



## **FDIC-Assisted Transactions: Target Sizes Shrink but Opportunities Remain Large**

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It's no surprise that the tally of bank failures continues to mount. As the first quarter of 2011 draws to a close, the total number of bank failures during the current cycle of turmoil in the banking industry has topped 350. According to the Federal Deposit Insurance Corporation ("FDIC"), last year's 157 bank failures was the highest number since 1992.

Last year is predicted by many (including the FDIC itself<sup>1</sup>) to represent the high point in the ongoing wave of bank failures. However, with more than 850 banks remaining on the FDIC's list of problem institutions as of the most recently-published *FDIC Quarterly Banking Profile*, the pace of failures in 2011 is most likely to abate **only slightly** from the peak.

However, while the number of failed banks is expected to remain high, the amount of assets held by failed banks has significantly declined. The size of the banks placed into FDIC receivership has steadily decreased during the current cycle. Total assets of the 157 bank failures during 2010 were \$90 billion, representing a dramatic decrease from the \$169 billion in assets held by the 140 banks that failed during 2009. The fact that bank failures now tend to be smaller institutions is not unexpected, in light of the tremendous difficulty that smaller banks currently face when seeking fresh capital, particularly when attempting to raise capital pursuant to a mandate from regulators.

These trends combine to spell ongoing opportunity for willing and qualified buyers, including for community banks for whom failed bank targets with smaller asset bases are highly attractive and uniquely suitable targets.

In addition, these opportunities are made even more noteworthy by the fact that such smaller targets, with fewer assets and less expansive franchises, in some instances will fail to attract significant bidding interest during the FDIC's pre-failure marketing efforts conducted by its Franchise Marketing organization. The result is likely to be potentially more attractive transaction economics for savvy bidders that recognize the opportunity the assets of smaller failed banks can represent.

### **Successfully Buying the Assets of a Smaller Failed Bank**

Bidders for all failed bank assets face the constraints and limitations necessitated by the FDIC's Franchise Marketing process, including tight timing, rigorous confidentiality obligations and limited opportunities for on-site due diligence (loan reviews). Bidders for smaller failed bank targets can improve their prospects for a successful outcome by utilizing several techniques:

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<sup>1</sup> "... the FDIC has been predicting that 2010 will be the high water mark for bank implosions. 'Going forward, the FDIC looks to see fewer failures,' agency spokesman Greg Hernandez said." The Washington Post, Dec. 28, 2010.

- With a smaller asset base, there is reduced margin for error, so the deepest possible understanding of the credit portfolio is key to success. With a smaller portfolio to review, bidders have an opportunity to extract more value from the limited on-site diligence window. Rather than conducting a spot check of random files or reviewing only the largest credits, bidders should: (a) maximize their on-site diligence window (*i.e.*, request the largest allowable on-site team for the longest window of time), and (b) expand review to as many credit files as possible, focusing on the commercial loans, lines of credit and largest residential loans and HELOCs. The greater a bidding team's knowledge of the credit portfolio, the more bidding power it commands.
- Local bidders always have an inherent advantage, because they know the local community, the competitive dynamics and the real estate market and in some instances may even have knowledge of individual borrowers. Whenever possible, bidders should maximize that advantage by conducting diligence on an open bank basis, as early as possible in the process. By remaining well-informed regarding publicly-available, formal regulatory actions (Consent Orders and Written Agreements) against local competitors, potential bidders can seek out or create open-bank diligence opportunities.
- Unlike bidders that may be interested in (or at least considering) failed bank targets of various sizes in multiple states, community bank bidders for smaller targets often are interested in a single target that represents a carefully-selected, well-understood, and in some cases ideal addition to the bidder's existing franchise. In such instances, skillful bidding is imperative. Hopeful bidders should heighten their chances of success by conducting "moot bidding" exercises. The bidder should conduct on-line diligence and prepare (but not submit) bids for failed bank targets failing prior to the bidder's true strategic target. The results of this exercise will sharpen the skills of the bidder's diligence team, and provide invaluable experience for the team responsible for drafting the bid. By studying the economics of the moot bid against the ultimate winning bid, the team will dramatically improve its likelihood of success for the team's eventual target.
- Smaller asset bases, for which more comprehensive diligence of the credit portfolio is possible, invite strategic consideration of non-loss-share transactions. Although highly disfavored for failed banks with larger asset bases (notably, the overwhelming majority of failed bank deals since 2008 have been structured to include loss sharing with the FDIC), the trend toward ever-decreasing failed bank asset bases makes non-loss-share deals less risky. Even if bidders strongly prefer the protection of loss sharing with the FDIC, the bidding team should at minimum consider the possibility that non-loss-share bids might be submitted by other bidders. The FDIC highly encourages submission of multiple bids. In light of the opportunity to submit bids of different types (*e.g.*, with and without loss share protection), bidders should at least consider the strategic possibilities available.

## Continued Process Changes

Simultaneous with the steady pace of Friday evening failed bank closures, the FDIC continues to refine its process for receiverships, consistent with its goal of minimizing costs to the insurance fund. The result is a process that is dynamic and in an ongoing state of change. Remaining well-informed about the FDIC's process is another key to being a successful buyer in FDIC-assisted transactions. However, bidders for smaller targets are often disadvantaged by not having previous experience with FDIC-assisted transactions, and being unfamiliar with the FDIC's process.

For example, the FDIC recently introduced its latest iteration (Version 3.01) of the Purchase and Assumption Agreement (the "P&A") pursuant to which failed bank assets are purchased. With Version 3.01, the FDIC has eliminated the former "With Loss Share" and "No Loss Share" versions of the P&A. A single version is now used for all Whole Bank transactions, and the exhibits including loss share terms and conditions (Exhibits 4.15A and 4.15B) are attached or excluded, based on the final terms of the transaction. In addition, the latest version is noteworthy for being the FDIC's most extensive "clean-up" of the P&A to date. Experienced bidders know that dozens of the changes to the document are merely cosmetic, making the document more internally consistent. Distinguishing between the cosmetic and substantive revisions can be a challenge for less experienced bidders, including those likely to focus on smaller failed bank targets.

## Conclusion

In conclusion, although failed bank targets are expected to generally be smaller in the year ahead, they will be numerous and represent significant opportunities for well-prepared bidders. Bidders for targets of all sizes can best prepare for success by approaching the bidding process strategically, and taking steps to familiarize themselves as much as possible with the FDIC's process for failed-bank transactions.

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*For more information regarding the fundamentals of acting as bidder in FDIC-assisted transactions, see the author's earlier article in the ABA Banking Law Committee Journal, October 2010.*

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