To Merge or Not: Governance and Navigating Uncharted Territories

By Evan Tomaskovic

It's a challenging environment right now, especially for community banks. The rising costs associated with implementing new regulations and compliance requirements are making it increasingly difficult to continue to operate under the "business as usual" mindset. However, when it comes to change, those in charge of governing the bank, including management and the board of directors, are often hesitant to explore a potential sale, acquisition or restructuring event.

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As pillars of the community, overseers of local banks would generally prefer to keep their locally, independently operated organizations intact as is, yet they are up against the harsh reality of the rising costs associated with running the institution in an economy that's recovering at a snail's pace.

Once this economic realization hits home, the decision to sell usually rises to the top as the only viable option to maximize value. But even when this path of action is decided, roadblocks stand in the way.

First and foremost, the market hasn't fully overcome the issues that plagued banking institutions during the financial crisis, causing it to be a less-than-ideal time for banks to put out the for-sale sign. While results have stabilized, the recovery has been slow and may take years to be fully recognized. Because balance sheets still remain undercapitalized, TruPs remain impaired in some cases, and excess spread income is suboptimal due to asset shrinkage for many banks.

Furthermore, capital structure issues add a layer of complexity to potential M&A activity. Many boards of directors at community banks nationwide must contend with TruPS and TARP obligations that stubbornly remain on their balance sheets. Even in cases where the bank is operating well and attractive as a potential acquisition candidate, without addressing the TRuPS and TARP issues, these institutions are often conventionally "unsellable."

Before making any move, the board should work closely with management to explore all potential alternatives prior to seeking a buyer.

Unsure of what items to place on the agenda for that meeting? Whatever you do, make sure to address the following questions.

- **Can the bank raise capital?** Depending on the profitability of the bank and composition of the balance sheet, sources of capital include private equity funds, as well as high net worth investors within the community that may have a personal interest in ensuring that the bank remains in its current state (though both sources are limited in terms of how much of a bank's equity they can own).

- **Should we acquire to build scale and help mitigate rising costs?** Rather than relying on organic growth to improve the bank's condition, which is a tough, long process, especially for community banks that are dependent on customers that reside within a relatively limited region, a defensive acquisition or merger of another entity might be a smart way to bolster the balance sheet.

- **The economy is gaining steam, so should we just wait it out?** Banks that are maintaining growth rates and considered to be in good shape might have the option of sticking it out until the market fully recovers. If enough capital is available and management is able to cover costs, eventually conditions will improve. In the best-case scenario, the bank might even be able to beat the market to the finish line.

From a community banking organization's board of directors' point of view, these ideas may have already been vetted and it's been decided that the best next step is to move forward in attracting a buyer. This approach is clearly a popular one. According to research firm SNL Financial, in 2013 there were 204 bank mergers in which the target bank had under $1 billion in assets.

However, as the interest rate environment continues to put pressure on banks and regulatory costs are rapidly rising, executives and board members are having trouble closing the deal. Although the numbers reveal a high level of activity, the process of attracting a potential buyer can be taxing.

Beyond the obvious task of dealing with any TruPS and TARP obligations from the balance sheet, what can the board do in the near-term to improve the bank's chances of becoming a saleable asset?

- The number one priority when considering a deal is to take an in-depth look at the balance sheet. Work through the books to ensure that they're as clean as possible and your organization is perceived to be an attractive asset. Let's face it, nobody wants to purchase a store filled with tattered, stained clothing.

- Another issue to consider? Who are your potential buyers? Often community banks and their management teams have tunnel vision when it comes to seeking suitors. The first region to explore, your own backyard, might not always be the best. As a rule, it's important to always remind yourself -- you never know where the buyer might come from.

As a board member or bank manager, you may not be savvy with regard to the M&A space, especially when it comes time to canvas a broad swath of the market. Find an expert advisor who knows the M&A arena inside and out. This individual should have connections to a wide range of influential players in the banking sector and the ability to expose your asset to a vast number of potential buyers. If the only people aware of your plans to sell are those in the local and regional community, chances are you're going to miss out on maximizing value. The more buyers you're in front of, the better chance you have to work out a lucrative deal.

Based on my experience working with management and boards of directors of community banks, they truly are a cut above in terms of keeping the bank and its customers' best interests in mind throughout the decision-making process. However, when faced with a situation where everything is on the line, it's important to not get lost out there trying to structure a deal. Keep your compass in plain sight at all times.

At the end of the day, fiduciary responsibility needs to be top priority and taking care of the bank's existing customers' deposits has to remain of utmost importance in the minds of the bank's executives.

In conclusion, the economic environment and banking industry have drastically changed over a relatively short period of time, forcing boards to face new challenges and make decisions that they may have never thought possible. The approach to corporate governance of community banks is rapidly changing, but the principles stay the same – above all, do what is best for your stakeholders, customers and your community.

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