Bank Notes

May/June 2010

A timely information and idea statement

Key Considerations Related to the Valuation of Net Assets Obtained in a FDIC-Facilitated Transaction

Many banks have been seizing the opportunity to be active with FDIC-facilitated transactions. These strategic transactions generally involve the acquisition of certain assets and liabilities through a purchase and assumption arrangement. In addition, the FDIC generally provides a guarantee on certain assets pursuant to a loss-sharing arrangement (LSA), acting like an insurance plan for the acquiring institution. Many of these transactions have resulted in an accounting gain (bargain purchase gain) for the winning bidders.

Accounting Standards Codification (ASC) Topic 805, Business Combinations, (previously FAS 141R), requires that all acquired assets and liabilities are recorded at fair value. Determining the fair value of the loans and deposits acquired, the related indemnification asset if there is a LSA and a core deposit intangible includes various complexities and challenges that are not common with normal bank mergers and acquisitions. The proper use of current market interest rates and credit related factors have a significant impact on the value of the loans, the indemnification asset, the potential bargain purchase gain and regulatory capital. The following provides an overview of some key considerations when valuing net assets obtained in a FDIC-facilitated transaction.

Complications in dealing with a failed institution

There are many inherent challenges that are involved with participating in an FDIC-facilitated transaction. Compared to most bank mergers and acquisitions, these transactions occur at a very rapid pace with limited time and information available for due diligence. Accordingly, due diligence continues subsequent to the closing on a FDIC-facilitated transaction. The results of pre-diligence and post-diligence efforts need to be properly integrated into the fair value modeling of net assets acquired.

Loan concerns

Because it is a failed institution, many loans are not in good shape. When determining fair value in healthy times, loans may receive a minor fair value adjustment, but with failed institutions, even performing loans are typically worth materially less than their book value. Moreover, non-performing loans are usually worth substantially less than their book value. A discounted cash flow method is typically used to determine the fair value of the loans and key assumptions include expected default and prepayment rates, and remaining term, as well as interest rate and market discount rates. For non-accrual loans, typically the fair value of the collateral and related expenses are also taken into account. As noted above, it is important to ensure that the fair values properly integrate the results of due diligence efforts, especially as it relates to expected credit loss, including probability of default and expected loss, given default, by loan type and quality.

The LSA between the FDIC and the acquiring institution is accounted for as an indemnification asset pursuant to ASC Topic 805. There is a correlation between the fair value of the loans and the LSA, as the expected credit loss assumed in valuing the loans, as well as the timing of the loss, is taken in account in determining the fair value of this indemnification asset.

Core deposit intangible

As with any valuation, the value of intangible assets must be determined. Assets such as the trade name are not as valuable with a distressed institution, but the core deposit intangible (CDI) is typically the key intangible asset. The CDI represents the value of the core deposit customer relationships.

CDI values are significantly lower than they were a few years ago due to the current interest rate market. With a failed institution, the premium is usually even lower due to higher expected attrition. A discounted cash flow method is also typically used to value a CDI, which reflects the cost savings the core deposits provide to the bank. Key assumptions include expected initial account run-off, annual attrition rate, current market interest rates, non-interest income, operating expenses attributable to core deposits and the alternative cost of borrowing, such as FHLB advance rates or brokered CD rates. In determining expected attrition rates, historical performance is considered, as well as the impact if it is

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Significant Accounting and Regulatory Implications to Accounting for Loan Participation Sales, Including SBA Loans

FASB Accounting Standards Codification (ASC) Topic 860 (formerly FAS 140 and FAS 166) has modified the accounting for transfers and servicing of financial assets. While this amended guidance has a meaningful impact on companies that have "qualifying special-purpose entities," it also created the concept of a "participating interest" which has a significant impact on how community banks account for loan participations and sales of the guaranteed portion of SBA loans. This amended guidance becomes effective for transfers of participating interests on or after Jan. 1, 2010 for calendar year companies.

Definition of a participating interest

A participating interest requires 1) proportionate ownership interest in an entire financial asset; 2) all cash flows (excluding fees for servicing or other services that are arms length) to be divided among participants in proportion to share of ownership; 3) that rights of each participating interest holder have the same priority (i.e. there can be no recourse and no participating interest holder is subordinated to another); and 4) that no party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to do so.

Loan participation issue

If a transfer of a portion of a financial asset does not meet the definition of a participating interest, the transaction must be accounted for as a secured borrowing. As such, "last-in, first-out" (LIFO) and "first-in, first-out" (FIFO) structured participations do not meet the definition of a participating interest and must be accounted and reported for as secured borrowings. For example, a FIFO participation generally pays principal cash flows to the lead lender first. All banks are encouraged to review their participation agreements to determine if they conform to the new definition of a participating interest.

It should be noted that loan participations transferred prior to the effective date of this guidance (Jan. 1, 2010) are not affected. However, 2010 advances under line of credit agreements (even if entered into prior to Jan. 1, 2010) will be impacted if they do not meet the definition of participating interest.

SBA loan sale accounting issue

The participating interest definition also applies to transfers of government-guaranteed portions of loans, for example, those guaranteed by the Small Business Administration (SBA).

A financial institution may originate a loan on which it obtains a SBA guarantee. The SBA will guarantee up to 90 percent of the loan. After origination, the institution may sell (transfer) the guaranteed portion of the SBA loan on the secondary market. At the date the guaranteed portion of the SBA loan is sold, the institution certifies that: (a) the institution has no knowledge of default by the borrower or likelihood of default; (b) the institution has paid the SBA the guaranty fee; (c) the loan is properly closed and fully disbursed; and (d) the institution acknowledges that it has no authority to unilaterally repurchase the guaranteed interest. The guaranteed portion of the loan is generally sold for a premium or at par.

Under the standard SBA loan sale agreement (SBA Form 1086), there is a 90-day warranty period during which the institution would be required to refund any premium received. For example, if the borrower prepays the loan for any reason within 90 days, the institution must refund any premium received. Also, if the borrower fails to make the first three monthly payments due after the sale (transfer) date and the borrower enters uncured default within 275 calendar days, the institution must refund any premium received.

Among the many changes made by this amendment guidance, one change in particular impacts the ability of the institution to recognize the transfer of a receivable until after the 90-day warranty period has expired. That change specifically requires that the portion transferred qualify as a participating interest. The related guidance states, "In certain transfers, recourse is provided to the transferee that requires the transferor to reimburse any premium paid by the transferee if the underlying financial asset is prepaid within a defined time frame of the transfer date. Such recourse would preclude the transferred portion from meeting the definition of a participating interest. However, once the recourse provision expires, the transferred portion shall be reevaluated to determine if it meets the participating interest definition."

As such, financial institutions will not be able to recognize gain on sales of the guaranteed portion of SBA loans when those loans are sold at a premium since the recourse precludes the transferred portion from meeting the definition of a participating interest. The transaction should be accounted for as a secured borrowing. After the expiration of the warranty period, the transfer should be re-evaluated to determine whether the conditions in ASC 860 have been met in order to achieve sale accounting treatment. The guaranteed portion of the loan (i.e. the portion sold) could be derecognized and the gain on sale could be recognized at that point.

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Points to Consider When Converting From an S Corporation to a C Corporation

Have regulators imposed restrictions such as limitations on distributions that make Subchapter S status less beneficial for your shareholders? Do you have potential new investors who are non-qualified Subchapter S shareholders? If so, you may be evaluating the voluntary termination of your S corporation election. In doing so, it is important to consider and plan for the tax consequences. Similarly, if you foresee an involuntary termination on the horizon, significant value can be generated for your shareholders through tax planning before the termination. Furthermore, a voluntary revocation that is incomplete or late can result in undesired tax consequences.

S status can be terminated in three ways:

- Voluntary revocation
- Automatic termination if eligibility rules not met
- Automatic termination if the corporation has passive investment income in excess of 25% of gross receipts for three consecutive years (generally does not apply to banks)

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assumed that interest rates will be reset. CDs are not typically included as core deposits for purposes of calculating the CDI due to their rate sensitivity.

Deposits

The institution's deposits themselves must be also valued, specifically the time deposits. Typically the book value represents the fair value of the demand deposits given a bank's ability to change the interest rates. Under the current rate market, the fair value of time deposits is typically higher than their book value, implying a premium. In an FDIC-facilitated transaction, the assuming bank may have the ability to reset the interest rate on certificates of deposits, negating some of the premium.

There are always many factors to consider when valuing the net assets in a bank merger or acquisition. However, when acquiring the net assets of a failed institution, there are often more complications and less time to manage them. Having a thorough knowledge of common issues at the outset of your transaction could eliminate difficulties and allow your purchase accounting efforts to progress more smoothly.

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In addition, there are transactions whereby the SBA loan is transferred at par and the seller agrees to pass interest to the purchaser at less than the contractual interest rate. The resulting spread is generally viewed as an interest-only strip. An interest-only strip results in a disproportionate sharing of cash flows on the entire SBA loan meaning the transaction must be accounted for as a secured borrowing.

The SBA recently solicited views from the public on the impact this amended accounting guidance is having on the SBA 7(a) program in an effort to consider potential revisions to the program that may minimize any adverse impact on the program. The deadline for providing comments to the SBA was April 19, 2010.

For more information regarding the above, including certain call reporting considerations, banks should review Financial Institution Letter (FIL-11-2010).

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