FEDERAL RESERVE SYSTEM

MERGERS AND ACQUISITIONS ACTIVITIES

PRELIMINARY BANK HOLDING COMPANY INSPECTION GUIDELINES AND PROCEDURES

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FEDERAL RESERVE SYSTEM

MERGERS AND ACQUISITIONS SECTION OF BHC SUPERVISION MANUAL

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1 - INTRODUCTION

Bank holding company mergers and acquisitions occur for strategic as well as financial reasons including expansion of product lines, geographic diversification, expansion of existing market share, diversification of earnings streams, and increasing shareholder value. Whatever the reason, there are significant risks associated with the mergers and acquisitions process. The management and directorate of acquiring companies should be aware of the risks inherent in the process as well as in each merger transaction. The inability to appropriately identify and quantify risks associated with a particular target could significantly affect the financial and operational capabilities of an acquiring company.

The mergers and acquisitions process can be divided into six major areas as follows:

1. Strategic plan and/or philosophy
2. Candidate selection
3. Pricing and negotiation
4. Due diligence review
5. Transition and integration
6. Post-merger performance monitoring

Examiners should be aware that mergers and acquisitions methods and procedures (formal and informal) will vary and that the primary focus should be to evaluate an organization's ability to identify, measure, and control risks inherent in the mergers and acquisitions process. The process for completing mergers and acquisitions will vary by company and by the type, structure, and strategic philosophy of each transaction. Many companies view acquisitions as an ongoing line of business, while others will consider acquisitions infrequently. No two acquisitions will be exactly the same. There will be variations in strategic objectives relative to the particular acquisition; methodologies relating to candidate identification; factors applied in valuing a targeted company; the ability to perform full or limited due diligence prior to signing a definitive purchase agreement; and the method of integrating the acquired company. In order to fully understand the mergers and acquisitions process of a particular bank holding company, examiners will need to meet with appropriate senior management to discuss the process and procedures (formal and informal) and will need to evaluate specific acquisitions which have been completed by the corporation.

2 - STRATEGIC PLANNING/PHILOSOPHY

A key to evaluating mergers and acquisitions activities is understanding the role of mergers and acquisitions in achieving corporate strategic objectives. These strategic objectives, formal or informal, should be clearly communicated to the personnel responsible for mergers and acquisitions activities. Mergers and acquisitions strategies may change over time as corporate philosophies, the industry, regulatory restrictions, and competitive issues change. Mergers and acquisitions considerations relative to corporate objectives can include, but are not limited to:

- Enhancement of shareholder value.
- Willingness of the corporation to take on problematic companies or enter into hostile takeovers.
- The target's financial performance.
- Compatibility of the target (e.g., culture, products).
- The effect of the acquired company on the consolidated organization (i.e., operations).
- Supervision and management control of the acquired companies (centralized or decentralized).
- Geographic, legal, and/or regulatory constraints.
- Acquisition size constraints (dollar limitations and minimums on desired market share).
- The ability to enter new markets or provide new products/services.
- The ability or the need to provide senior management to acquired companies.
- The ability to finance the transaction.

Once a company's acquisition plans or philosophies have been identified, they should be communicated to the personnel responsible for mergers and acquisitions and incorporated into the various aspects of the mergers and acquisitions process. A clear understanding of corporate objectives by all personnel involved in the mergers and acquisitions process is essential to identify appropriate candidates. Additionally, as strategies change relative to the organization's operating environment, continued communication is critical to the overall process.

3 - CANDIDATE SELECTION

Identification of merger candidates is generally fostered through relationships by senior management officials of the acquiring company with their counterparts at the target company. These relationships may be cultivated over a short period of time or years of communicating with the target company. In many cases, acquiring companies will not only use senior management at the parent company but will also utilize second-tier bank and bank holding company affiliate officers to identify candidates. In those cases, clear communication of corporate objectives to secondary personnel is necessary. At times, target companies will approach a company and express an interest in being acquired, while in other cases a financial institution will make a strategic decision to be acquired and will open itself to a bidding process. Other sources of candidates include governmental agencies, investment bankers, and consultants.

Candidate identification can be a formal or informal process. Bank holding company mergers and acquisitions personnel may prepare detailed financial analyses and pricing models on targets utilizing public information (e.g., SEC reports, annual and quarterly reports, regulatory reports). The focus of the modeling exercise is to estimate the cost to acquire a targeted company and the effect of that cost on the consolidated organization. Other companies may not create a pricing model for a candidate until the target has expressed interest in being acquired. A key to reviewing any target, however, is determining how the target fits into the acquiring company's strategic philosophies. Considerations that prevent the acquisition of a target may include incompatible product lines; dispersed geographic locations; anti-trust restrictions; and/or diminished shareholder value. Candidate selection should be consistent with the corporation's strategic philosophies and/or objectives.

Government facilitated sales such as FDIC-assisted transactions are a frequent source of candidates. This type of acquisition could provide entry into new markets or improve existing market share. In either case, the company will generally be involved in a bidding/negotiation process predicated upon a review of the target company's condition and earnings potential. In many cases, based upon the FDIC's proposed terms, the acquiring company may have the ability to exclude the riskier aspects of the transaction (i.e., problem loan portfolios). Management needs to be able to react quickly to opportunities that arise and to appropriately assess the inherent risks as with any other transaction.

Other frequent sources of merger and acquisition candidates are investment bankers and consultants. Generally, they are involved at the request of the seller and are acting on behalf of the seller. Acquiring companies generally understand that investment bankers attempt to sell a bank at the highest price and their commissions are often based on the sale price. Management should continue to exercise the same diligence in reviewing candidates referred by investment bankers or consultants as they would when transacting any other acquisitions.

A final issue relating to candidate selection is the willingness of the acquiring company to entertain hostile takeovers. If a company utilizes hostile takeover strategies, management must be aware of the inherent risks and must weigh these risks against the perceived benefits. Management should consider whether the benefits of the hostile acquisition outweigh the risks (e.g., cost, personnel issues, publicity, etc.). In many cases, companies that actively acquire other companies will not entertain hostile takeovers given the perceived risks and publicity. Additionally, targets of hostile takeovers often seek competitive bids and subsequently merge with another company.

4 - PRICING/NEGOTIATION

Senior management of bank holding companies view the pricing and negotiation process as proprietary, and details of these activities should be held in the strictest of confidence.

Pricing and negotiation of mergers and acquisitions transactions is a fluid process. Factors affecting the process include the level of information available to effectively price a transaction; the willingness of the target to provide information; the buyer's/seller's willingness to exchange stock; the required accounting method; the letter of intent or lack thereof; the level of confidentiality; and the terms of the definitive agreement. These components will vary in order, importance, and magnitude with each acquisition.

The acquiring company prepares a preliminary financial analysis to determine an acceptable price range which is dependent upon the proposed structure of the transaction and the level of information available. The initial pricing generally relies heavily on public information. As the pricing and negotiation process continues, additional information may be provided by the target. Pricing is strongly influenced by the sufficiency and quality of information provided. The quality and availability of information are dictated by the selling company, and its willingness to provide additional data will influence the acquiring company's ability to effectively determine a price. In most cases, the better the financial condition of a targeted company, the less willing the company is to negotiate. At times, information will be shared between executives at the highest levels of the organizations, while in other cases, the selling company may allow some limited due diligence.

Pricing models will be affected by how the acquisition is structured, and whether pooling or purchase accounting will be utilized. A pooling involves the issuance of common stock by the acquiring company for common stock of the seller. Assets and liabilities are acquired at historical book value with no intangibles created. Capital accounts are essentially unchanged, and capital ratios are minimally affected. In a purchase transaction, assets and liabilities are purchased at fair market value with the possibility of the creation of intangibles if a premium above book value is paid. Creation of intangibles generally results in a negative effect on regulatory capital ratios. Additionally, the amortization of intangibles is factored into earnings assumptions.

The use of pooling or purchase accounting can be affected by the following:

- the ability to conform the transaction to pooling requirements from an accounting standpoint;

- the seller's desire to have a non-taxable sale (pooling);

- the purchaser's desire to clearly identify the value of assets and liabilities being purchased (purchase); or,

- the size of the transaction and impact on dilution, capital levels, and capital ratios.

Whether an acquisition is a pooling or purchase, companies will determine the target's earnings potential and the effect on shareholder value. This generally involves determining earnings per share dilution and the amount of time required to recapture earnings dilution. The earnings analysis usually includes the amortization of intangibles (in the case of a purchase transaction), projected expense savings, and/or added costs. Another method for pricing an acquisition is the net present value of the target's future income streams projected over a period of time. This method is generally utilized with purchase accounting transactions and involves numerous projections and assumptions relating to earnings, assets, and liabilities over a number of years. Although multiples of book value are commonly utilized by the market to analyze transactions, the purchase price should be further supported by more analytical or sophisticated methods of valuation.

Whether a company utilizes pooling or purchase accounting, the examiner should review the pricing methodologies to determine factors utilized in the pricing model, the principal assumptions relied upon for analysis, and management's pricing philosophies. The examiner should also compare pricing with the company's strategic financial objectives (e.g., avoidance of EPS dilution).

After the price is negotiated, the buyer and seller enter into a definitive agreement which defines both parties' responsibilities from the time the agreement is signed until consummation of the merger. The definitive agreement may include representations and warranties, the method of determining the purchase price, and indemnifications from certain liabilities identified during the due diligence process. Indemnifications are available only where a seller is a surviving entity. The definitive agreement in larger transactions tends to be negotiated prior to the public announcement of the acquisition and prior to full due diligence. It will contain provisions for terminating the transaction based upon significant due diligence findings. In smaller transactions, the definitive agreement may not be negotiated until the full due diligence review has been completed. The level of confidentiality and type of transaction will determine the order of pricing, negotiation of the definitive agreement, and the conduct and scope of due diligence (limited and/or full scope).

Finally, the confidentiality of merger discussions is critical, especially if the acquiring company decides not to pursue the transaction. In those circumstances, the reputation of the target company, no matter what its financial condition, could be adversely affected.

5 - DUE DILIGENCE

Due diligence is the process by which an acquiring company identifies major risks or "deal breakers" in an acquisition transaction. The purpose of the process is to identify, evaluate, and communicate key risks and opportunities relating to a proposed acquisition to senior management and the directorate. The due diligence process also serves to validate the terms of a transaction and to establish a starting point for the transition and integration phases of the acquisition. Some companies tie due diligence directly into the transition and integration process, while other companies only provide due diligence findings to the transition and integration teams.

Due diligence can occur either prior to or after the public announcement of an acquisition depending upon the type and structure of the transaction, and the desires of the purchasing and selling companies. A limited due diligence using publicly available information is usually performed prior to making an initial offer. However, the timing and scope of a more thorough due diligence is generally controlled by the target company which may not allow such an in-depth review prior to an initial offer.

A due diligence review is generally similar to a bank examination. Each review is designed to address the particular circumstances of a transaction, and staffed by experienced personnel with the appropriate expertise. Some companies maintain a dedicated staff of mergers and acquisitions specialists, while others develop a pool of experienced personnel to draw from.

Due diligence procedures can be either formal or informal, and are generally tailored to fit the particular circumstances of the transaction. Procedures may take the form of information request lists and questionnaires, and/or broad guidelines for procedures to be accomplished during the review. Due diligence procedures are generally established and maintained by individuals responsible for reviewing their particular areas of expertise, and are generally performed by individuals with experience relevant to the area being reviewed.

Coordination of the due diligence process is generally the responsibility of a group of personnel from the acquiring company's mergers and acquisitions area. This group determines the scope, staffing, time restrictions, and coordination and reporting procedures for the due diligence review. Communication of findings throughout the process is essential to ensure that all of the due diligence teams are aware of the findings that affect their particular areas of responsibility.

Frequently, the acquiring company determines during the due diligence review that there exists conditions of such a critical nature that the review and the transaction should be terminated. At other times, the findings may not be significant enough to terminate the acquisition but could prompt the need to renegotiate the terms or price of the transaction. Management should have a mechanism for monitoring and evaluating significant due diligence findings.

In certain circumstances, an acquiring company may rely on third parties to perform due diligence reviews. This generally occurs when the company lacks sufficient expertise in a particular geographic market, product, and/or line-of-business. Management should be able to adequately evaluate the findings presented by the third party; incorporate the findings of the third party into the pricing models and/or terms of the agreement; and develop plans for the sound post-merger management of the target.

6 - TRANSITION AND INTEGRATION

Following the public announcement of an acquisition, the focus of the mergers and acquisitions process shifts to the transition and integration phases. These phases are critical to ensure that the acquired company is acclimated to the policies and procedures of the acquiring company, and that the financial reporting and management information systems will function properly. Representatives of the acquiring company and a pending affiliate generally begin planning for transition and integration once the definitive agreement, which defines the terms and conditions of the proposed acquisition, has been signed. The definitive agreement will generally have stipulations relative to actions that can or cannot be taken prior to the legal consummation date of merger. Management should have a process in place to continuously monitor compliance with these stipulations throughout the transition process.

Although rapid integration of a pending affiliate is important, the acquiring company should be aware of the "change in control" issues relative to managing a company prior to the legal consummation date of merger, as promulgated by Regulation Y. An acquiring company's management should not attempt to manage or control the business or operations of a pending acquisition prior to the legal consummation date of merger. However, it is unreasonable to expect the acquiring company to wait until that time to initiate the transition and integration phases relative to policies, procedures and management reporting systems.

Transition and integration are parallel phases that manage the consolidation of an acquired company's cultural environment, operations, and management information systems into those of the acquiring company. These two phases are distinguished by the fact that they may follow extremely different time frames depending upon the acquiring company's strategic objectives. It is most important that a process is in place, either formal or informal, to ensure that all critical areas are addressed during the transition and integration phases. This process may range from one individual being responsible for overall transition and integration, to a dedicated group being responsible for these phases.

The transition phase occurs during the time period between the signing of the definitive agreement and the legal consummation date of the merger. This phase generally involves acclimating the acquired company to the policies and procedures of the acquiring company in all areas, including credit underwriting, customer products, and personnel practices.

The integration phase is the consolidation of software applications, general ledgers, and management information systems. The method of integrating operations ranges widely from full conversion upon acquisition, to the maintenance of separate systems. The integration phase is generally driven by corporate strategic philosophies dictating the manner in which the bank holding company is to be structured and supervised.

Possible corporate structures range from autonomous bank subsidiaries to the consolidation of bank subsidiaries into a limited number of legal entities. The acquiring company may in some instances operate the acquired company as a stand-alone operation, as is frequently the case in an out-of-market acquisition. In other instances, the acquired company may be fully integrated into a second-tier holding company or a subsidiary bank if the acquisition is in-market. The type of corporate structure can be affected by regulatory considerations such as prohibitions against interstate banking. No matter how the company is structured, combining operations is a critical issue to managing and controlling both the acquired company and the consolidated organization.

Due diligence findings are also important elements in the transition and integration process. It is critical that procedures are in place to communicate these findings to the management teams responsible for transition and integration. Findings can be communicated either by direct reporting between the due diligence teams and the transition and integration teams, by having the same staff perform both the due diligence and the transition and integration, or by making due diligence and transition and integration one process.

Finally, another key element to successful transition and integration is the involvement of the staff that will be responsible for implementing the plans and objectives of the acquiring company. Without their input and acceptance, goals may be established that may not or cannot be achieved.

7 - POST-MERGER PERFORMANCE

Monitoring the success or failure of mergers and acquisitions is influenced by numerous variable factors. Some of these factors include the following:

- structure of the transaction (e.g., pooling or purchase);

- type of business or entity being acquired (e.g., bank or nonbank);

- changes in the business subsequent to acquisition (e.g., reorganizing on a line-of-business basis);

- location of acquisition (e.g., in-market or out-of-market);

- management's philosophy regarding integration of policies and procedures, financial information and operations;

- transactions with affiliates; and,

- other economic variables.

Management's ability to monitor and evaluate post-merger performance is particularly limited when an acquiring company consolidates the acquired company into exiting operations. Over time, the acquired company will generally take on the attributes of the acquiring company, reducing management's ability to accurately monitor the overall performance of the acquisition. This limitation is exacerbated if subsequent acquisitions are merged into the operation.

An acquired company's performance can be evaluated by monitoring consolidated earnings per share dilution, or incremental earnings per share dilution, on an ongoing basis. However, monitoring consolidated earnings per share dilution can only be useful as long as there are no subsequent acquisitions which could mask dilution associated with a particular transaction. Monitoring incremental earnings per share dilution is usually possible only where an acquisition occurs out-of-market or is a new nonbanking activity, and where financial performance is tracked separately.

In most instances, monitoring and evaluating an acquired company's performance is limited to reviewing earnings enhancements to noninterest income, and expense reductions, and is accomplished by comparing budgeted information of the separate entities to the actual combined performance of the merged operation. Management should have a process in place for monitoring significant earnings enhancements and expense savings items such as personnel reductions and branch closings or consolidations.

Finally, in acquisitions where purchase accounting is used, certain aspects of the transaction need to be monitored more closely. It is appropriate to review the volume of intangibles created to assure consistency with the terms of the original transaction. Further, the amortization schedule used to charge-off intangibles should be periodically reviewed for consistency with accounting principles and regulatory reporting requirements.

8 - IDENTIFIED RISKS OF MERGERS AND ACQUISITIONS

There are a significant number of risks associated with the mergers and acquisitions process. Management and the directorate of acquiring companies should be aware of the risks inherent in the process, as well as in each merger transaction, and should ensure that sufficient controls exist to mitigate their negative impact.

The key areas of mergers and acquisitions risk include:

- Lack of strategic plan or philosophy.
- Inappropriate pricing methodologies.
- Inability of due diligence to identify financial and operational risks.
- The negative impact of an acquired company on the consolidated organization (e.g., asset quality, management information systems).
- Inadequate management controls or financial reporting.
- Inability to operate in geographically dispersed locations.
- Inability to achieve projected cost savings.
- Assuming control of an company prior to consummation of an acquisition in violation of Regulation Y.
- Impact of acquisition activity on ongoing operations.
- Assumption of legal liabilities from target.
- Loss of customer base from the acquired company caused by a poor transition process.
- Hostile takeovers and the inherent problems associated with such.

The focus of the examiner in charge of reviewing an company's mergers and acquisition process should be on management's method for identifying, controlling, and mitigating the above-noted areas of risk. No two companies will manage the process in the same manner, and the examiner needs to evaluate the acquiring company's overall operation used to make acquisitions.

9 - INSPECTION OBJECTIVES

The examiner's objectives in reviewing the mergers and acquisitions process are:

1. To determine that management is identifying, measuring,and controlling all key areas of risk during the mergers and acquisitions process (e.g., candidate selection, pricing, due diligence, transition, integration, and post-merger analysis).

2. To determine the adequacy of written and informal policies and procedures, and adherence to such policies and procedures by management.

3. To evaluate strategies and objectives relating to mergers and acquisitions activity and to determine whether acquisitions meet those criteria.

4. To determine that the board of directors is adequately informed by management of the condition (financial and nonfinancial) of companies being acquired and the effect thereof upon the consolidated organization.

5. To determine that the board of directors is effectively monitoring mergers and acquisitions activities of the bank holding company.

10 - INSPECTION PROCEDURES

Bank holding company mergers and acquisitions activities will vary by company and by the type, structure, and strategic philosophy of each transaction. The examiner assigned to complete the inspection procedures should be aware that methods and procedures can and will vary and that the primary focus should be to evaluate controls (formal and informal) that are in place to mitigate the risks inherent in the mergers and acquisitions process. The key areas of the process to be reviewed are not necessarily in step-by-step order to be followed in every transaction but, rather, are an overview of the various components that make up an acquisition.

The inspection procedures, generally written for larger bank holding companies that treat acquisitions as a line of business, should be tailored to the company being reviewed. Two primary components to the review will be evaluating specific acquisitions completed by the corporation, and meeting with appropriate senior management personnel to discuss the process.

1. Review the corporation's **strategic plan and/or philosophy** as it relates to mergers and acquisitions; specifically, objectives relating to growth, market share, economies of scale, diversification of earnings, new or expanded product lines, geographic diversification, and shareholder value. Evaluate formal and informal procedures limiting acquisitions relative to the target's financial performance, dilution, transaction dollar size, geographic location, and/or volume of transactions to be integrated into the company. Determine how the process is linked into the planning, budgeting, and funding processes. Review how corporate acquisition philosophies and guidelines are approved and communicated to management. Determine and evaluate the corporate philosophy relating to hostile takeovers.

2. The **candidate selection** process may be formal or informal depending upon the organization. Determine the process and method for candidate selection of mergers and acquisitions targets and the relationship thereof to corporate strategic philosophies. Review the unit responsible for identifying targets, and evaluate the personnel and mechanisms in place to assess candidates. Review how corporate objectives relate to the various types of targeted acquisitions (e.g., mergers, FDIC-assisted transactions, asset or deposit acquisitions,

line of business acquisitions, etc.). Review price modeling to determine the factors considered relative to pooling-of-interests or purchase accounting as well as the financial factors considered (e.g., expense savings, financial impact on the organization, and/or shareholder value). Determine whether management tracks prices paid by other companies for comparative purposes and analysis.

3. The **pricing and negotiation** process is considered proprietary by senior management of bank holding companies and should be treated in strict confidence. Review the pricing method for transactions to determine the factors considered in pricing an acquisition, the focal points of analysis, management's general philosophy relative to pricing an acquisition, and the manner in which the pricing fits with the company's strategic financial objectives (i.e., EPS dilution). Additionally, review the company's philosophy relative to pooling-of-interests or purchase accounting.

   Determine how the pricing method is affected by due diligence findings (e.g., reserve and market value adjustments, anticipated divestitures required, restructuring costs, expense savings, etc.). Finally, review the negotiation process for the definitive agreement, which can be negotiated prior to or after due diligence is complete, depending upon the type of acquisition.

4. Review the adequacy of the **due diligence** process. The examiner's evaluation of the overall due diligence process should focus on coordination of the due diligence review and the individual review teams; qualifications of the participants and their experience levels; scope requirements for, and actual coverage of, areas reviewed; sufficiency of review procedures in each area covered; procedures for reporting results; and, personnel impact on day-to-day operations of both the acquiring and target companies.

   As appropriate, the due diligence process may include the following subjects or functions:

Loans and Reserves	Loan Review	Credit Policy
Investments	Finance	A/L Management
Funds Management	Trust	Internal Audit
External Audit	Operations/Systems	Human Resources

Legal	Marketing	CRA
General Services	Management	Bank Admin.
Investment Advisors	Business Retention	Premises/Fixed Assets

Evaluate how additional costs, expense savings, and significant concerns noted during the due diligence review are reported and factored into the ultimate decision to amend the price, renegotiate the transaction, proceed with the transaction as structured, or terminate the transaction. Review the adequacy of third party due diligence reviews.

5. Review the **transition and integration** process. Determine the overall strategies, goals, and philosophies related to integrating information systems. Identify how and to what extent information systems management is involved in the overall mergers and acquisitions process. Determine how the process is coordinated and documented from due diligence findings to post-merger reviews. Review the focus of due diligence on types of information obtained, types of systems, costs to convert systems, servicer contracts, level of EDP audit involvement, customer products, and impact on merger decisions. Review how information systems are consolidated including procedures, mapping of systems, individuals involved in the process, internal controls, and audit involvement. Review the effect of post-merger results on future information systems conversions.

6. Review the **post-merger** process for evaluating the success or failure of mergers and acquisitions activities, and management's ability to track cost savings or earnings enhancements. The evaluation should include financial performance measurements, expense savings performance, and the method for providing information on lessons learned that may have a bearing on future acquisitions. Review whether specific acquisitions contributed to corporate strategic objectives, and whether management was able to meet cost savings projections, earnings enhancements, and non-dilution objectives. Also, review management's ability to retain the business of acquired companies, its ability to integrate acquired companies, and the ability of the due diligence process to identify risks.

7. Other areas that the examiner should review include:

   a. Internal audit review of the mergers and acquisitions process.

   b. Approval process for mergers and acquisitions (management and directorate).