned about confidentiality that the partner may require that reviews of certain information can take place only when a bank employee is in the room.

RCSAs and audit reports should be a high priority review for the due diligence team. Both provide two key sources of insight. First, they provide areas of focus that may reveal a deal-breaker. Second, they allow the due diligence team to assess the quality of risk identification and controls, both matters critical to a successful risk assessment.

Planning On-site Due Diligence Who

Once a bank has assembled a complete due diligence checklist, designated subject matter experts should be identified by the due diligence manager to take part in the due diligence. Given confidentiality, all members of the due diligence team should be advised of their “insider” status and understand the strict prohibitions against trading bank stock or disclosing insider information to anyone other than as expressly directed by the due diligence manager. (In fact, it is best to not allow insiders to trade the stocks of any bank during this “quiet” time of due diligence.)

1. Coordinator Structure

- Vendor – Participate in vendor days – Artifact “System Survivor Spreadsheet”
- Communication – Inventory communication needs (legal requirements vs. client experience)
- QA – Document all test plans for each line of business
- Training – Inventory training needs and develop a comprehensive training plan across the project
- Logistics (Bank in a Box) – Shipment of supplies to all the acquired locations

2. Specific ORM and ERM program documentation is reviewed to determine adequacy of risk management functions and impact to existing bank programs. Program documentation includes but is not limited to:

- Enterprise risk management
- Third-party risk management
- Model risk management
- Data governance
- Stress testing
- Incentive compensation and related risk assessments
- Operational loss event capture
- Risk and control self-assessments
- Regulatory finding reports regarding risk management functions
- Internal audit reports regarding risk management functions

3. Credit portfolios with scope determined by CCO, credit team, and nuances of specific portfolios. Scope may include (but is not limited to):

- Risk ratings
- Variances in underwriting between banks
- Variances between credit policies
- Non-accrual recommendations
- Charge-off recommendations
- Staff recommendations
- Portfolio metrics

4. Charter collapse decision – recommended to align to conversion implementation. With the charter alignment to conversion, the acquired bank continues to operate normally (CTR / SAR / case management) with oversight from bank FID.

Tools/Documents

Due Diligence What and Who: A word of caution is appropriate here. After the largest bank failure in history occurred, i.e., the failure of RBS, the U.K. bank regulators highly criticized the RBS board for engaging in a hostile takeover that allowed for only minimal due diligence. This lesson should not be lost at any bank. Banks that take lightly due diligence run substantial risk of error.

The purpose of due diligence is to identify matters and factors material to a potential transaction. The due diligence team should have designated subject matter experts responsible for assessing each area and uncovering material matters that inform deal price and structure. Areas of paramount importance are HR, credit, securities, deposits, accounting, audit, legal, facilities, and IT/MIS.

HR issues of chief concern include “golden parachutes” and other contractual obligations, headcount/ payroll, insurance and benefits including pensions and other obligations, and identification of key personnel who are deemed critical to revenue production and oversight of people, processes, and systems. Forecasted headcount cuts and the timing of staff layoffs and associated cost of severance should be documented and viewed as critical inputs into the financial model. The bank’s HR executive should be responsible for assessing cultural fit of an acquisition as well as estimating the impact the merger will have on the acquired bank’s culture.

The accurate assessment of credit and securities risks will make or break a merger transaction. The credit and securities experts on the due diligence team will determine current fair market values which will be used by the CFO and outside audit firm to determine the goodwill/intangibles associated with a potential transaction. During due diligence, the acquiring bank will assess the acquired bank’s loan review findings and processes. A red flag that can be a deal-breaker is evidence of weak and inaccurate credit ratings and inaccurate assessments of loan/lease loss reserves. The recent introduction of CECL should mean that the acquired bank is currently advised as to the proper accounting for reserves, and therefore, questions about reserve adequacy should be deemed a matter of materiality as reported to the due diligence manager. For both securities and credit portfolios, the due diligence team must have a clear line of sight to duration risk, hedges, and off-balance sheet obligations including, but not limited to, bank guarantees/standby L/Cs, and traditional letters of credit.

Since the Financial Panic of 2008, bank core deposits have taken on a heightened benefit and economic value to banks. In recent years, some merger transactions have been driven by a desire to acquire low- cost core deposits. Therefore, it is incumbent on the due diligence team to properly analyze the fair market value of deposits. Again, like with credit, the bank’s CFO and outside auditor will determine the goodwill/intangibles to be assigned based on the bank’s understanding of the economic fair market value of deposits. Related to the deposit analysis will be the need to assess the branch footprint. The branch analysis should consider the risk of deposit run-off associated with branch closures and reductions in staff.

Accounting issues must be identified by designated subject matter experts both inside and outside the bank. The highest priority should be model accuracy, verification, and validation. To achieve an accurate financial model, the due diligence manager must collect all data and findings material to the merger transaction, including determination of the intangibles identified by the internal and outside accountants.

Having a skilled internal auditor on the due diligence team is critical to a successful due diligence. Among the auditor’s chief goals should be an assessment of the quality of the audit reporting and findings of the bank on the other side of the transaction. In addition, the auditor should investigate and review, if possible, regulatory findings, including MRAs and MRAs. Finally, the audit expert on the due diligence team should have a firm handle on the stature of the audit function and the responsiveness of the bank to audit findings.

The member of the due diligence team with legal expertise is responsible for identifying direct and contingent legal risk. This person also provides an informed view of the quantity of legal risk. Outside legal counsel may be engaged to assist the legal expert on the due diligence team in developing a financial determination of legal risk. Since legal risk is often difficult to determine with precision, the legal expert on the due diligence team should be prepared to assess probabilities that allow the board to determine range of outcomes.

IT, management information systems, and cybersecurity require deep subject matter expertise in assessing the risk of a merger candidate. Fortunately for the ease and accuracy of risk assessment, most mid-tier banks in recent years have transitioned these activities to third parties that are today subject to intense scrutiny by U.S. regulators. The best place to start for the IT expert on the due diligence team is a review of all systems and information architecture. This should include, as appropriate, a review of process maps, redundancy and contingency plans, incident reports, audit findings, and RCSAs. For work outsourced to third parties, the due diligence team should request a review of regulatory examinations as well as any reviews conducted by the bank or a consortium on behalf of the bank:

1. Stock purchase agreements or any agreements related to ownership, etc.
2. BOD meeting minutes over last three years
3. Annual shareholder meeting minutes
4. Human resources information
 - Executive officer/management changes (and reasons) over last three years
 - Bios of key officers/employees
 - Copies of incentive plans, retirement, stock option, etc. plans
 - Director retirement policy/agreements
 - Copies of employee handbook and policies/procedures
 - List of independent contractors
5. Financial information
6. Audited quarterly financials for last three years
7. Key P&L metrics by customer/product/channel/geography
8. Contingent liabilities, off-BS liabilities
9. Capital ratio and risk weighted assets calculations
10. List and detail of all fixed assets

Accounting, Audit, and Tax

1. Key accounting policies and overview of financial, accounting, and internal audit staff
2. Correspondence and reports to and from company's public accountants for the last three years
3. Other special tax considerations

Loan Portfolio and Credit Quality

1. Loan originations for last three months
2. Loans outstanding by lender
3. Current and historical yields by loan type
4. Allowances for loan loss reserving practices, amounts
5. Historical and projected net charge-offs, accruals, recoveries, and collections

6. Detailed information on:
 - Loan rating system and total by ratings
 - Concentrations of credit
 - Problem assets, including watch list and problem loans
 - LTVs
 - OREO properties
 - TDRs
 - Collection methods
7. Underwriting policies and recent changes
8. List of loan participations

Deposits – Pricing, Rate Sheets, Maturity Schedules, Fee Schedules

Distribution Channels – Channels and Hours, Online Banking Agreement, Teller Transactions, ATM List

Facilities – Copies of Leases, Renovations, Acquisitions, Tax Values, Property Insurance

IT – IT Hardware Inventory and Maintenance Agreements

Regulatory and Compliance

1. Last 5 years regulatory proceedings or issues, investigation, administrative actions
2. Last 10 years communications with regulatory agencies
3. Documentation of last 10 years compliance with BSA
4. Customer complaint files
5. Suspicious activity & CTRs filed in last three years
6. Risk oversight committee minutes

Legal

1. Summary of litigation, consent decrees, employment or labor issues, environment issues
2. List of loans to or from related parties
3. List of licenses, patents, trademarks, trade names, service marks, permits
4. Intercompany agreements or arrangements
5. Actual and potential conflicts of interest

Insurance – All Coverage and Copies of Policies, Loss Reports

Further Detail on Mortgage Banking & Wealth Management

Mobilization

Objectives

- Engage in project management discipline
 - Communication plan
 - › LD1 (Legal Day 1)
 - › SD1 (System Day 1)
 - Mailing list requests – Attached to a client letter
 - Log risk, issues, decision log (LD1 and SD1)
 - Attend weekly integration meetings
 - Attend sub-project team meetings grouped by line of business
 - Leads (cards, digital, retail, commercial, etc.)
- Communications materials

Key Activities

- ERM / ORM processes begin operating under bank policy targeting Legal Day. Third-party work was aligned with finance processes for onboarding and managing vendor activity and payments
- Credit risk group works closely with credit administration to monitor credit portfolios. The scope of that involvement is determined by the CCO and CRR director and is entirely dependent on the nuances of the portfolio to be reviewed
- Announcement to Legal Day 1
 - Evaluate program governance
 - Risk assessment of transaction monitoring, CDD / EDD and OFAC
 - Looking for policy / process / coverage gaps

