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BANKING & FINANCE

Dodd-Frank brings expansion opportunities — and obstacles

Increased compliance costs, succession planning, management fatigue, higher capital requirements and fear of lost opportunities.

All are likely drivers of a bank merger wave to come.


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Regardless of the motives, the regulatory landscape for mergers has changed since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act and — despite Dodd-Frank — merger activity is expected to be high.

NEW OBSTACLES

Banks should expect to face higher pro forma capital requirements and greater attention to Community Reinvestment Act compliance. And they will continue to encounter regulatory pressure on loan concentrations and classified asset ratios.

The Collins Amendment to Dodd-Frank establishes a floor on bank capital and a bias toward common equity capital.

The result will be that banks should expect to have to satisfy higher capital requirements than before for an approvable merger transaction.

Adding to the capital challenge is Dodd-Frank's change to the definition of "accredited investor" — that is, the net worth of an individual will no longer include the value of the investor's primary residence. Thus, banks contemplating a merger should review current capital to determine whether a capital raise will be needed to accomplish an acquisition.

Many recent transactions have been challenged on Community Reinvestment Act grounds. In fact, most of the approval orders issued by the Board of Governors of the Federal Reserve System in 2010 and 2011 reflect comments on institutions' fair lending records. Given Dodd-Frank's heavy emphasis on consumer protection, that trend is likely to continue.

Bankers should expect pro forma loan concentrations and classified assets to be a continuing concern of regulators in the application process. Those anticipating a merger transaction should consider whether an action plan should be developed to address loan concentrations or classified assets to be ready for merger.

NEW OPPORTUNITIES

Effective July 21, out-of-state banks will have the ability to "de novo" branch across state lines — a departure from prior law, which required an acquisition of a bank over five years of age, a failure transaction or branching reciprocity between states.

While the ability to branch will most likely benefit banks in neighboring states that may have the best ability to grow organically in state, other out-of-state banks will have a quick entry and expansion opportunity without the initial expense of acquiring a whole bank.

> "Regardless of the reasons for a transaction, the next few years promise to be an interesting and challenging time for merger participants."

The new branching authority will likely eliminate the value of the "strip-charter," a by-product of some transactions, which was an entry vehicle for out-of-state holding companies desiring to enter a state. Strip charters — the sale of a naked bank charter stripped of its assets — may have value in limited circumstances.

Increased capital requirements will create greater buying opportunities for banks with strong balance sheets.

Here are five common tasks for buyers and sellers:

• Identify goals. To execute a plan, there needs to be one. While this is a simple concept, it is important for the regulators to be able to understand how the transaction fits into the bank's business plan. A transaction that is greatly outside a bank's current plan will require additional communication with regulators.

• Put a team together. Whether a bank is a buyer or seller, it needs a team to spearhead the effort. A team will give direction and be accountable to the effort and will permit management to continue the day-to-day operations of the bank without too much distraction. Outside members of the team should include the bank's accountants and outside counsel at appropriate times. Inside counsel, if any, should be on the team from the beginning.

• Communicate with the board. The board of directors needs to be kept up to date and fully informed on merger planning. Good communication will enable the bank to react quickly to opportunities that may arise. And, having an informed board may expedite the required board approval.

• Put the house in order. Whether the bank is a buyer or seller, existing regulatory criticisms need to be addressed promptly so that they do not bog down or completely derail the approval process.

• Set expectations to the new normal. Buyers and sellers should expect transactions to take longer because of more intense due diligence and longer approval periods. Regulators will take special care in considering acquisitions. Capital will be key, as higher capital requirements may make acquisitions susceptible to required contemporaneous capital raises.

Regardless of the reasons for a transaction, the next few years promise to be an interesting and challenging time for merger participants. The time to prepare is now.

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