HOW MERGERS ARE CHANGING BANKING LANDSCAPE

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ABSTRACT

Last year, this author examined the three major financial issues impacting the merger of banking institutions and found that median price to tangible equity, median price to earnings, and premium to core deposits were the monetary drivers. While there is no doubt that the financial drivers are important, it has become apparent from examining the literature, factors such as regulatory overreach, low interest rates, problem banks, management succession, and competition have become equally important. The financial issues and the economic issues have created perfect storm to drive more shareholders to seek shelter through the merger of their bank with another bank.

Key Words: *Banks, Mergers, Regulation, Acquisition*

INTRODUCTION

There has been a spike in bank mergers and acquisitions across the country in the past decade. Larger banks are merging, mid-size banks are buying smaller community banks, and community banks are merging with other community banks. What is causing all of this movement and consolidation? Why are there becoming fewer banking options? What are the benefits to these institutions merging? Some banks were acquired because they were in trouble and some were acquired for this reason and that they added market share and assets to larger stronger banks. Some bank mergers occurred to combined assets so that two smaller banks could merge and increase profitability. Increased regulations have also increased the cost associated with banks remaining compliant in today's highly regulated banking environment. Other banks look at mergers and acquisitions as an opportunity to grow and increase shareholder value. The recent economic downturn and the impact it had on the banks has contributed to making this a prime time for banks to be purchased. Recently in 2014 most of the mergers and acquisitions have involved smaller banks that have struggled. Now with the market improving there is a shift where valuations are increasing and stronger banks will also be seeing movement as well.

LITERATURE REVIEW

The literature to support regulation as a factor was driven basically by Cornett, et al (2006) who noted in their study that regulatory burden had a major impact in promoting merger activity. Banks that had problems or sought relief from the issues facing them, tended to look for a merger partner to take the over as note by Jagtiani (2008). Barth, et al (2012) examined the number and value of bank mergers and acquisitions both domestically and globally. While their main focus was global, they found that there were three main variables in completed transactions—the rule of law in the specific country, the level of discrimination, and bank domestic credit. Winkler, et al (2014) noted that the Dodd-Frank Act had given rise to a 41 percent increase in regulatory burden. Genay and Podjasek (2014) indicated that the perfect

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storm was brought about by lower interest rates coupled with a slow recovering economy. Kowalik, et al (2015) examined the post crisis merger market and noted that acquired banks tend to be smaller, have lower earnings, regulatory issues, and less capital.

The above literature addresses on the single issues, however, there is no literature to date that addresses both the financial and economic issues as joint causal effects of merger motivation. This study will focus on pulling the issues together.

REGULATORY OVERREACH

The costly regulatory environment for financial institutions to remain compliant and keep up with regulatory operational requirements has drastically increased in recent years. Unfortunately, it is expected to increase as the Dodd-Frank Act is fully implemented. This has put .an additional burden on smaller financial institutions. Part of these costs has to do this with back office, paperwork, and monitoring requirements attached to the new regulations. Many banks, large and small, are having to hiring additional employees and enhance technology to remain compliant. "The Act imposed 398 new regulations that have thus far added more than $21.8 billion in costs and 60.7 million paperwork burden hours. These measures have transformed the financial industry, overhauled mortgage lending, and directly affected the availability of credit. With roughly one-quarter of the law still left to implement, it's safe to say that the true economic impacts won't be understood for years." (Winkler, et al, 2014) The increase of cost for this regulation is expected to be around 41%.

While Dodd Frank was implemented to fix abuse and systematic weaknesses in the financial sector, it has had the opposite effect. The burdensome costs have reached beyond the financial sector to consumers and businesses. Due to the increased cost to comply with Dodd Frank, this has driven up fees and loan pricing passed on to the consumer. Part of the reason for increased mergers is with the increase in cost regarding regulations like Dodd Frank, smaller banks are not able to keep the same margins thus sell to stronger banks. This is because under Dodd Frank banks have faced increased cost of compliance, increased cost of raising capital standards, and regulatory uncertainty.

It should also be noted that most of the most expensive regulatory changes have nothing to do with the causes of the economic downturn. Much of the Dodd Frank requirements have to do with paperwork and the cost with the millions of hours of paperwork has not been consistently documented. Due to this, the heavy cost associated with Dodd Frank are often not realized by most people outside the financial industry. Dodd Frank is continually changing from updated revisions. More than 80 percent of banks have reported an increased compliance cost caused by Dodd Frank of 5%. "Increased compliance costs include the need for outside expertise, additional staff, and time spent on additional paperwork. In the survey, many small banks reported the need to trim back or eliminate some products and perks offered to customers, especially with regard to residential mortgages, home equity lines of credit, overdraft protection, and credit cards." (Winkler, et al, 2014).

Expectations are that the new regulations are ultimately going to restrict credit availability due to the risks associated with the uncertainty in these new regulations. This not only affects consumers and small businesses, but also affects the banks' ability to generate income. Dodd-Frank has cost the financial services industry 60.7 million in paperwork burden hours and costing them more than $21 billion. While Dodd-Frank is supposed to limit risk, most of the smaller firms are paying the price with stagnant job growth and being more susceptible to mergers and acquisitions. The financial industry as a whole has struggled since 2010. What is

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interesting is that many of the small financial businesses, small community banks, have struggled since the passage of Dodd-Frank. Yet the larger banks and financial institutions with 1000 or more employees have grown 10.2%. It appears the smaller firms are absorbing and feeling most of the regulatory burden.

Another regulatory change was the implementation of the Consumer Financial Protection Bureau which was started a little over five years ago. This adds additional costs and paperwork hours to the burden placed on banks. The law is becoming increasingly more costly on financial institutions as agencies implement more and more costly rules and regulations. Part of the struggle, especially with the smaller banks is the restriction of products resulting from these new regulations in addition to the increased costs. There is still one quarter of the regulation left to implement so one can only assume the costs and burden will continue to increase. When these regulations where initially passed they were targeting the larger institutions, it is the smaller institutions that are truly being negatively impacted. This has led to smaller banks merging together to increase in size to remain profitable throughout this costly time.

In a study conducted by Peirce, et al (2014) at the Mercatus Center at George Mason University the following data was gathered from a sample of banks surveyed. In regards to increased compliance cost, most of the banks surveyed see Dodd-Frank and more burdensome than the Bank Secrecy Act. Staff typically was increased in small banks from one to two to handle the regulatory aspect. More than a quarter of the banks planned on hiring additional compliance staff in the next year. Smaller banks are planning on cutting products and services due to Dodd- Frank. Mortgage, home equity, and overdraft products are the primary products that are looking to be affected. This also affects revenue. “More than a quarter of respondents anticipate engaging in a merger or acquisition in the near future, which would reduce the number of small banks.. “(2014, Peirce, et al).

Banks are monitored differently depending on their size. Banks under 1B are monitored one way. $1-5B another way, $5-50B differently, and $50B plus all have the unique measures. Sometimes mergers are done not only for economies of scale but to push banks into a different regulatory bracket. Banks also responded notating that regulatory costs rather than helping consumers are negatively impacting customers. Small banks play an important role in serving small communities, small businesses, and borrowers with unique needs and due to these increased regulations are having to merge and be acquired to survive therefore the number of small banks in on the decline.

LOW INTEREST RATES

Financial institutions exist on the spread between what they pay for money and what they can charge for money. As simple as this may sound, it is the driving issue to bank profitability. A good place to begin is with the financial collapse of 2008 and the events leading up to it. Prior to the collapse, both regulations and the free market encouraged as many people to buy homes as possible. A saturated home ownership market and rising interest rates (such as the Federal funds rate hitting 5.25% in 2006) led to a decline in home construction categories. Additionally, the environment forced many subprime borrowers into default as they could not keep up with rising interest rates. As many financial institutions packaged their subprime notes and sold into the secondary market, the defaulting loans had an immediate effect.

In the first quarter of 2007 alone, the world mourned the announcement of the bankruptcy of 25 subprime lenders. Additionally, many investment vessels, such as hedge funds, began announcing major losses as a result of previous investments in the subprime mortgages. By the

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end of the year, countries world-wide were coordinating in a way never before seen in an attempt to stave off the impending financial tragedy. The Fed responded in the way they knew best; dropping the Federal funds rate. By 2008, the rate was dropped down to 1%, 4.25% lower than just 2 years earlier.

Banks found it very difficult to make a profit with interest rates so low. This was compounded by the decline of the stock market leaving the public with the only safe place to put their deposits was the banking system. Banks taking the deposits, for the most part had no place to loan their money since the economy had substantially dried up the lending market. The deposits had to be backed by additional capital. Banks suddenly did not need these excess deposits. Without lending sources and low rates, many banks sought a merger partner to bail them out of their problems.

PROBLEM BANKS

Motley and Harahan (2009) in light of the 2008 Financial Crisis evaluated the largest 50 of the 73 de novo banks chartered in 2008 and examined their results after one year of operation. The results were impactful with only three of the banks reporting a profit while in the remaining 47 de novo banks of the 50 total, one bank reported a negative return of 23.33 percent, two others had a negative 9 plus percent return, and most of the remainder on average reported a negative 4.00 percent return. A negative return of average assets over a several year period would erode the capital which would seriously impact a bank's ability to continue to be solvent. The opposite was true of banks in the pre-crisis era resulting in the 50 largest de novo banks in a study prepared by Mazur and Cope (2007) wherein they reported that 20 of the 50 largest de novo banks chartered in 2005 were profitable after one year in 2006. Only one de novo bank reported a negative return on average assets of over 4.00 percent. From these examples, it is obvious that the financial condition was a major factor in post crisis charter de novo banks.

As a result of the crisis, Glasser (2009) noted in an article that the Federal Deposit Insurance Corporation issued a letter to all de novo banks that extended special reporting and examinations from five years to seven years. It was noted that the extension means banks will continue to be subjected to higher capital requirements, supervised lending limits, and more frequent examinations. The issue behind this extension was more than 80 banks failures in 2009 with approximately 20 percent in operation less than 7 years. Regulators believe this extended time close supervision will tend to help reduce de novo bank failures.

Approximately 800 de novo banks opened since 2002, and Terris (2011) found that some 9 percent have failed. He said, "Banks that were established from 2005 through 2007, just before the onset of the deep depression, had slower ramp-ups to profitability than the de novos of previous years. But failures have been more frequent among banks launched from 2002 to 2004. Nearly 17 percent of the banks established in 2003 have failed…." (Page 14). According to Genay, et al (2014) "…the severe recession triggered by the financial crisis and the subsequent slow recovery have led to lower expected real returns from investments." While it is known that low interest rates and flat yield curves can negatively impact banks' profits, what really causes these to impact banks is when they are combined with declining economic conditions. Low interest rates for the long term can have a positive effect on the economy which can drastically increase a banks profit so this ties into what occurred in the past years. The banks that could weather the storm did and now that the economy is improving are going to be in a position to thrive and prosper. This will also make them prime for being purchased as well if they wanted to sell.

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MANAGEMENT SUCCESSION

Few organizations, including banking institutions have a firm plan of management succession. Many will note that they do not want to have the staff to know who will succeed the chief executive officer or one of the other "C" level officers. When the time comes due to death, resignation, retirement, or other reasons, most organizations have to rethink whether they have a qualified replacement or whether or not it might be advisable to put the bank on the merger market. Leadership to guide the organization is a very critical issue, as evidenced by seeing banks that lose a leader and cannot seem to keep the bank on course with replacement management.

COMPETITION

Bank expansion has long been a significant cause of bank mergers. Just because a bank has a branch in a large metro market does not mean that it has completed all market expansion in that area. In large cities, it may take many branches to effectively compete for the banking business and further, in order to service the entire market area.

When a bank decides they want to service a new part of the same service area, they must decide many of the same things as if they were moving to a completely new city. In short, they can merge with an existing competitor in the target market, or they can start up a new branch and grow the market share organically. If a bank is looking to quickly make an impact on market share, quickly increase net income, and quickly have a new branch fund its own expenses through the loan portfolio of that target location, then often times the best course of action would be to merge with an existing competitor.

In a similar vein, many banks may consider mergers in order to grow into a completely new market area. A well-capitalized bank that has a strong management team may decide after much research, that the shareholders and directors believe it would be in the bank's best interest to expand into a new market. At this point, assuming they do not mind paying a premium, their most likely course of action would be to merge with an existing bank group that has branches in all or most of the target market areas in the state.

Another common reason for Merger activity is to protect a bank's existing market share. For example, a large community bank might enjoy its significant market share in its operating area for a number of years. If some new bank moved into the area and started poaching good customers, the larger, more established bank might consider merging with that bank as a way to prohibit any further loss of market share. However, if the larger bank did not feel the newer bank was a threat, then it might wait and see if that bank can compete. However, this could prove a costly mistake if the larger bank makes any miscalculation. Therefore, banks that act to protect their market share must be very diligent in their research and background information of the target bank.

Still another traditional reason for a bank merger is to correct some banking ratios that may have moved outside of their target ranges. For example, assume that some critical ratios such as its loan-to-deposit ratio, liquidity ratio, net interest margin ratio, or other ratios are out of line.

The bank begins to make a number of internal changes with the aim of dropping the ratio down to the acceptable range. However, these changes will take quite some time to work through the system and the bank executives search for a faster alternative. At this point, the large community bank would attempt to merge with a bank that would balance the ratios, and combine

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the new bank's high liquidity with the older, more mature bank's deposit portfolio. If all goes as intended, the result will be a nice return for the shareholders of the acquired bank, a new location or two for the acquiring bank, and a much needed injection of deposits into the framework of the existing larger bank.

Another potential reason for a merger is for income or cost diversification. Jagtiani (2008) summarized the crux of diversification. "…through diversifying mergers, the combined banks would benefit from reduced earnings volatility and default probability. The opposite of this idea is the focusing hypothesis, which predicts that mergers between similar banking firms would create more value by allowing the merging firms to concentrate in the narrow area in which they both do best" (Page 35). In other words, while an example of the focusing hypothesis would be for a niche bank to buy a similar niche bank, diversification hypothesis allows very different banks to merge as a way to increase confidence and decrease risk associated with total income. Merging two difference income streams could be likened to why a stock portfolio has multiple stocks, not just one single asset. By diversifying the income streams, shareholders and executives can feel confident that their bank does not live or die based off of one income stream.

The final noted reason for bank mergers is simply take advantages of efficiencies and inefficiencies of separate banks. Generally, the purchasing bank is more efficient across the board, and is looking to purchase an inefficient bank that it can "fix". For example, perhaps a purchasing bank has an extremely efficient loan operations department that has capacity to handle more loan volume. Their target might be an inefficient bank that has good loan production with good asset quality, but high loan operational overhead expenses. By merging with the inefficient bank, the purchasing bank can absorb the existing income while cutting a significant portion of the costs.

Since Jagtiani's article is slightly dated (being published in 2008), a reasonable person might question if his findings, and perhaps all of the listed traditional reasons for mergers, are still applicable to modern times. Kowalik,et al (2015) published an article just this year addressing many of the key traditional reasons for mergers. In short, yes; all of the listed traditional reasons for mergers are still as relevant as ever.

Their conclusions, based on the four years from 2011 to 2014, seem to match exactly what has been seen historically. Kowalik,et al (2015) noted "… the mergers of community banks over the past four years and finds they are consistent with the goals of achieving greater economies of scale and improving efficiencies. Acquired banks tend to be smaller and have a lower return on assets, lower net interest income, and higher non-interest expenses than non-acquired banks. Acquired banks may be less profitable because they tend to have lower loan and higher cash and deposit shares. In addition, the condition of acquired banks tends to be worse than their industry peers in terms of capital, supervisory examination ratings, and problem loans and assets. Among the characteristics that differentiate acquired banks, statistical analysis suggests profitability and efficiency are the most important factors"

CONCLUSION

The current banking environment is unlike anything the industry has seen before. The costly regulatory environment for financial institutions to remain compliant and keep up with regulatory operational requirements has drastically increased in recent years. Unfortunately, it is expected to increase as the Dodd-Frank Act is fully implemented. This has put .an additional burden on smaller financial institutions. Part of these costs has to do this with back office, paperwork, and monitoring requirements attached to the new regulations. Many banks, large and

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small, are having to hiring additional employees and enhance technology to remain compliant. “The Act imposed 398 new regulations that have thus far added more than $21.8 billion in costs and 60.7 million paperwork burden hours.

Low interest rates impact bank spreads and is the driving issue to bank profitability. A saturated home ownership market and rising interest rates (such as the Federal funds rate hitting 5.25% in 2006) led to a decline in home construction categories. In the first quarter of 2007 alone, the bankruptcy of 25 subprime lenders shocked the nation’s financial system. Additionally, many investment firms, such as hedge funds, began announcing major losses as a result of previous investments in the subprime mortgages. By the end of the year, countries world-wide were coordinating in a way never before seen in an attempt to stave off the impending financial tragedy. The Fed responded in the way they knew best; dropping the Federal funds rate. By 2008, the rate was dropped down to 1%, 4.25% lower than just 2 years earlier. Banks found it difficult to operate profitably at these low rates.

Loans started going bad as the Crisis of 2008 brought about many foreclosures, business closures, and personal bankruptcies. As a result, many banks had reserves that became depleted with all of the loan losses. Banks that had problems were forced to recapitalize, sell, or be closed by the regulatory authorities. Merger, if possible, was probably the best solution.

When the time comes due to death, resignation, retirement, or other reasons, most organizations have to rethink whether they have a qualified replacement or whether or not it might be advisable to put the bank on the merger market. Leadership to guide the organization is a very critical issue, as evidenced by seeing banks that lose a leader and cannot seem to keep the bank on course with replacement management. Again, many banks choose merger with a well-run organization as the best option.

Intense competition exists in the financial arena; therefore it is critical that a bank has all of the tools that it needs to be able to effectively compete. Competition may be the cause for banks to consider mergers in order to grow into a completely new market area. A well-capitalized bank that has a strong management team may decide after much research, that the shareholders and directors believe it would be in the bank’s best interest to expand into a new market. Conversely, a bank that is under-capitalized and limited in its ability to compete may choose to merge with a strong bank.

Mergers will continue to be a major concern for the banking industry as it deals with regulatory burden, problem banks, management succession, low interest rates, and competition. Both financial and economic issues will drive merger activity in the future.

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